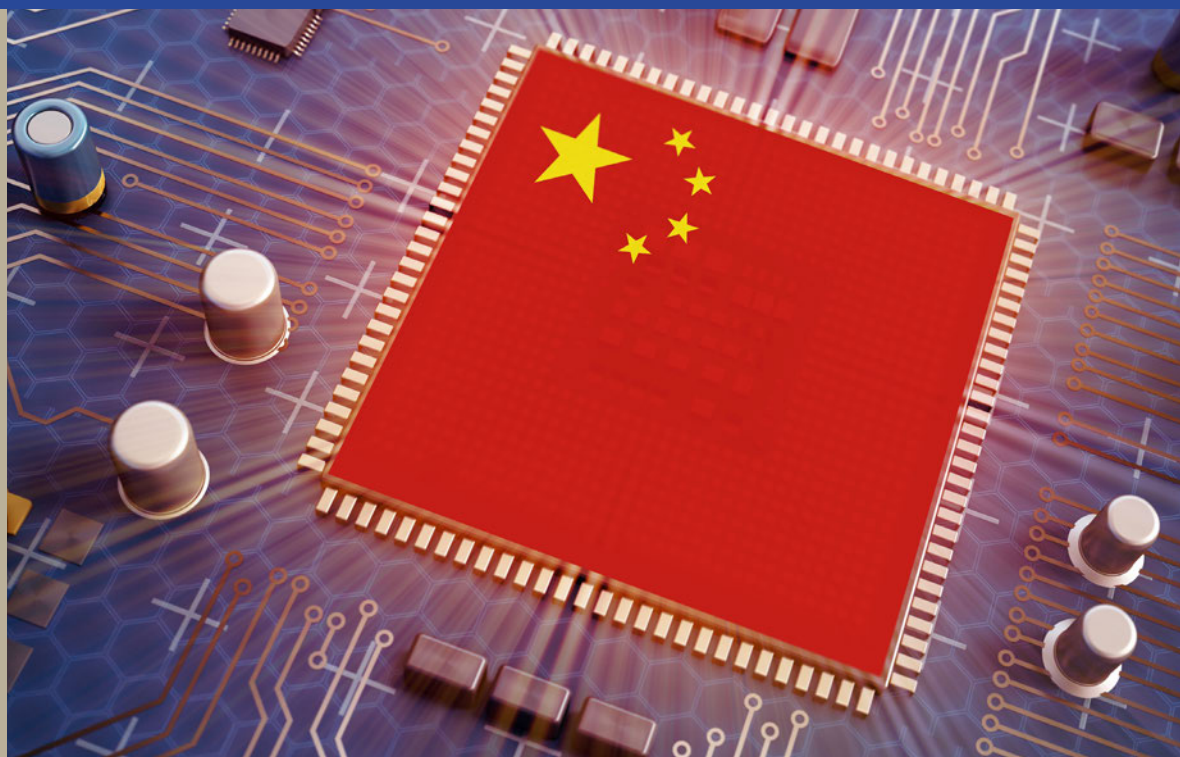
KOMMERSKOLLEGIUM
NATIONAL BOARD OF TRADE SWEDEN

From Economic Growth to Statecraft

What China's trade policy means for Europe



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Preface

Over the past decade, trade policy has become dominated by questions of economic security, technological leadership, and geopolitical competition. Economic instruments that were once primarily viewed as tools for promoting growth and efficiency are now increasingly used to advance strategic objectives and manage vulnerabilities arising from global interdependence. As a result, trade policy can no longer be understood in isolation from broader political and security considerations.

China has been central to this transformation. As the world's second-largest economy and a dominant actor in manufacturing and supply chains, China plays a pivotal role in global trade. At the same time, China's economic model differs in important respects from that of market economies. Trade and investment policy are closely integrated with broader political objectives, industrial policy, and long-term strategic planning. This has contributed to growing concerns regarding industrial subsidies, overcapacity, strategic dependencies, and the use of economic relations as instruments of statecraft.

The purpose of this report is to analyse China's trade and investment policy in the context of its broader political economy. The report examines the structural incentives that shape China's economic model, the challenges facing the Chinese economy, and the policy instruments used to promote technological upgrading, economic security, and geopolitical influence. It further discusses the implications of these developments for the European Union and Sweden.

Understanding the drivers of China's economic behaviour is becoming increasingly important for policymakers. Many of the challenges associated with China's trade and investment practices are not temporary distortions but reflect structural features of the Chinese economic system. Effective policy responses therefore require a long-term perspective that balances openness with resilience, economic cooperation with risk management, and competitiveness with security considerations.

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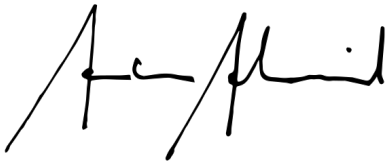

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Executive summary

This report analyses China's trade and investment policy as an integral component of its political economy and broader strategic orientation. It argues that China's economic behaviour cannot be interpreted through a conventional market-based or efficiency-driven framework. Instead, China systematically deploys economic instruments to advance political objectives, technological upgrading, and geopolitical influence.

The central claim is that persistent industrial overcapacity and extensive state intervention are not cyclical distortions or incomplete reforms, but structural features of China's development model. These features arise from deeply embedded incentive structures within the party-state system, where economic policy is designed to sustain growth, ensure employment, preserve political stability, and strengthen China's geopolitical influence. As a result, China's external economic behaviour, particularly in trade and investment, reflects systemic characteristics that are unlikely to converge with market-based models in the foreseeable future.

This dynamic is reinforced under the 15th Five-Year Plan, which prioritises technological self-reliance, industrial upgrading, and supply chain resilience while maintaining reliance on investment-driven growth. Although the plan recognises the need to strengthen domestic demand, it does not fundamentally alter the underlying drivers of overcapacity.

China's political economy is characterised by centralised strategic direction combined with decentralised implementation. While the central government defines priorities, provincial and municipal authorities execute them. This governance structure creates strong incentives for local governments to promote investment, expand industrial capacity, and support local firms, often through subsidies, preferential financing, and regulatory protection.

These incentives contribute directly to persistent overcapacity. Empirical evidence indicates that state support in China is both extensive and multifaceted, including direct subsidies, tax incentives, subsidised credit, and discounted land allocation. Crucially, such support is frequently allocated according to political priorities rather than market signals, resulting in inefficient resource allocation and excess production capacity.

The consequences are visible across both traditional and emerging sectors. In industries such as steel, longstanding investment patterns have produced structural surplus capacity that exceeds domestic demand. Similar dynamics are now evident in newer sectors, including electric vehicles and photovoltaics, where rapid capacity expansion has outpaced market absorption. These sectors are characterised by declining rates of return, rising inventories, and intensifying price competition, indicating systemic overcapacity rather than cyclical fluctuation.

China's growth model has historically relied on external demand to absorb surplus production. As domestic demand remains weak relative to industrial output, excess capacity is redirected to export markets. This has contributed to a significant expansion of China's trade surplus and intensified global competitive pressures.

The international spillovers are substantial. Large-scale exports of subsidised goods exert downward pressure on global prices, affecting competitors in third markets and contributing to industrial adjustment pressures in advanced economies, including the EU. At the same time, China's role in global value chains has evolved. Beyond being a major exporter of finished goods, China holds a dominant position in upstream segments, including the processing of critical raw materials and key intermediate inputs. This dual role creates asymmetric dependencies that can be leveraged for strategic purposes.

Trade and investment policy play a central role in this system. China increasingly uses economic instruments as tools of economic statecraft. Industrial subsidies enable firms to expand globally; investment policies facilitate technology acquisition and outward expansion; standards-setting initiatives shape technological ecosystems; and export controls on critical inputs demonstrate the capacity to leverage supply chain dependencies. Taken together, these instruments form a coherent framework for strengthening China's economic resilience, advancing its technological capabilities, and enhancing its position in the global economy.

At the same time, China's economic model faces mounting domestic constraints, including slowing productivity growth, high debt levels, demographic pressures, and declining returns on investment. Overcapacity exacerbates these challenges by reducing profitability and increasing financial risks. However, adjustment is constrained by the same political and institutional factors that generate these imbalances. Local governments remain dependent on investment-led growth, while employment considerations limit the scope for capacity reduction. As a result, the structural drivers of overcapacity are likely to persist, even as policymakers seek to manage their effects.

Against this background, the report argues that EU and Swedish policy must be grounded in a structurally realistic understanding of China's economic system. The challenges arising from China's trade and investment practices are systemic rather than cyclical and therefore require a coherent and forward-looking policy response. Importantly, the EU already possesses many of the necessary instruments. The key challenge lies in their strategic use, coordination, and effective implementation.

Three overarching policy priorities emerge:

- **Monitoring and anticipating structural distortions**

  The EU should move from reactive, case-by-case responses towards a more anticipatory and systemic approach to China's economic model. This requires stronger analytical capacity to monitor Chinese industrial policy, identify emerging overcapacity risks, and assess their effects not only on EU markets but also on European competitiveness in third countries. Existing trade defence, economic security, and industrial policy tools should be better integrated into a coordinated monitoring framework capable of responding to long-term structural distortions rather than isolated trade disputes.

- **Differentiating between economic, economic security, and national security concerns**

  As the boundaries between trade, technology, and security become increasingly blurred, the EU must apply a more differentiated and proportionate approach to risk management. Trade distortions, strategic dependencies, and national security risks require different policy responses and should not be addressed through interchangeable instruments. Economic security concerns may justify higher costs in strategically sensitive sectors. Broad-based decoupling from China, however, is neither feasible nor desirable. China will remain a central actor in global trade, investment, and technological development, and continued engagement will remain economically beneficial in many sectors where overriding security concerns are absent.

- **Strengthening Europe's long-term competitiveness and resilience**

  The EU's long-term response to China's state-driven economic model depends fundamentally on strengthening its own economic foundations. This includes improving the EU's capacity to scale innovation, deepen capital markets, reduce internal fragmentation, and accelerate the diffusion of technology across the internal market. Industrial policy will play a greater role in this process, but should remain focused on frontier technologies and long-term competitiveness rather than broad-based capacity expansion in mature sectors. At the same time, greater coordination between trade policy, industrial policy, and economic security instruments will be necessary to ensure coherent and strategically aligned responses.

The report also underscores the importance of maintaining selective engagement with China. Cooperation remains necessary in areas of shared interest, including climate change and elements of global economic governance. However, such engagement should be targeted, conditional, and based on a clear assessment of underlying asymmetries.

In sum, China's trade and investment policy reflects a coherent strategy in which economic instruments are embedded within a broader political and geopolitical framework. Persistent overcapacity, extensive state intervention, and the strategic use of interdependencies are defining features of this model.

For the EU and Sweden, this implies a long-term policy challenge. Effective responses will require a careful balance between openness and resilience, competition and cooperation, and short-term adjustment and long-term strategic positioning. Above all, policy must be grounded in a clear understanding of the structural drivers shaping China's economic behaviour and their implications for the global economy.

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1 Introduction

Global trade and investment policy has entered a distinctly geoeconomic phase. Economic instruments are increasingly deployed to advance strategic and security objectives, and interdependence, once seen primarily as a source of efficiency, is now viewed as a potential vulnerability. This shift reflects a broader re-politicisation of economic policy in a more contested and multipolar world order.

China has been central to this transformation. Unlike Western economies, China has not operated within a politics-neutral, market-driven framework. Its economic system is characterised by party-state capitalism, in which markets are embedded within, and subordinated to, political objectives. Trade and investment policy are therefore not autonomous policy domains but integral components of a broader development strategy aimed at technological upgrading, economic resilience, and the strengthening of national power.

This report builds on the premise that China's external economic behaviour cannot be adequately understood through conventional economic theory centred on efficiency, comparative advantage, or market convergence. Instead, it must be analysed through the lens of China's political economy. Persistent industrial overcapacity, extensive state intervention, and the strategic use of economic instruments are structural features of a system in which growth, employment, and regime stability are prioritised over market-based adjustment.

These dynamics have become more pronounced as China has moved up global value chains and strengthened its position in critical sectors, including advanced manufacturing, green technologies, and key upstream inputs. At the same time, China's policy framework, reflected in successive industrial strategies and Five-Year Plans, continues to emphasise technological self-reliance and supply chain control. This combination of domestic objectives and external economic expansion has significant implications for global markets and governance structures.

For the European Union, this creates a complex and enduring policy challenge. China is simultaneously a major trading partner, an increasingly formidable economic competitor, and a systemic rival. Economic relations remain deep: China is one of the EU's largest trading partners, with highly integrated supply chains and significant commercial interdependence. However, this relationship is also increasingly characterised by asymmetries. European firms face persistent barriers in the Chinese market, while Chinese exports, often supported by state intervention, exert growing competitive pressure in Europe and third markets.

At the same time, China's central role in global supply chains, particularly in critical raw materials and intermediate goods, raises concerns about strategic dependencies and economic security. These concerns are reinforced by the increasing use of economic instruments for strategic purposes, including export controls, investment screening, and regulatory measures that can influence market access and supply conditions.

Against this backdrop, the central question for the EU is not whether to engage with China, but how. The challenge lies in balancing continued economic cooperation with the need to address systemic distortions, manage strategic dependencies, and respond to geoeconomic competition.

This report provides an analytical framework for understanding China's trade and investment policy as an expression of its political economy and strategic objectives. It assesses the structural drivers shaping China's economic behaviour and examines their implications for the EU and Sweden. On this basis, it identifies policy priorities aimed at strengthening resilience, preserving openness, and ensuring a more balanced and sustainable economic relationship with China.

2 China's political economy: the Party, incentives and global integration

2.1 Party-state capitalism

China's economic model is best understood as a form of party-state capitalism in which market mechanisms operate but remain subordinate to the strategic imperatives of the Chinese Communist Party (CCP). The institutional fusion of Party and state creates a political economy in which economic, industrial, technological, monetary, and financial policies are coordinated within a centralised political hierarchy. Economic instruments are not deployed primarily to maximise efficiency or growth, but to advance broader objectives related to regime stability, technological upgrading, and geopolitical influence.

Three interrelated features are central to this system: pervasive Party control over economic actors, centralised planning combined with decentralised implementation, and an increasing concentration of decision-making authority under Xi Jinping.

First, the CCP exercises direct and indirect control over the business sector. State-owned enterprises (SOEs) remain dominant in strategic sectors such as energy, telecommunications, transport, and advanced manufacturing, and continue to serve as instruments of industrial policy. Although the number of SOEs has been reduced through successive market reforms, their strategic importance has been preserved. At the same time, private firms operate within a system in which alignment with Party priorities is essential. The Party's influence extends into corporate governance through formal mechanisms such as Party committees embedded in firm structures, where Party secretaries frequently hold senior management positions and retain influence over key strategic decisions (Kroeber, 2020).

In recent years, this control has been further institutionalised through the expansion of so-called 'golden shares', whereby state entities acquire minority equity stakes, often as small as one per cent, combined with special voting rights that enable influence over strategic decision-making. These arrangements allow the Party-state to exert control without full ownership, blurring the boundary between public and private enterprise and reinforcing the political character of economic governance.

Second, long-term planning remains a defining feature of China's economic system. Unlike other economies that transitioned from central planning to market economic systems, China has retained and adapted long-term economic and development planning as a tool of strategic coordination (Hu, 2013). Five-Year Plans have evolved from setting rigid production targets into comprehensive policy frameworks that establish priorities for industrial upgrading, technological development, and resource allocation, thereby aligning policy across ministries, financial institutions, and local governments (Heilmann and Melton, 2013).

Notably, however, implementation takes place within a governance structure that combines central direction with local experimentation. Provincial and municipal authorities are granted flexibility to adapt central objectives to local conditions, enabling policy innovation and the gradual scaling of successful initiatives (Naughton, 2007; Ang, 2016; Daokui Li, 2024). This model, often described as 'directed improvisation', has historically contributed to the dynamism of China's economic development (Heilmann, 2013). At the same time, it creates powerful incentives at the local level to prioritise growth, output, and alignment with central policy priorities.

Local officials are evaluated on their ability to deliver economic performance and demonstrate political loyalty, which encourages overinvestment and the duplication of industrial capacity across regions (section 2.2).

Third, while Party control over the economy has been a constant feature of the system, the degree of centralisation has increased significantly under Xi Jinping. Earlier periods of reform were characterised by greater technocratic autonomy and collective decision-making, particularly under Deng Xiaoping, Jiang Zemin, and Hu Jintao (Shirk, 2018; Li, 2016). Under Xi, decision-making authority has become more centralised and personalised. The establishment of numerous Central Leading Groups and Commissions, covering areas such as economic reform, finance, cyberspace, and foreign affairs, has consolidated strategic control within Party structures, many chaired directly by Xi (Fewsmith, 2021; Tan, 2022).

At the same time, ideological discipline has been strengthened. Local experimentation continues, but within more clearly defined political boundaries, as policy initiatives must now align with 'Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era' (Fewsmith, 2021). This combination of administrative decentralisation and political centralisation allows flexibility in implementation while ensuring adherence to overarching strategic objectives.

Beyond firm-level and institutional control, the Party-state also relies on broader mechanisms of social and economic governance. Systems such as the hukou household registration system continue to regulate labour mobility and access to social services, shaping patterns of urbanisation and labour allocation (S, 2023). Digital surveillance, internet regulation, and administrative oversight further enable the state to monitor and guide economic activity, reinforcing regime stability and aligning market behaviour with Party priorities (Pei, 2024; Junerfält, 2024).

Taken together, these features give rise to a political economy in which resource allocation is determined not primarily by market signals but by a combination of political priorities, administrative coordination, and strategic planning. Economic policy is therefore embedded in the broader objectives of the Party-state. Industrial policy, financial regulation, and trade policy are coordinated instruments within a unified system aimed at sustaining growth, achieving technological upgrading, and strengthening China's position in the global economy.

This systemic integration has two important implications. First, economic outcomes such as persistent industrial overcapacity are not cyclical distortions or transitional phenomena, but structural features of China's growth model. Second, China's trade and economic policies cannot be understood in isolation from its political economy and the CCP's broader strategic objectives. Rather, they form part of a comprehensive approach in which economic instruments are deployed to shape both domestic development and the international economic environment in line with Party priorities.

2.2 Incentive structures

The institutional features of China's party-state capitalist system translate into distinct incentive structures that shape economic behaviour at all levels of governance. While the preceding section established the central role of the CCP in coordinating economic activity, the key analytical question is how this system generates specific economic outcomes. In practice, the interaction between political objectives, administrative decentralisation, and state-directed finance creates strong incentives for investment expansion, industrial upgrading, and policy alignment, often at the expense of market-based efficiency.

A defining feature of China's political economy is the delegation of policy implementation to provincial and municipal authorities within a centrally defined strategic framework. Local governments play a critical role in translating national priorities into concrete investment decisions, while the cadre evaluation system links political advancement to economic performance and alignment with central objectives (Naughton, 2007; Ang, 2016; Daokui Li, 2024). This creates strong incentives for local officials to prioritise rapid growth, industrial expansion, and visible policy outcomes.

The resulting dynamic resembles a form of politically driven competition between provinces, which compete to attract investment and develop industries aligned with national priorities. While this mechanism has contributed to rapid industrialisation and technological upgrading, it also leads to the duplication of capacity across regions. When multiple jurisdictions simultaneously promote the same strategic sectors, aggregate investment exceeds domestic and often even global demand.

This dynamic is reinforced by China's financial system, in which state-owned banks and policy banks allocate credit in line with government priorities rather than purely commercial criteria (Kroeber, 2020). Preferential access to financing and implicit state guarantees weaken market discipline and create soft budget constraints, allowing firms to expand capacity even when returns decline (section 3.1). As a result, investment cycles are prolonged and adjustment mechanisms remain weak.

The combination of central strategic direction and localised implementation further amplifies these incentives. Central strategies such as *Made in China 2025* (MIC 2025) and the *Dual Circulation Strategy* translate broader priorities into concrete investment programmes, supported by subsidies, preferential regulation, and state-backed financing, while decentralised implementation enables rapid scaling through provincial and municipal industrial policy initiatives (Haapaniemi, 2023; Garcia Herrero, 2021).

At the firm level, these incentives shape strategic behaviour. Companies operate in an environment where access to capital, market opportunities, and regulatory support depends on alignment with state priorities. This encourages expansion in politically favoured sectors and sustained investment in technological upgrading, even where short-term profitability is uncertain. In some cases, this leads to rapid innovation and scale advantages; in others, it results in excess supply and declining returns (section 3.2).

The evolution of China's innovation system illustrates this duality. Extensive state support for research and development, combined with coordinated industrial policy, has contributed to significant technological progress. At the same time, large-scale investment programmes have contributed to persistent overcapacity in sectors such as steel, solar photovoltaics, and wind power (OECD, 2026; European Commission, 2023). The integration of civilian and military innovation systems further reinforces the strategic orientation of technological development (Junerfält, 2024).

The prioritisation of growth, employment, and technological self-reliance, combined with political incentives for alignment with central leadership, creates a systematic bias towards expansion rather than consolidation. Market exit mechanisms remain weak, particularly for firms with strategic or political relevance. As domestic demand remains insufficient to absorb rising output, these dynamics spill over into global markets (section 3.2.4). Firms respond by expanding exports and competing aggressively on price, thereby externalising domestic imbalances. Patterns of overcapacity, price suppression, and trade frictions are therefore best understood as endogenous outcomes of China's political economy rather than trade distortions.

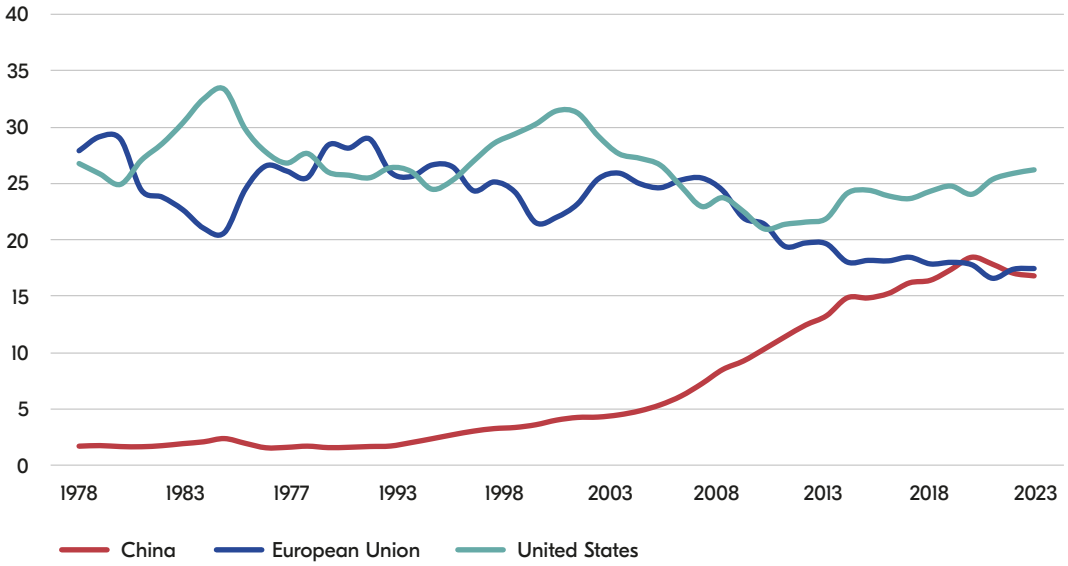
2.3 Global integration

China's integration into the global economy has been a central driver of its economic transformation. However, consistent with the party-state capitalist system outlined above, this integration has not followed a linear path of market liberalisation. Rather, it has been selectively managed and strategically directed to support domestic industrial upgrading, technological development, and the expansion of China's position within global economic structures.

2.3.1 Managed integration into global value chains

China's initial integration into the global economy was anchored in an export-oriented development model that leveraged cost advantages in labour-intensive manufacturing. Beginning with the 'reform and opening' period in the late 1970s under Deng Xiaoping, the establishment of SEZs and the gradual reduction of trade barriers enabled China to embed itself in emerging global production networks. By the early 2000s, China had assumed a central role as an assembly hub within global value chains, importing intermediate goods, assembling them at scale, and exporting finished products to advanced economies.

Figure 1. Per cent of global GDP, USD

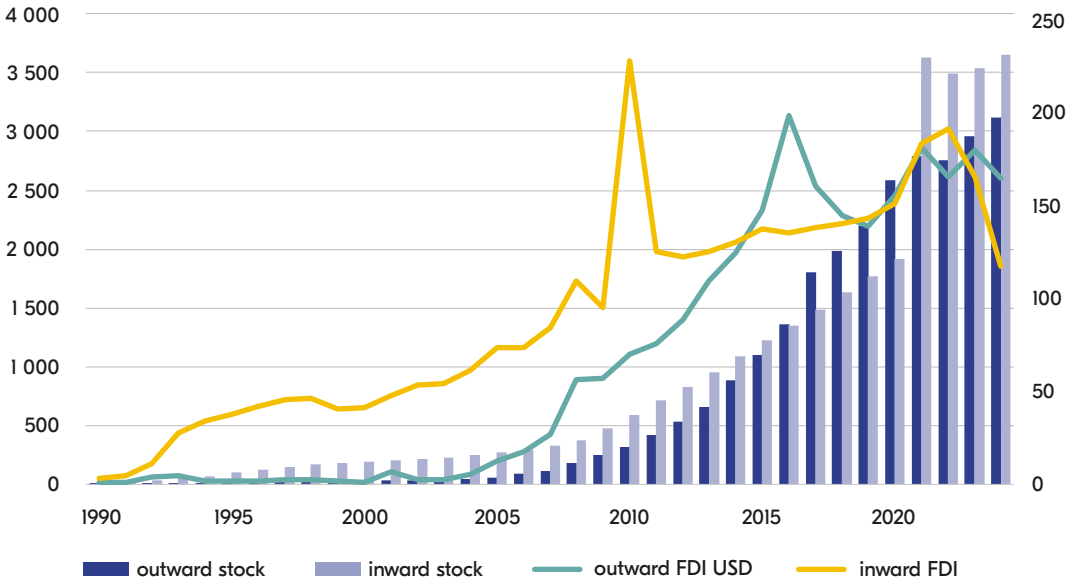


Data World Bank, World Development Indicators.

Trade liberalisation and accession to the WTO in 2001 accelerated this process. Tariff reductions, from above 35 per cent in 1990 to below 10 per cent at accession and near global averages thereafter, facilitated deeper integration into global markets. This integration was accompanied by a rapid expansion in trade volumes and a significant increase in China's share of global GDP (Fig. 1). At its peak, trade accounted for more than 60 per cent of China's GDP, underscoring the centrality of export-oriented manufacturing to its growth model.

FDI played a pivotal role in this phase. Inflows increased from negligible levels in the early 1990s to nearly USD 190 billion by 2022 (Fig. 2), providing not only capital but, above all, access to technology, managerial expertise, and international markets. Foreign-invested enterprises dominated China's export sector in the early stages of integration.

Figure 2. FDI stocks (left axis) and FDI flows (right axis), bn USD current



Data from UNCTAD (2025).

This process was not market-driven. Instead, Beijing, under CCP guidance and directives, actively shaped the conditions of integration, using policy tools to channel foreign investment into targeted sectors, extract technology, and build domestic capabilities. Integration into global value chains was embedded from the outset within a broader strategy of industrial upgrading.

2.3.2 Upgrading and repositioning in global production networks

Over time, China has moved beyond its initial role as a low-cost assembly platform. OECD Trade in Value Added (TiVA) data show a decline in the foreign value-added content of exports from 22 per cent in 2008 to 15.8 per cent in 2020, reflecting the expansion of domestic supplier networks and the internalisation of production stages (OECD, 2023). The share of imported intermediate inputs used in export production has similarly declined, indicating a shift towards greater domestic control over value creation.

This transformation has been accompanied by a structural upgrading of China's industrial base. Manufacturing remains central to industrial value added, accounting for approximately 83 per cent of GDP, with production increasingly shifting towards higher value-added segments.[1]

A distinctive feature of China's development trajectory is that, rather than transitioning into a narrower set of more sophisticated manufacturing industries, China remains competitive across entire value chains. Chinese firms occupy central positions across a wide range of industries, from basic assembly to technologically advanced manufacturing. As a result, China competes simultaneously with advanced economies in capital-intensive high-technology sectors and with developing economies in labour-intensive production.

At the firm level, domestic companies have increasingly replaced foreign-invested enterprises as the primary drivers of export growth. This shift reflects both technological upgrading and the emergence of large national champions supported by

1. UNdata (2024). Gross Value Added by Kind of Economic Activity at Current Price.

industrial policy and state-directed finance. While foreign firms remain embedded in China's industrial ecosystem, the distribution of value creation has shifted decisively towards domestic actors.

2.3.3 Foreign investment as a strategic instrument

China's position in global capital flows has evolved alongside its industrial transformation. While initially a major recipient of foreign investment, China has become one of the world's largest sources of outward FDI. Outward investment flows increased significantly from the mid-2000s, peaking at nearly USD 200 billion in 2016 and remaining elevated thereafter (Fig. 2). In 2025, Chinese FDI into the EU reached a 7-year high (Kratz et al., 2026)

This shift reflects a strategic reorientation of investment policy. Under initiatives such as the *Going Out* strategy and the Belt and Road Initiative (BRI), Chinese firms have been encouraged to invest abroad to secure natural resources, access foreign markets, and acquire advanced technologies. These investments are not purely commercial but are subject to administrative approval processes that assess alignment with national priorities, involving central government institutions, including Ministry of Commerce of the People's Republic of China (MOFCOM), National Development and Reform Commission (NDRC), and State Administration of Foreign Exchange (SAFE).[2]

As a result, China's outward investment regime functions as an instrument of industrial and technological policy. Investments in strategic sectors are actively supported, while those deemed inconsistent with national objectives can be restricted. This selective approach enables Beijing to direct international capital flows in support of broader economic and geopolitical objectives.

At the same time, recent trends indicate a shift in inward investment dynamics. While foreign firms remain deeply integrated into the Chinese economy, declining inflows and stable investment stocks suggest increasing caution among multinational enterprises. Rather than expanding operations, many firms appear to adopt a more defensive posture, reflecting regulatory uncertainty, geopolitical tensions, and concerns about market access. This shift does not signal disengagement but points to a gradual reconfiguration of China's role in global investment networks.

2.3.4 Structural dominance in supply chains

China's integration into global markets is not limited to manufacturing but extends to upstream segments of key industrial supply chains. The country has established a dominant position in the processing and refining of critical raw materials, including rare earth elements such as graphite, gallium, and germanium. According to the US Geological Survey (2024), China accounts for a majority of global processing capacity in several of these materials, often exceeding 80–90 per cent. The European Union is 100 per cent import dependent in rare earths. According to reports from the European Commission, nearly 100 per cent of all heavy rare earth imports and 85 per cent of light rare earths imports originate from China (European Commission, 2023).

This dominance is the result of long-term central planning and targeted industrial policies. Critical raw materials, for instance, were identified as crucial for development as early as the 1960s. Since the early 2000s, they have been classified as strategic assets, subject to export controls, licensing regimes, and state coordination (Duan, 2022; Gunter & Arcesati, 2025). The consolidation of the sector, including the creation of

2. National Board of Trade (2024). Analys om granskning av utgående investeringar. Dnr 2023/01883.

China Rare Earth Group, has further strengthened the state's ability to manage supply and influence global markets (Vekasi, 2021).

China's control extends far beyond the extraction of these precious metals and across the entire value chain. China is not only the World's largest processor of critical raw materials but also the largest importer. Many raw materials, including those for which China does not dominate extraction, are exported to China for refinement. China's dominant position in critical raw materials processing increases Beijing's leverage over downstream industries and allows for the selective use of export restrictions and pricing mechanisms as tools of industrial and geopolitical strategy. Its dominance in this sector therefore reinforces China's role as a central node in global supply chains, far beyond critical raw materials themselves.

2.3.5 Monetary and macroeconomic policies

China's integration into global markets has also been shaped by its macroeconomic framework, particularly its exchange rate regime and capital controls. Unlike fully market-determined currencies, the renminbi operates within a managed system in which the central bank intervenes to limit volatility and maintain external competitiveness.

This framework has historically supported export-oriented growth by preventing excessive currency appreciation during periods of large trade surpluses. In particular, in the period following mid-2022, the renminbi depreciated substantially against the EUR, increasing price-competitiveness of Chinese exports into Europe (Fig. 3). While allegations of currency manipulation remain contested (Hassan, Mertens, and Zhang, 2016; Klein, 2015), the combination of exchange rate management, capital controls, and large foreign exchange reserves provides the authorities with significant capacity to influence trade dynamics. International Monetary Fund (IMF) estimates suggesting an undervaluation of the renminbi (IMF, 2026) highlight the potential macroeconomic dimension of China's competitiveness in global trade.

Figure 3. Exchange rate EUR/CNY

Data from the IMF (2025).

More broadly, monetary and financial policy are embedded within the Party-state system and aligned with strategic objectives, including employment stability, industrial competitiveness, and economic resilience. As such, macroeconomic policy functions as a complementary instrument to industrial and trade policy in sustaining China's position in global markets.

2.4 Technological self-reliance

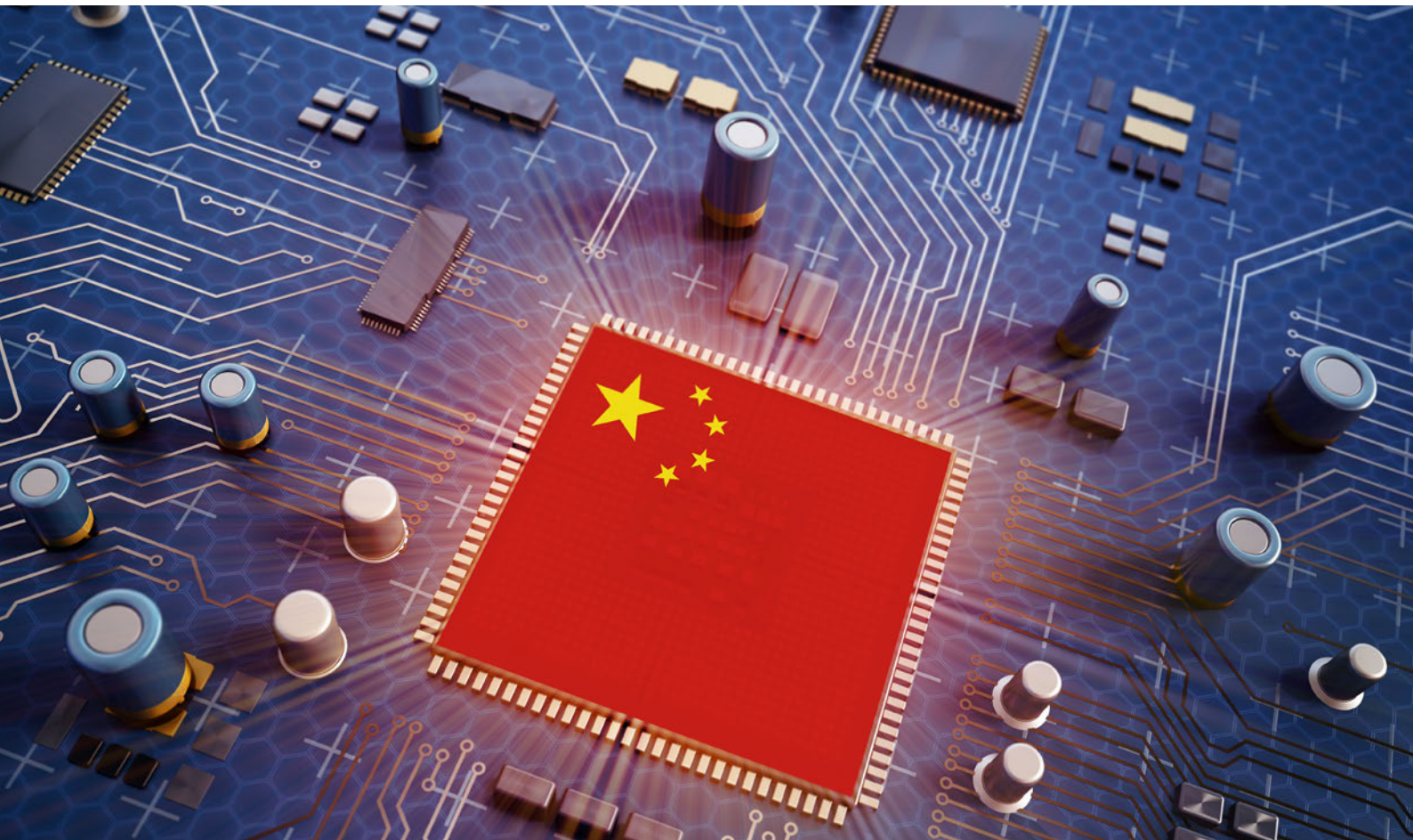
Technological self-reliance has become a central pillar of China's economic and geo-political strategy. Within the party-state system, technological capability is viewed as a core determinant of national power, economic security, and international influence. China's push for indigenous innovation and technological self-reliance must therefore be understood as a strategic response to both domestic development objectives and external vulnerabilities.

2.4.1 From technology absorption to indigenous innovation

China's technological development strategy has evolved from a model based on technology absorption to one centred on indigenous innovation. During the early phases of reform, industrial upgrading relied heavily on FDI, primarily through joint ventures, and the import of foreign technology. Over time, however, Chinese policy-makers increasingly viewed dependence on foreign Intellectual Property and critical technologies as a structural vulnerability.

This shift became explicit with the Medium- to Long-Term Plan for Science and Technology (2006–2020), which elevated 'indigenous innovation' as a core policy objective (CBR, 2010; Zenglein and Holzmann, 2019). Policy instruments included joint-venture requirements, technology transfer arrangements, preferential procurement rules, and local content requirements aimed at fostering domestic technological capabilities.

The global financial crisis of 2008 further reinforced this trajectory. Large-scale stimulus measures channelled through state banks and local governments (section 3.1.2) accelerated investment in infrastructure and heavy industry, the backbone of domestic economic growth, as well as emerging technologies, while embedding technological upgrading within a broader industrial policy framework (OECD, 2019; European Commission, 2023). Import substitution policies became more prevalent, as access to



the domestic market was increasingly linked to domestic innovation capacity (European Union Chamber of Commerce in China, 2021). The Dual Circulation Strategy further reinforces this approach by aiming to integrate domestic industries into global markets at higher value-added stages. Its overarching goal is to mobilise domestic resources to advance technological self-reliance, enhance the value-added content of domestic production, and foster indigenous innovation (Haapaniemi, 2023; Garcia Herrero, 2021). In practice, this has led to foreign companies being forced out of the domestic market once domestic competitors' technology reaches a comparable standard.

With the 15th five-year plan,[3] the CCP has elevated technological self-reliance to a core development objective. Accordingly, Beijing plans to implement 'extraordinary measures' to reduce remaining dependencies on foreign technology and shield against geopolitical risk (section 4.4). Notably, the latest five-year plan further prioritises the dissemination and commercialisation of technology across all spheres of society. This will create demand for domestic technology and stimulate innovation.

2.4.2 Institutional architecture of the innovation system

China's technological capabilities are underpinned by a dense institutional framework that integrates state planning, industrial policy, and research and development. Long-standing programmes such as the 863 Program and the Torch Program have supported strategic technologies and facilitated the commercialisation of research (Gu and Lundvall, 2006). These initiatives have created the foundation for a state-coordinated innovation system linking research institutions, industrial firms, and government agencies.

This system operates within the broader party-state capitalist framework, where coordination replaces market-driven allocation as the primary mechanism for resource mobilisation. Financial resources are channelled through state-owned banks, policy funds, and government-backed investment vehicles, enabling large-scale and long-term investments in priority sectors. The National Semiconductor Industry Investment Fund ('Big Fund'), for example, has mobilised over USD 200 billion to support domestic chip production (Semiconductor Industry Association, 2020).

At the same time, provincial governments play a key role in implementing national innovation strategies. Technology clusters, such as those in artificial intelligence, big data, and advanced manufacturing, illustrate how decentralised implementation interacts with central priorities (section 1.2). This reinforces the incentive structures described above, enabling rapid scaling of technological capabilities. At the same time, it contributes to the duplication of investments across regions and creates inefficiencies in strategic industries.

A distinctive feature of China's technological strategy is the integration of civilian and military innovation systems. Under the doctrine of military-civil fusion, technological development is expected to contribute simultaneously to economic growth and national security objectives. This approach enables the transfer of knowledge and capabilities across sectors, particularly in areas such as artificial intelligence, quantum computing, advanced materials, and aerospace (Junerfält, 2024).

This dual-use orientation reinforces the Party's strategic objective of technological self-reliance. Innovation is not confined to commercial objectives but embedded within a broader framework of national power, linking industrial policy, defence capabilities, and

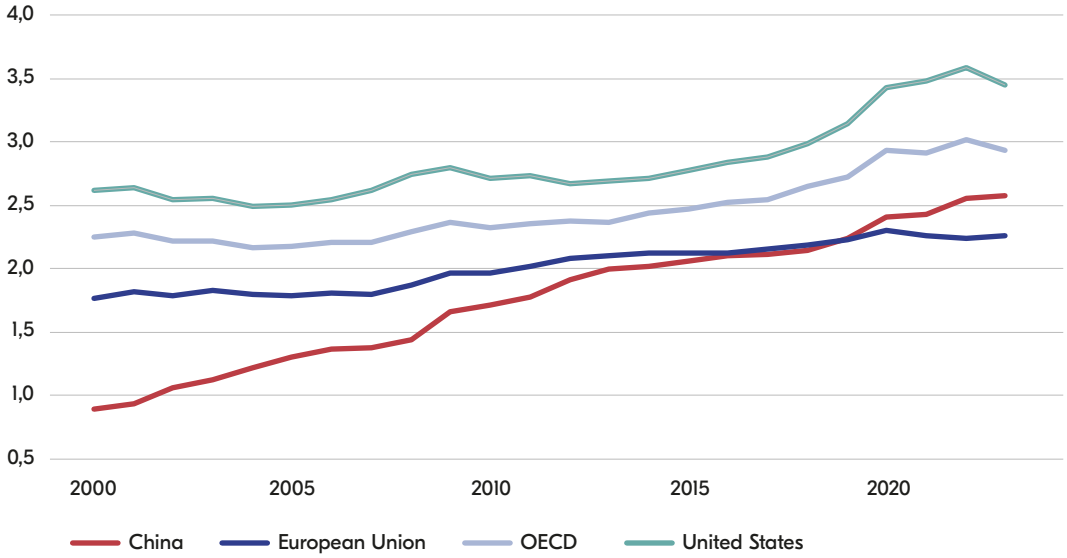
3. https://www.news.cn/politics/20260313/085af5de5a4b4268aa7d87d90817df2f/c.html.

geopolitical ambitions. Technological leadership is viewed as a prerequisite for achieving strategic autonomy and shaping the international order. In practice, this renders cooperation with Chinese actors, including research institutions, highly problematic, as virtually all relevant commercial and research actors are linked to the Chinese military and intelligence apparatus in an integrated technology ecosystem.

2.4.3 Innovation capacity and technological outcomes

The expansion of China's innovation system has led to a significant increase in measurable technological output. Most patent filings today originate from China, accounting for nearly half of global filings in 2024 (Fig. 5), with the majority originating from domestic firms. R&D expenditure has risen to approximately 2.5 per cent of GDP, approaching levels observed in advanced economies (Fig. 4).

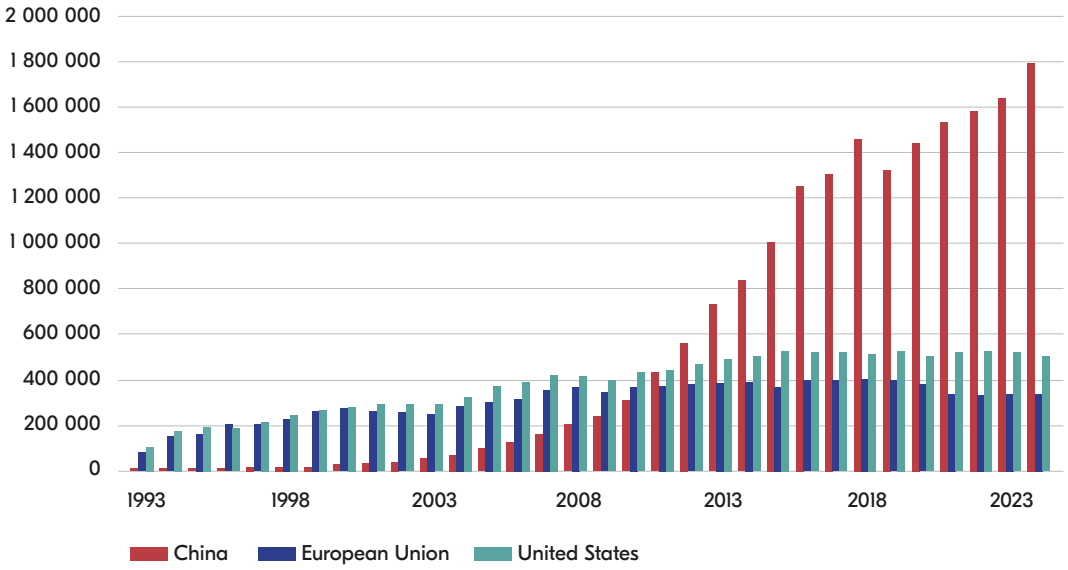
Figure 4. R&D expenditure (per cent of GDP)



Data from World Bank, World Development Indicators (2026).

China has also achieved notable progress in several strategic technologies. In fields such as renewable energy, batteries, telecommunications, and certain segments of artificial intelligence, Chinese firms have established global leadership positions. The country has moved from a marginal role in frontier technologies in the early 2000s to a leading position in the majority of critical technology domains by the early 2020s (Wong Leung et al., 2024). Beijing's focus on technology dissemination, particularly with respect to Artificial Intelligence, will undoubtedly accelerate this development.

Figure 5. Total patent applications (direct and PCT national phase entries)



Data from WIPO (2026).

However, this expansion in innovation capacity has not been matched by corresponding productivity gains. Total factor productivity growth has declined in recent years, reflecting inefficiencies associated with large-scale state-directed investment (Parikh, 2025). Concerns have also been raised about the quality of patents, many of which lack commercial applicability (He, 2021; Boeing and Mueller, 2019). This is a direct consequence of the quantitative patent filing objectives set out in consecutive five-year plans. These patterns illustrate the trade-offs inherent in China's model: rapid scaling of technological capacity alongside persistent inefficiencies in resource allocation.

2.5 Structural dominance in global supply chains: scale, control, and leverage

China's position in global supply chains has evolved from that of a manufacturing hub to that of a structurally dominant actor across multiple stages of production. This dominance is not confined to final goods but extends upstream to critical inputs and downstream to complex manufacturing systems. As a result, China occupies a central position across a wide range of industrial ecosystems, enabling it to shape global production patterns, pricing dynamics, and market access.

2.5.1 From integration to dominance

China's early integration into global value chains was characterised by its role as a final assembly platform reliant on imported intermediate inputs. Over time, however, this position has shifted towards greater control over upstream and midstream production stages. The declining share of foreign value-added in exports, from 22 per cent in 2008 to 15.8 per cent in 2020, reflects the internalisation of supply chains and the expansion of domestic supplier networks (OECD, 2023).

This transformation has resulted in a form of systemic centrality. Rather than specialising narrowly according to comparative advantage, China now operates across multiple segments of value chains simultaneously, from raw material processing and component manufacturing to final assembly and export. This breadth distinguishes China from other major economies and allows it to compete across both high- and low-value segments of production.

At the firm level, the increasing dominance of domestic companies in export production further reinforces this position. Chinese firms have replaced foreign-invested enterprises in many sectors, capturing a larger share of value creation while maintaining integration into global production networks.

2.5.2 Dominance in manufacturing ecosystems

China's structural position is particularly evident in manufacturing. The country accounts for a disproportionately large share of global production in key industrial sectors, including electronics, machinery, renewable energy technologies, and electric vehicles. In several of these sectors, Chinese firms control not only final assembly but also critical components and intermediate inputs.

In electronics and ICT equipment, China has moved beyond assembly into increasingly complex manufacturing, although reliance on imported high-end semiconductors persists (OECD, 2023). In renewable energy technologies, such as solar photovoltaics and batteries, Chinese firms dominate global production capacity and have achieved significant cost advantages, enabling them to shape global pricing dynamics.

Importantly, this dominance is not limited to individual sectors but reflects the emergence of integrated manufacturing ecosystems. Dense supplier networks, economies of scale, and coordinated industrial policies allow Chinese firms to produce at lower cost and greater speed than competitors. These ecosystem advantages are difficult to replicate and reinforce China's central role in global production systems.

2.5.3 Dominance in critical raw material supply chains

China's most strategically significant position lies in upstream segments of supply chains, particularly in the processing and refining of critical raw materials. According to the US Geological Survey (2024), China accounts for approximately 69 per cent of global rare earth mining and between 85–90 per cent of refining capacity. It dominates 96 per cent of global processing of battery-grade graphite, 91 per cent of rare earths used in permanent magnets, and produces 94 per cent of gallium and 60 per cent of germanium.

This dominance is the result of long-term state planning and targeted industrial policy. Since the early 2000s, critical raw materials have been classified as strategic assets, subject to export controls, licensing systems, and state coordination (Duan, 2022; Gunter & Arcesati, 2025). The consolidation of the sector into large state-controlled entities, such as China Rare Earth Group, has further strengthened Beijing's capacity to manage supply and influence global markets (Vekasi, 2021).

A key feature of this dominance is its concentration in processing rather than extraction. Many countries extract raw materials, but China refines and processes them into usable industrial inputs. This creates a structural dependency, as downstream industries globally rely on Chinese processing capacity even when raw materials originate elsewhere. In some segments, such as heavy rare earth processing, China effectively controls the entire global value chain.

2.5.4 Policy-enabled supply chain control

China's position in global supply chains is reinforced by policy instruments that allow the state to manage access to critical inputs. Export licensing systems administered by MOFCOM enable authorities to control volumes, prices, and the allocation of export permits. These mechanisms allow for differentiated access, prioritising domestic firms, state-owned enterprises, and politically aligned actors (Yue-Zhen, 2025).

Export controls on materials such as rare earths, graphite, gallium, and germanium illustrate how these instruments can be used strategically (Appendix I). While often justified on environmental or national security grounds, such measures also provide leverage over downstream industries and foreign economies dependent on these inputs.

This capacity for selective restriction transforms supply chain dominance into a form of geopolitical leverage. By controlling key nodes within global production networks, China can influence not only prices but also the availability of critical inputs, thereby shaping industrial outcomes beyond its borders.

2.5 Interdependence and asymmetric dependencies

China's structural dominance does not imply autarky. The country remains integrated into global supply chains and continues to depend on foreign inputs in certain high-technology areas, particularly advanced semiconductors and specialised services. However, this interdependence is asymmetric.

While China relies on external suppliers in specific high-end segments, many economies, particularly in Europe, are dependent on China across a broader range of inputs and production stages. For example, the European Union sources approximately 89 per cent of its rare earth imports from China (European Commission, 2023), with dependencies often increasing further along the value chain (JRC, 2025).

This asymmetry creates structural vulnerabilities. Disruptions in Chinese supply, whether due to policy decisions, domestic constraints, or geopolitical tensions, can have disproportionate effects on downstream industries in other economies. Conversely, China's exposure to external dependencies is more concentrated and therefore more manageable from a policy perspective.

2.6 Interim conclusion: global dominance as strategic objective

Taken together, China's economic model is best understood as a system in which industrial development, technological upgrading, and global integration are coordinated to achieve strategic control over key segments of the global economy. Supply chain dominance is not an unintended outcome of scale or efficiency alone, but the result of deliberate policy choices embedded in the party-state system. By aligning industrial policy, state-directed finance, and technological development, Beijing has secured central positions in critical production networks, particularly in upstream processing and strategically important manufacturing ecosystems.

This position enables China not only to compete globally, but to shape the conditions of competition. Control over key inputs and production stages allows Chinese firms to influence prices, determine market access, and transmit domestic imbalances, most notably overcapacity, into global markets. At the same time, it provides the Chinese leadership with a form of structural leverage, as dependencies in foreign economies can be translated into economic and, where necessary, political influence.

Crucially, this model does not imply disengagement from global markets. Rather, China pursues a strategy of selective integration in which openness is maintained where it supports domestic upgrading, but reduced where it creates strategic vulnerability. Technological self-reliance and supply chain control are therefore mutually reinforcing objectives within a broader framework aimed at strengthening strategic autonomy.

For European policymakers, this implies that China's role in global supply chains cannot be assessed solely through the lens of efficiency or comparative advantage. The consolidation of Chinese dominance in critical sectors reflects systemic features of its political economy and is likely to persist. While defensive instruments can mitigate some immediate effects, they do not address the underlying drivers. A credible response therefore requires a combination of internal capacity building, supply chain diversification, and closer coordination with international partners to reduce structural dependencies while preserving the benefits of economic engagement. At the same time, this dominance contributes to structural imbalances in the global economy. Persistent overcapacity in key sectors, driven by the incentive structures outlined above, interacts with supply chain centrality to amplify global price pressures and trade tensions. As Chinese firms expand exports to absorb excess production, their position within supply chains allows them to transmit domestic imbalances internationally.

Taken together, China's role in global supply chains represents a qualitative shift in the structure of the global economy. Rather than functioning as one participant among many, China has become a system-defining actor whose policies and production decisions have far-reaching implications for global markets.

3 China's economic challenges

The structural challenges facing China's economy are best understood as endogenous outcomes of the political-economic system outlined in the previous chapter. The combination of centralised strategic direction, decentralised implementation, and state-directed finance creates a persistent bias towards investment-led growth and industrial expansion. Economic outcomes are thus shaped less by market mechanisms than by political incentives prioritising GDP growth, employment, and technological upgrading.

Rising debt, declining productivity, weak household consumption, and adverse demographic trends are not exogenous shocks but cumulative effects of a model in which capital is systematically directed towards politically prioritised sectors, often irrespective of demand or returns. These dynamics generate structural inefficiencies, most notably persistent industrial overcapacity (Box 1).

There is no generally accepted definition of overcapacity in Economics. Intuitively, it describes a situation when the market doesn't clear and when, as a consequence, a need to store or destroy excess supply arises. Historically, butter or sugar 'mountains' or wine 'lakes' in the EU would be an example. In this context, however, we choose to rely on a definition used by Rhodium Group. According to their definition, overcapacity arises when production capacity exceeds the level that can be absorbed under normal market conditions and, thus, remains underutilised (Boullenois et al., 2024). While overcapacity is a common phenomenon in market economies and often reflects cyclical fluctuations, China's overcapacity is structural in nature. That is to say that domestic challenges and political incentives favour investments in sectors that are already suffering from underutilised capacity. Slowing growth, fiscal pressures, and the weakening of traditional growth engines, particularly the property sector, intensify reliance on state-directed investment to sustain activity, further expanding capacity in already saturated sectors. As a result, underutilised capacity is maintained and often expanded rather than reduced through market adjustment.

This dynamic extends beyond China's domestic economy. As internal demand remains insufficient to absorb rising output, excess production is channelled into export markets, contributing to global price suppression and trade tensions. At the same time, declining returns on investment, rising financial risks, and a more restrictive external environment limit the sustainability of continued capacity expansion. The forces driving overcapacity therefore also undermine the long-term viability of China's growth model, creating a structural tension at its core.

Box 1. Examples of overcapacity

Steel

China built up a massive steelmaking capacity throughout the 2000s and 2010s, far beyond what its domestic construction and manufacturing sectors required. Despite periodic efforts to cut back, China still produces around 55 per cent of global steel output. The 2016–2017 campaign to close inefficient mills and promote consolidation briefly improved utilisation rates, but many local governments resisted permanent shutdowns due to employment concerns. As a result, substantial excess capacity persisted.

To keep mills operating, surplus steel was diverted into export markets – Chinese steel exports peaked around 2015 and remain significant today. Domestic political incentives also play a role: provincial governments frequently award infrastructure procurement contracts to local state-owned steelmakers, and in some cases even exclude out-of-province firms from tenders (Gunter et al., 2025). These practices protect local industry but undermine national consolidation efforts and reinforce structural overcapacity.

Electric Vehicle (EV)

China now accounts for roughly 35 per cent of global EV manufacturing, with production capacity estimated at around three times domestic demand (Tang, 2025). This rapid expansion has intensified global price competition and driven profit margins sharply down. Among China's 33 largest EV brands, the median net profit margin fell from 2.7 per cent in 2019 to 0.83 per cent in 2024. Performance varies widely: BYD reportedly increased its margin to 5.7 per cent, while firms like Nio and Xpeng still report double-digit losses – though their profitability has improved over the past five years. Industrial diversity matters: diversified firms such as BYD and Xiaomi offset EV losses with revenue from electronics and household appliances (Reuters 2025c).

Financial strain has cascaded through EV supply chains. Large manufacturers are increasingly delaying payments to suppliers: BYD and Geely reportedly take 127 and 193 days, respectively, to settle invoices, while Nio and Xpeng exceed 200 days. Inventory levels have doubled since 2019, and debt-to-inventory ratios have surged by 21 per cent in the same period (Reuters 2025c). These symptoms – thin margins, rising inventories, and supplier distress – are typical indicators of systemic overcapacity.

Solar

China also dominates the global solar industry, producing about 80 per cent of all photovoltaic products, including polysilicon, wafers, cells, and modules. Yet capacity growth has far outstripped demand. Capacity utilisation fell below 60 per cent in 2024 and dropped below 40 per cent in 2025, even as China added 212 GW of new solar capacity in the first half of 2025 – more than double the addition in the same period of 2024 (Pettis 2025b). Analysts estimate that China's existing production capacity could meet global annual demand through 2032 without further expansion (Reuters 2025).

The financial consequences have been severe. Losses across the photovoltaic value chain exceeded USD 40 billion in 2024 (Howe & Xu 2025). Among the 64 largest solar manufacturers, year-on-year net profits fell 22.4 per cent, and several major firms shifted from over USD 100 billion in profits in 2023 to net losses in 2024 (Xiao 2025). These trends exemplify the depth of overcapacity in China's clean-energy manufacturing sectors.

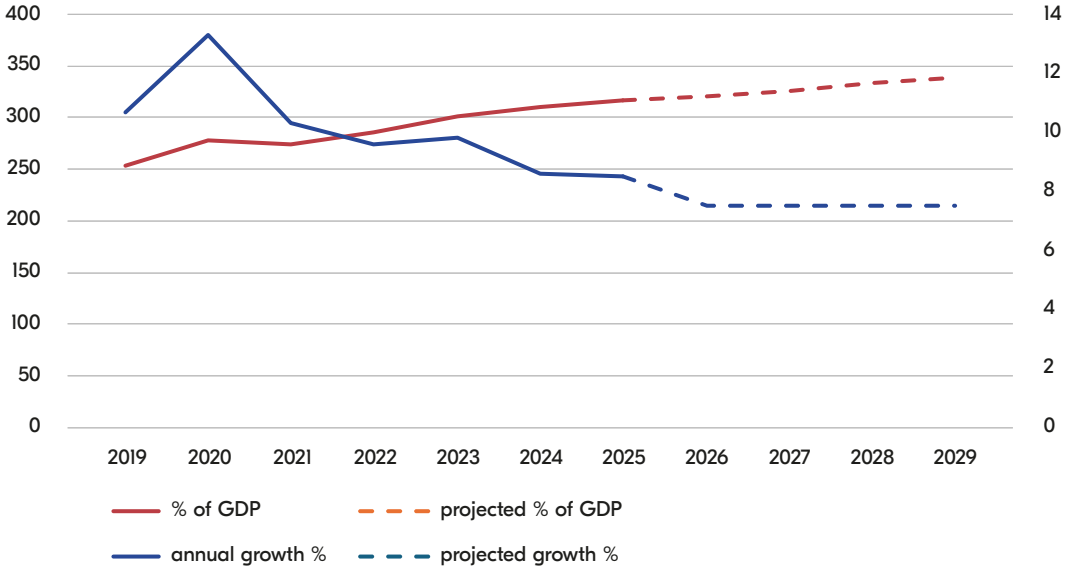
3.1 The investment trap: debt-driven growth and declining efficiency

China's growth model is increasingly characterised by structural dependence on investment-driven expansion sustained through debt accumulation. This 'investment trap' reflects the interaction between political incentives, fiscal structures, and state-directed finance, which together reinforce a cycle of capital mobilisation despite declining returns. Rather than functioning as a temporary stimulus mechanism, debt-financed investment has become a systemic feature of China's economic model, closely linked to persistent overcapacity.

3.1.1 Debt as a mechanism of growth

Debt has become a central feature of China's economic system. While headline government debt appears moderate, at around 69 per cent of GDP, this understates the scale of leverage within the broader financial system. Total Social Financing (TSF), which captures credit to the real economy, reached approximately 309 per cent of GDP by mid-2025, placing China among the most highly leveraged major economies (IMF, 2024).

Figure 6. Total Social Financing, per cent of GDP (left) and per cent of annual growth (right)



Data from IMF staff report implementation of article IV Consultation (2026).

More important than the scale of debt is its composition. Credit expansion has been disproportionately directed towards politically prioritised sectors rather than productive private investment (Pettis, 2025). State-owned enterprises and local governments are incentivised to sustain investment in line with industrial policy objectives, often irrespective of financial returns. As a result, capital continues to flow into sectors already characterised by excess capacity, including infrastructure, heavy industry, and emerging technologies, reinforcing the structural bias towards expansion.

The dominance of state-owned banks in credit allocation further entrenches this dynamic. Lending decisions are aligned with policy priorities rather than risk-adjusted returns, weakening market discipline and enabling low-productivity investment to persist. Over time, this has contributed to declining capital efficiency, as additional investment yields diminishing marginal returns.

3.1.2 Local governments and quasi-fiscal expansion

Local governments play a central role in sustaining this investment dynamic. Within China's decentralised governance system, provincial and municipal authorities are responsible for delivering economic growth and public services, yet operate with limited access to stable tax revenues. This mismatch has led to reliance on off-balance-sheet financing mechanisms, most notably Local Government Financing Vehicles (LGFVs).

LGFVs function as quasi-fiscal instruments that enable local governments to sustain investment beyond formal budget constraints. By borrowing against land and future revenues, these entities finance large-scale infrastructure and industrial projects, with outstanding debt estimated to exceed 50 per cent of GDP (Kunath, 2025). While this system has facilitated rapid capital mobilisation, it has also blurred the boundary between fiscal and financial policy.

Many LGFVs operate with weak or negative cash flows, relying on refinancing and implicit state guarantees to remain solvent (Hendy et al., 2024). This perpetuates a cycle in which new borrowing is required to service existing debt, sustaining investment even as underlying returns decline. Under pressure to meet growth targets and align with central priorities, local governments continue to channel resources into investment projects irrespective of demand conditions, reinforcing overcapacity in sectors where market signals would otherwise favour consolidation.

3.1.3 The property sector as financial and fiscal anchor

For more than two decades, the property sector functioned as both a key growth engine and a central fiscal pillar. At its peak, real estate and related industries accounted for close to 30 per cent of GDP (Rogoff & Yang, 2021), generating demand across a wide range of industrial inputs and providing critical revenues through land sales.

Since 2021, however, the sector has entered a prolonged downturn. Falling prices, declining sales, and rising developer defaults have weakened both household wealth and local government finances. The contraction of the property sector has reduced domestic absorption capacity, particularly in upstream industries such as steel and construction materials, thereby exacerbating existing overcapacity.

At the same time, declining land-sale revenues have intensified fiscal pressures on local governments. Rather than reducing investment, many have turned to alternative financing mechanisms, particularly LGFVs, to sustain economic activity. In some cases, these entities have absorbed distressed property assets, further entrenching state involvement in the sector (Hale et al., 2025).

Policy responses have reinforced this reallocation dynamic. Financial resources have been redirected away from real estate and towards industrial sectors aligned with strategic priorities, including advanced manufacturing and technology. While this shift supports long-term upgrading objectives, it also channels capital into sectors already experiencing rapid capacity expansion, reproducing the underlying conditions for overcapacity.

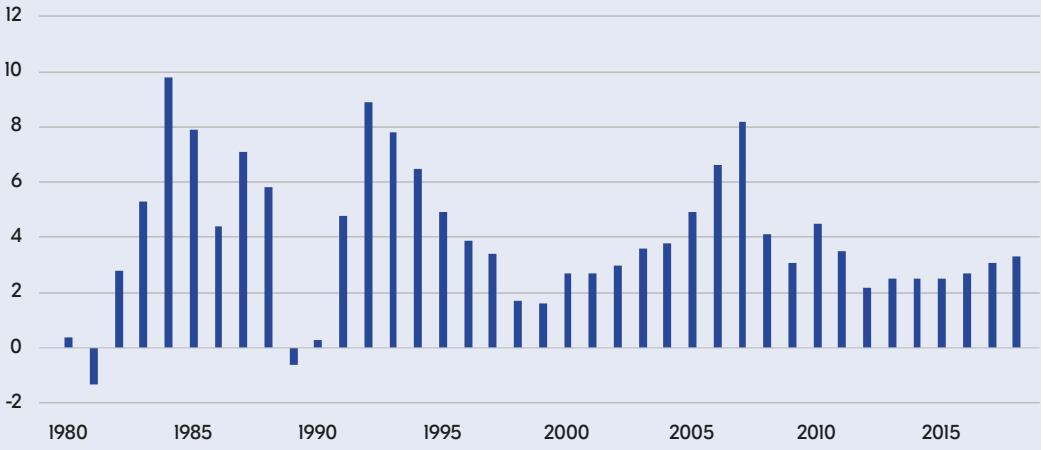
3.1.4 Declining efficiency and capital misallocation

These dynamics are directly reflected in declining economic efficiency. Total factor productivity (TFP), which surged during earlier phases of reform, has stagnated at historically low levels since the mid-2000s. At the same time, the divergence between output per hour worked and output per worker indicates that growth is increasingly driven by capital deepening rather than improvements in efficiency (Box 2).

Box 2. The effects of Chinas debt-driven, state-directed investment model

Total factor productivity (TFP) surged during the decades of economic reform throughout the 1980s and 1990s. TFP growth has been highly volatile over the years. Since the mid-2000s however, this trend has stagnated at historically low levels (Fig. 7).

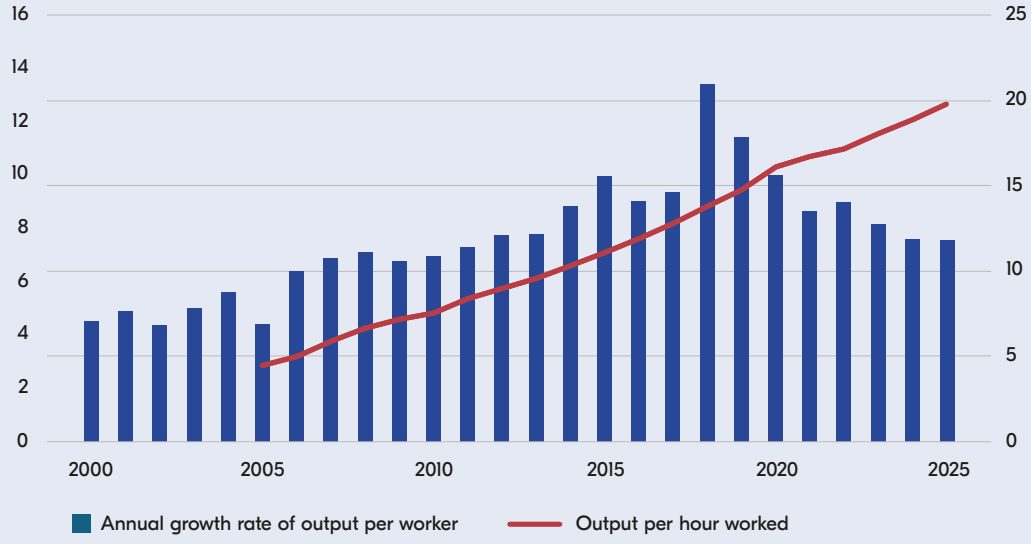
Figure 7. Total Factor Productivity, per cent.



Data from World Bank – World Development Indicators (2025).

The slowdown coincides with the post-2008 expansion of credit and the growing dominance of politically prioritised but low-return sectors such as infrastructure, real estate, and heavy industry. Although output per hour worked has increased, output per worker has steadily declined since 2010 (Fig. 8).

Figure 8. Output per hour worked, annual growth rate of output per worker (left axis) and per cent of GDP (right axis).



Data from ILO (2026).

This divergence indicates that while China continues to expand its productive capacity – driven mainly by capital accumulation – the efficiency with which capital and labor are utilised has declined. The resulting pattern of diminishing marginal returns underscores how the misallocation of resources within a state-dominated credit system has weakened the quality and sustainability of China's growth.

This pattern reflects systematic capital misallocation. Credit continues to flow towards state-linked entities and policy-prioritised sectors, while more productive private firms face relatively constrained access to finance (Betts and Cao, 2025). As a result, resources are locked into low-return activities, reducing aggregate productivity and crowding out more efficient investment.

The persistence of this allocation mechanism is rooted in the institutional features of the party-state system. Political incentives prioritise scale, output, and alignment with central policy objectives over profitability. Consequently, investment continues even as marginal returns decline, reinforcing the structural bias towards expansion.

Within China, these dynamics are increasingly described as 'involution' (neijuan), referring to intensifying competition that yields diminishing returns. The concept reflects official recognition of a growth model in which expanding output no longer translates into higher productivity or welfare, but instead reinforces inefficiencies and excess capacity (Pettis, 2025b; Gunter & Soong, 2024).

3.1.5 Financial and systemic risks

The expansion of debt-financed investment has growing implications for financial stability. The banking sector is heavily exposed to local government liabilities, with LGFV-related debt accounting for a significant share of bank balance sheets (IMF, 2022). A deterioration in local government finances therefore poses systemic risks, particularly for regional financial institutions.

At the same time, implicit guarantees, based on expectations of state intervention to prevent defaults, distort risk pricing and delay restructuring. Policy measures such as debt swaps and loan rollovers have provided short-term liquidity relief but have not addressed the underlying drivers of debt accumulation (Pettis, 2025). These mechanisms effectively lock the system into continued investment expansion by preventing the exit of inefficient firms and projects.

Recent policy interventions indicate growing awareness of these risks. Authorities have sought to curb 'disorderly competition', intervened in price wars in sectors such as electric vehicles, and promoted consolidation in industries such as solar manufacturing (Pettis, 2025b; Reuters, 2025). However, these measures remain sector-specific and do not alter the underlying incentive structure. As a result, overcapacity is often shifted across sectors rather than reduced, reflecting a pattern of adjustment without structural reform.

3.2 Demand constraints: weak consumption and limited domestic absorption

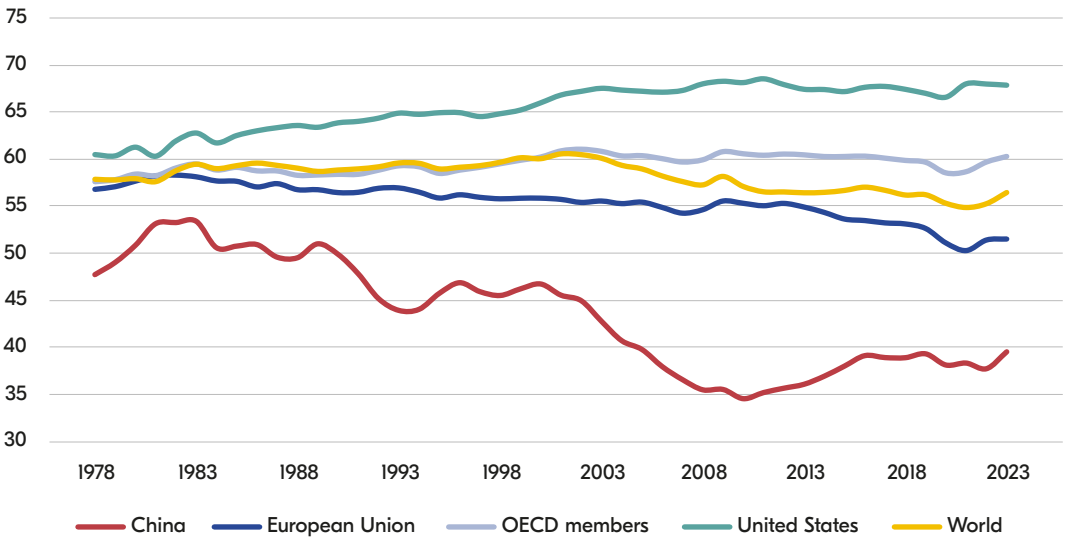
A central structural constraint in China's economic model is the persistent weakness of domestic demand, particularly household consumption. Despite sustained growth and repeated policy efforts, domestic consumption remains insufficient to absorb a meaningful proportion of China's expanding industrial output. This imbalance reinforces the effects of overcapacity on global markets, linking domestic macroeconomic dynamics directly to China's global economic footprint.

3.2.1 Structural suppression of household consumption

Household consumption in China remains structurally low relative to both GDP and international benchmarks. In 2024, consumption accounted for approximately 38 per cent of GDP, while gross domestic savings exceeded 43 per cent (World Bank, 2024).

This contrasts sharply with advanced economies, where consumption typically represents between 50 and 70 per cent of GDP (Fig. 9), and with the EU, where it stands at approximately 52.8 per cent (Eurostat, 2024).

Figure 9. Household expenditure, per cent of GDP

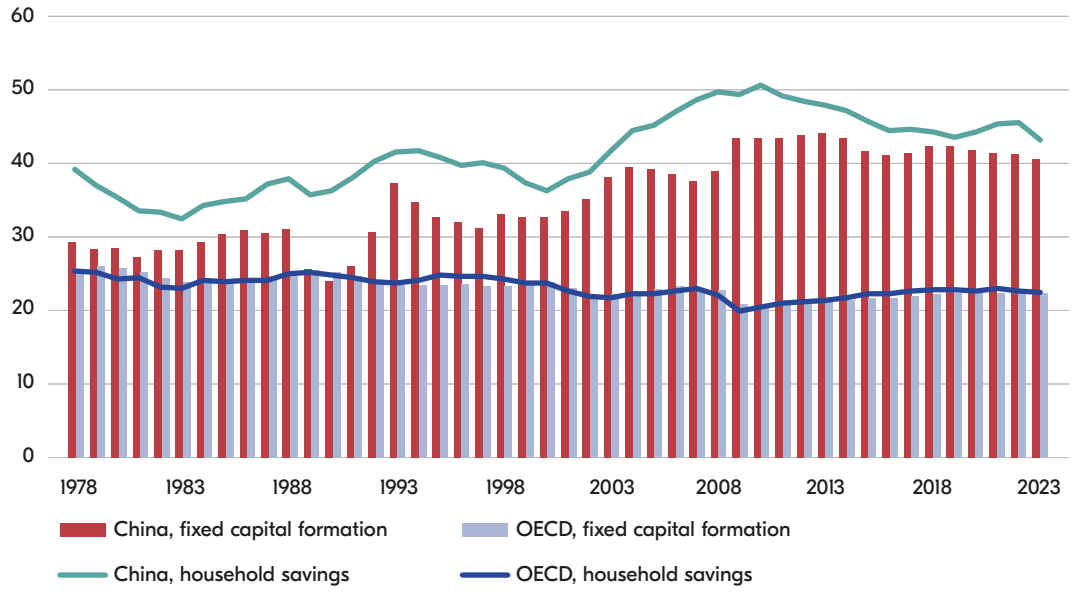


Data from World Bank – World Development Indicators (2025).

This imbalance reflects institutional and structural factors rather than cyclical weakness. High precautionary savings are driven by limited social safety nets, rising costs of housing, healthcare, education, and pensions, as well as slowing wage growth (Gao & Hall, 2025). In this context, households retain a significant share of income as a buffer against uncertainty rather than increasing consumption.

The result is a persistent gap between domestic demand and production capacity. While investment remains above 40 per cent of GDP (Fig. 10), its marginal contribution to growth is declining, reinforcing the structural imbalance between supply and demand. Policy-driven investment in already saturated sectors further suppresses prices and profitability, complicating debt servicing and discouraging private capital allocation (ECB, 2024; Carnegie, 2025).

Figure 10. household savings and fixed capital formation, per cent of GDP



Data from World Bankd - World Development Indicators (2025).

3.2.2 The property sector and the wealth effect

The weakness of consumption is closely linked to developments in the property sector. Residential real estate accounts for an estimated 60–70 per cent of household wealth, making it the dominant store of value in the Chinese economy.

The prolonged downturn since 2021 has therefore had a pronounced negative wealth effect. Falling property prices, stalled construction projects, and rising developer defaults have reduced household confidence and weakened expectations of future income and asset appreciation. As a result, households have become more cautious, further reducing discretionary spending.

At the same time, the property slump has indirect effects on consumption through fiscal channels. As revenues from land-right sales decline, local governments face tighter budget constraints, limiting their ability to expand social services and reduce household out-of-pocket costs. This reinforces the structural drivers of high savings, as households continue to self-insure against risks related to healthcare, pensions, and education.

3.2.3 Demand constraints and overcapacity

The persistence of weak domestic demand has direct implications for China's industrial structure. As household consumption remains insufficient, the economy lacks an internal mechanism to absorb rising industrial output. This reinforces the dynamics described in previous sections: continued investment expands productive capacity, while demand lags behind.

While excess industrial production has been redirected into export markets, reinforcing global price pressures, the property downturn has also reduced China's role as an importer of commodities. Lower demand for key commodities such as iron ore and copper has contributed to lower global prices, affecting resource-exporting economies (World Bank, 2025).

In this context, overcapacity is not merely a function of excessive supply, but also of insufficient domestic absorption. The imbalance between production and consumption is therefore central to understanding the persistence of excess capacity across sectors ranging from heavy industry to advanced manufacturing (Tang, 2025).

This dynamic is further exacerbated by the structural characteristics of China's growth model. Political incentives and financial structures continue to prioritise investment over consumption, directing resources towards industrial expansion rather than household income growth. As a result, the gap between supply and demand is continuously reproduced.

This accelerates the effects of involution, which materialise in labour markets, where wage pressures, rising youth unemployment, and delayed payments across industrial supply chains signal growing strain within the real economy (Reuters, 2025).

3.2.4 Externalisation of domestic imbalances

Given the constraints on domestic absorption, excess production is increasingly channelled towards export markets. Weak consumption thus translates directly into rising trade surpluses and growing dependence on external demand. China recorded a trade surplus of approximately USD 1.2 trillion in 2025, reflecting both strong export performance and limited domestic demand (Brown & Mischer, 2025).

In sectors such as solar panels and electric vehicles, Chinese firms have leveraged scale and cost advantages to offer products at prices often 20–30 per cent below those of Western competitors, intensifying competitive pressures in global markets (Lombardo et al., 2025).

At the same time, the external environment is becoming more restrictive. Trade defence measures, tariffs, and regulatory barriers have expanded across both advanced and emerging economies, with a growing number of countries introducing measures targeting Chinese exports (Gunter & Soong, 2026).

This creates a structural tension. While weak domestic demand increases reliance on export markets, access to those markets is becoming more constrained. As a result, China faces increasing difficulty in externalising its domestic imbalances, even as the underlying drivers of overcapacity persist.

3.2.5 Limits to policy adjustment

Chinese policymakers have recognised the need to strengthen domestic demand and have introduced a range of targeted measures to stimulate consumption. These include subsidies for durable goods, minimum wage increases, childcare support, and consumer credit programmes (Brown & Mischer, 2025; Wakabayashi, 2025).

However, these interventions have had limited and often short-lived effects. For example, subsidy programmes have generated temporary spikes in consumption, followed by rapid slowdowns once support measures expire. This reflects the fact that the underlying drivers of weak consumption, including income distribution, precautionary savings, and structural uncertainties, remain largely unaddressed.

A more durable shift towards consumption-led growth would require deeper structural reforms, including stronger social protection systems, higher household income shares, and a reallocation of capital away from industrial investment towards services and household sectors. Such reforms, however, would challenge existing political and institutional arrangements, limiting the scope for adjustment within the current model.

3.3 External constraints: limits to exporting overcapacity

China's external environment is becoming increasingly restrictive, placing growing constraints on its investment-driven and export-oriented growth model. These constraints operate across multiple dimensions, including market access, technology flows, capital, and supply chains, and interact directly with the domestic dynamics outlined in previous sections. While external pressures do not fundamentally alter the internal drivers of China's economic model, they limit its capacity to externalise domestic imbalances, particularly overcapacity.

3.3.1 Erosion of market access

At the centre of these dynamics is the intensifying trade and technology conflict between China and advanced economies. The United States, the European Union, Japan, and an increasing number of emerging economies have expanded the use of tariffs, trade defence instruments, local-content requirements, and regulatory barriers targeting Chinese exports (Gunter & Soong, 2026; Chor & Li, 2024).

These measures directly affect China's export-dependent sectors at a time when domestic demand remains insufficient to absorb industrial output. As overcapacity persists in sectors such as electric vehicles, batteries, solar panels, and industrial machinery, reduced access to traditional export markets increases pressure on Chinese firms and local governments. Export restrictions therefore not only constrain growth but also amplify existing domestic imbalances by limiting the system's primary adjustment mechanism.

The effects are already visible in shifting trade patterns. Exports to the United States declined by approximately 20 per cent in 2025, while exports to Association of Southeast Asian Nations (ASEAN) and Africa increased significantly, reflecting a reorientation of trade flows (ECB, 2026). At the same time, exports to the EU continued to grow, although this may partly reflect trade diversion following U.S. tariff increases (Schulte et al., 2026).

This reallocation highlights both the adaptability and the limits of China's export model. While Chinese firms can redirect exports towards alternative markets, the global expansion of trade defence measures, with 52 of the 70 largest economies initiating new measures in 2025, suggests that available outlets are narrowing (Gunter & Soong, 2026).

3.3.2 Technological dependencies and restrictions

China's integration into global technology ecosystems remains incomplete, leaving it dependent on foreign inputs in several critical areas. Advanced semiconductor manufacturing equipment, high-end components, specialised services, and certain raw materials continue to be sourced from abroad (Gerards Iglesias & Matthes, 2023).

These dependencies have become increasingly salient in the context of coordinated export controls and investment restrictions led by the United States and supported, to varying degrees, by allies. Restrictions targeting semiconductors, artificial intelligence, and quantum technologies limit China's access to frontier technologies and constrain its ability to upgrade in key sectors (Shivakumar et al., 2024; 2025).

While such measures may accelerate domestic innovation efforts, their short-to medium-term effect is to increase costs, reduce efficiency, and slow technological upgrading. More importantly, they reinforce the strategic logic of technological self-reliance, encouraging further state-led investment in sectors already characterised by rapid capacity expansion and diminishing returns.

3.3.3 Global supply chain reconfiguration

China's role in global supply chains is also evolving in response to geopolitical and economic pressures. While the country remains a central node in global manufacturing, supply chains are increasingly being reconfigured through diversification strategies such as 'China+1'. Southeast Asia, in particular, has emerged as a key destination for outward investment and production relocation (Durá & Vandermeeren, 2024; Benson & Sicilia, 2023).

However, this reconfiguration does not necessarily reduce dependence on China. In many cases, value chains become regionally distributed but remain functionally centred on Chinese inputs, technology, and capital (Hassler & Lund, 2025). As a result, China retains significant influence over regional production systems, even as final assembly shifts to other locations. Diversification strategies therefore often relocate production geographically but have limited effects on structural dependence on Chinese inputs, capital, and technology.

At the same time, China's industrial overcapacity generates spillover effects in these regions. Increased exports of low-cost industrial goods have contributed to competitive pressures and, in some cases, premature deindustrialisation in countries such as Indonesia and Thailand (Tang, 2025). These dynamics are prompting more defensive trade policies among emerging economies, further constraining China's export opportunities.

3.3.4 Strategic vulnerabilities and geopolitical risk

China's external constraints are also shaped by its dependence on global trade routes and upstream resource inputs. Despite its dominance in downstream processing, China relies heavily on imported raw materials and energy, much of which is transported through strategically sensitive maritime routes such as the South China Sea and the Malacca Strait (Winnerstig, 2019).

In response, Beijing has sought to mitigate these vulnerabilities through investments in overseas infrastructure and logistics networks, particularly under the BRI. By the end of 2024, Chinese entities had invested in 129 port projects globally, including 17 under majority ownership (USTR, 2025). These efforts aim to secure supply chains and reduce exposure to external disruptions, but also reflect the growing securitisation of economic policy.

Geopolitical tensions further amplify these risks. A potential crisis in the Taiwan Strait, for example, would disrupt global semiconductor supply chains, with significant implications for both China and the global economy. Taiwan accounts for the vast majority of advanced semiconductor production, and any disruption would constrain China's access to critical inputs while simultaneously affecting global manufacturing systems (Vest et al., 2022; Cheng-hui, 2025).

3.4 Political constraints: regime priorities and limits to adjustment

The persistence of China's structural economic imbalances cannot be understood without reference to the political constraints embedded in its governance model. While the preceding sections have demonstrated how debt dynamics, declining efficiency, and weak domestic demand reinforce investment-driven growth, the key question is why these dynamics are not corrected through policy adjustment. The answer lies in the interaction between economic management and regime priorities, which constrain the scope for structural reform.

3.4.1 Growth, employment and regime legitimacy

Economic performance remains a central pillar of political legitimacy in China. Although the basis of legitimacy has evolved, from rapid growth to a broader emphasis on stability, technological advancement, and national strength, the delivery of economic outcomes remains critical to regime credibility (Shirk, 2018; Fewsmith, 2021).

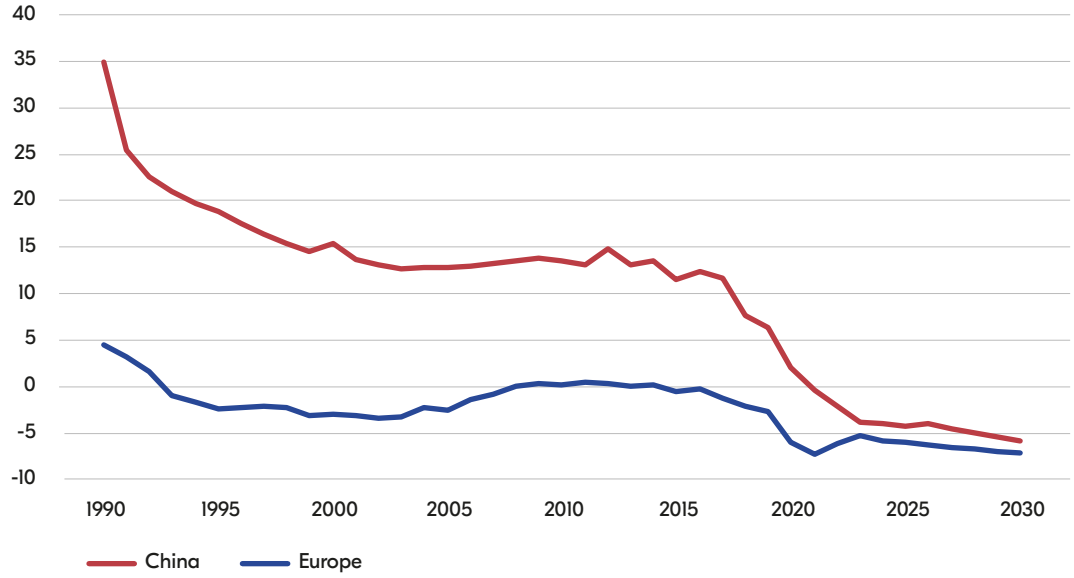
In this context, maintaining growth and employment is not merely an economic objective but a political imperative. Local governments, whose performance is evaluated partly on economic indicators, are incentivised to sustain investment and industrial activity even when returns decline. As outlined in previous sections, this reinforces the bias towards expansion and contributes directly to persistent overcapacity.

The prioritisation of stability also constrains adjustment. A rapid contraction in investment or the closure of excess capacity would entail a significant rise in unemployment, particularly in industrial regions. Given the potential social and political consequences, policymakers face strong incentives to avoid disruptive reforms, favouring instead gradual adjustment and continued support for existing sectors.

3.4.2 Demographic challenges

Demographic trends constitute an additional structural headwind to China's growth model. The legacy of the one-child policy (Fig. 11), combined with rising living costs and limited social protection, has resulted in persistently low fertility and a rapidly ageing population (Rajah and Leng, 2022). China's working-age population has been declining since 2011 (Fig. 12), while the dependency ratio continues to rise (Fig. 13), placing increasing pressure on labour supply and public finances.

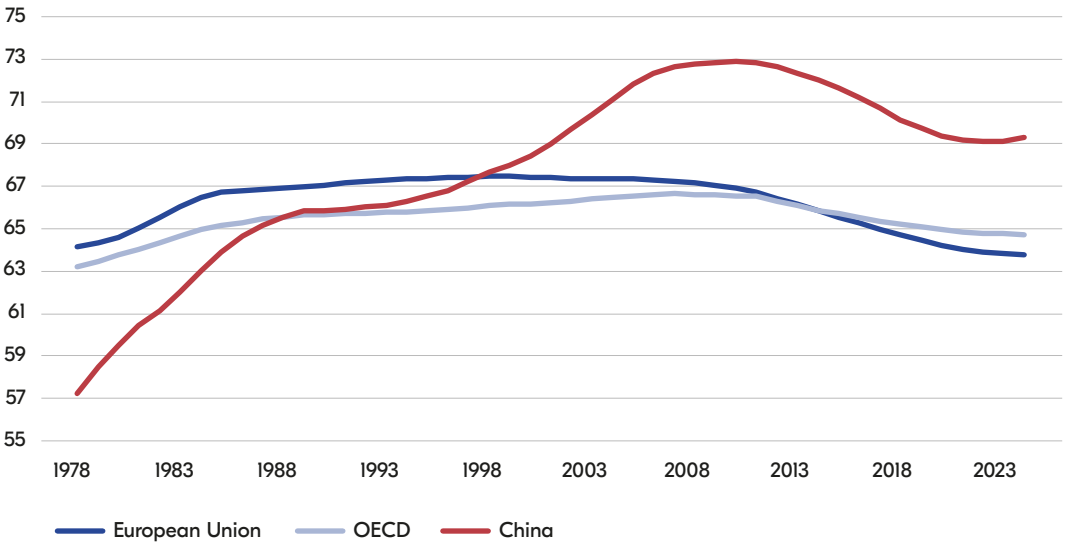
Figure 11. Crude rate of natural change of population, per 1,000



Data from UN Population Division (2026).

These dynamics have direct economic implications. A shrinking workforce reduces potential economic growth, while ageing increases precautionary savings and dampens household consumption, thus exacerbating an already negative trend (section 3.2). In parallel, fiscal pressures are rising, as demands for pensions, healthcare, and elderly care expand in a system that remains underdeveloped relative to advanced economies (Kolk and Pårup, 2023). This limits the state's capacity to support a transition towards consumption-led growth.

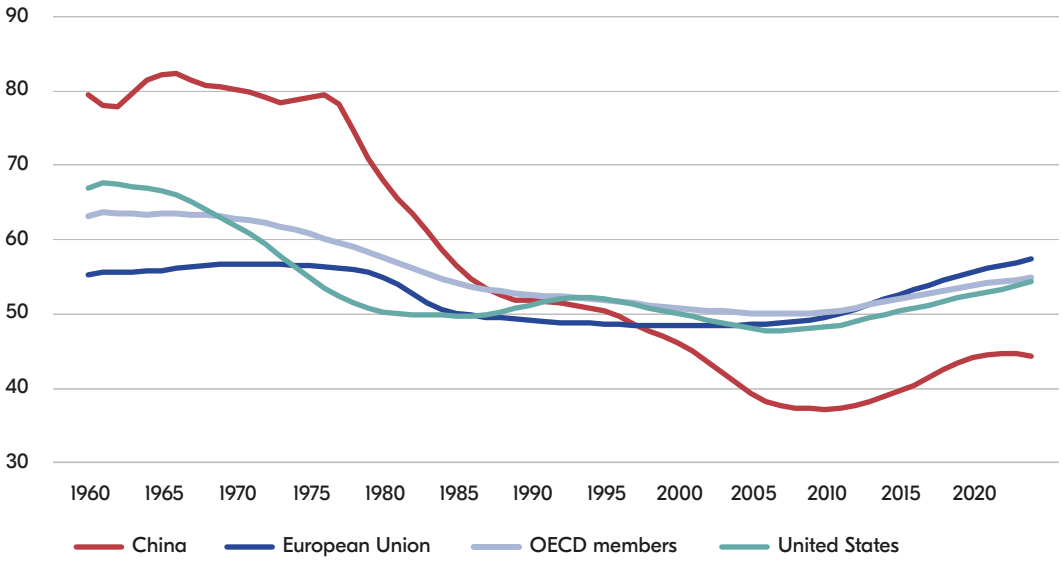
Figure 12. Working age population, per cent total population



Data from OECD (2024).

Labour market developments reinforce these constraints. While urban sectors face skill shortages and rising wages, other parts of the economy are characterised by weak demand, layoffs, and declining income expectations (Huld, 2025; Brown & Mischer, 2025). At the same time, talent outflows[4] and demographic decline weigh on China's innovation capacity (Omaar, 2024).

Figure 13. Age dependency ratio, per cent of people aged 65+ per 100 people of working age



Data from World Bank World Development Indicators (2025).

Taken together, demographic change amplifies China's existing structural imbalances. It weakens domestic demand, constrains productivity growth, and increases fiscal pressures, thereby reinforcing reliance on investment-driven expansion. In this sense, demographic trends do not offset overcapacity but contribute to its persistence.

3.4.3 Centralisation and policy rigidity under Xi Jinping

Under Xi Jinping, China's political system has become more centralised, with greater concentration of decision-making authority within Party structures. The expansion of Central Leading Groups and Commissions has strengthened coordination across policy areas but has also reduced the scope for autonomous decision-making at lower levels (Fewsmith, 2021; Tan, 2022).

This centralisation has two implications. First, it reinforces the strategic coherence of economic policy, ensuring alignment with long-term objectives such as technological self-reliance and industrial upgrading. Second, it reduces institutional flexibility, as policy direction is more tightly linked to central priorities and political considerations.

While local governments retain some implementation flexibility, their actions are increasingly constrained by the need to demonstrate alignment with central leadership. This limits the scope for bottom-up adjustment and reinforces the continuation of investment-driven strategies, even where local conditions might warrant consolidation.

4. The Global AI Talent Tracker.

3.4.4 Constraints on rebalancing towards consumption

A shift from investment-led to consumption-led growth is widely recognised as necessary to address China's structural imbalances. However, such a transition faces significant political and institutional barriers.

Rebalancing would require a redistribution of income towards households, expanded social welfare provision, and a reallocation of capital away from industrial sectors towards services and consumption. These changes would alter the distribution of economic power within the system, reducing the relative role of state-owned enterprises, local governments, and policy-driven investment.

From a political perspective, such reforms entail difficult trade-offs. Strengthening household consumption would require fiscal reforms that reduce reliance on land sales and investment-driven growth, while expanding social spending would increase fiscal pressures at both central and local levels. Moreover, reducing support for industrial sectors could undermine strategic objectives related to technological upgrading and national security.

As a result, policy efforts to stimulate consumption have largely relied on incremental measures, such as subsidies and targeted support, rather than structural reforms. These interventions have had limited and often temporary effects, reflecting the underlying constraints on more fundamental adjustment.

3.4.5 Financial discipline and the limits of market correction

The persistence of soft budget constraints reflects not only economic factors but also political considerations. Allowing widespread defaults among local governments, state-owned enterprises, or large private firms would impose significant economic and social costs, with potential implications for financial stability and public confidence.

Consequently, the state continues to play a central role in managing financial risks through implicit guarantees, debt restructuring, and liquidity support (Pettis, 2025; IMF, 2022). While these measures prevent systemic crises, they also delay resource reallocation and the exit of inefficient firms.

This dynamic reinforces the investment trap described earlier. By preventing market-driven correction, political intervention sustains existing structures and prolongs capital misallocation, contributing to declining efficiency and persistent overcapacity.

3.4.6 Political priorities and industrial policy

Industrial policy remains a central instrument of economic governance, closely linked to political objectives. Initiatives such as MIC 2025 and the Dual Circulation Strategy reflect a strategic emphasis on technological upgrading, supply chain security, and reduced external dependence (Haapaniemi, 2023; Garcia Herrero, 2021).

While these policies aim to strengthen long-term economic resilience, they also reinforce existing imbalances. By directing resources towards priority sectors, they sustain high levels of investment even where demand is uncertain or returns are declining. The political importance of achieving technological leadership further limits the willingness to scale back support for these sectors, even in the presence of overcapacity.

3.5 Interim conclusion

Taken together, the dynamics analysed in this chapter point to a structural tension at the core of China's economic model. Rising debt, declining productivity, weak domestic consumption, and external constraints do not lead to adjustment or a reduction in industrial capacity. Instead, they reinforce the underlying incentive structure, shaped by political priorities, fiscal arrangements, and state-directed finance, that sustains investment-led growth and continuous capacity expansion.

This results in a self-reinforcing cycle. As traditional growth drivers weaken and domestic demand remains insufficient, investment is redirected towards industrial sectors aligned with strategic objectives. This further expands productive capacity despite declining returns, intensifying overcapacity. Excess production is increasingly channelled towards external markets, linking China's internal imbalances directly to global price pressures and trade tensions.

At the same time, the sustainability of this model is increasingly constrained. Declining capital efficiency, rising financial risks, demographic pressures, and tightening external conditions limit the system's ability to absorb further expansion, both domestically and internationally. External restrictions, in particular, reduce China's capacity to offload excess production, while technological dependencies and geopolitical risks increase the cost of continued upgrading.

Crucially, these constraints do not fundamentally alter the model. Political priorities, particularly the emphasis on growth, employment, and strategic sectors, limit the scope for structural adjustment. Rebalancing towards consumption or allowing market-driven consolidation would entail economic and social disruptions that conflict with core regime objectives. As a result, the mechanisms that sustain growth in the short term, including debt expansion, industrial policy, and financial support, also perpetuate structural imbalances and delay adjustment.

The outcome is an economic system under increasing pressure. Overcapacity emerges not as a temporary distortion but as a structural feature of China's political economy, reinforced by both domestic constraints and policy responses. At the same time, the very dynamics that intensify overcapacity also undermine its long-term viability, creating a persistent tension between expansion and sustainability.

For European economies, this implies that China's impact on global markets, particularly through price suppression and competitive pressures, is likely to persist. However, it also suggests that this model is subject to growing internal and external constraints, which may shape its trajectory over time, even if they do not fundamentally alter its immediate effects.

4 China's trade policy

China's trade policy is best understood as an extension of its political-economic system, in which the CCP coordinates economic instruments to advance strategic objectives related to industrial upgrading, technological self-reliance, and geopolitical influence. Rather than reflecting market-driven liberalisation, China's integration into the global economy has been shaped by a state-directed approach in which trade, industrial, and investment policies function as core tools of national development.

In this context, trade policy extends well beyond traditional instruments such as tariffs and import restrictions. It encompasses a broad set of mutually reinforcing measures, including export controls, industrial subsidies, technology transfer mechanisms, foreign investment regulation, and government procurement, many of which operate through domestic regulation but have significant effects on global markets. These instruments are deployed not in isolation, but as part of an integrated policy framework that shapes production structures, allocates resources, and influences global value chains.

Under Xi Jinping, this system has become more explicitly strategic. Economic policy is increasingly aligned with national security considerations and long-term technological ambitions, while legal and regulatory frameworks are used to safeguard China's interests and counter external pressures (Yue-Zhen, 2025). As a result, trade policy serves not only economic objectives but also broader goals of reducing external dependencies, expanding China's position in global supply chains, and strengthening its international leverage.

The combined effect of these policies is most visible in the expansion of industrial capacity across a wide range of sectors, contributing to persistent overcapacity and intensified competition in global markets. For the EU and Sweden, this integrated model presents challenges that cannot be addressed through traditional trade instruments alone, but require a coordinated approach linking trade, industrial policy, and economic security.

4.1 Export controls and economic sanctions

China's export control system is one of the CCP's most powerful trade-policy instruments. By intertwining industrial planning, resource governance, and national security, export controls give the party control over strategic raw materials and technology, shaping both domestic industrial development and international dependencies. The system is embedded in a political-institutional structure where the CCP exercises direct authority over the business sector, and where Xi Jinping's highly centralised decision-making enables the rapid translation of security and industrial priorities into concrete trade measures (Naughton 2022; Brødsgaard 2018; Doshi 2021).

Beijing's export control regime is governed primarily by the Export Control Law (2020) and[5] the Foreign Trade Law (2023),[6] and complemented by administrative measures issued by the General Administration of Customs (GAAC) and MOFCOM.[7] The law authorises restrictions on the export of goods and technologies to safeguard 'national security or interests', pursuing a 'holistic view of national security, safeguard international peace, [and] balance security and development' – a broad formulation granting substantial discretion to the Party-state. The Export Control Law provides for a complete system of export controls on dual-use and military items, as well as other goods and services with national security implications. Relevant items are published in regular updates to the Export Control List of Dual Use Items. However, MOFCOM issues regular announcements under the Regulation on the Export Control of Dual-use Items[8] regarding additional items to be placed on the list. The Export Control Law also empowers the government to impose temporary control measures on items, technologies, and services not included in the Dual-Use List for up to two years. Lastly, MOFCOM, in combination with the Ministry of Science and Technology, issues the Catalogue of Technologies Prohibited and Restricted from Export.[9]

The Administrative Regulations on Import and Export of Technologies[10] further regulate export restrictions under the Foreign Trade Law on technology, as set out in the Catalogue on Technologies Prohibited from Export.[11] The Catalogue lists technologies that are banned from export, as well as technologies that are restricted and therefore subject to an export licensing procedure. The 2025 revision of the Catalogue added battery cathode material and Lithium refining technology.[12] Given the parallel application of the Export Control Law and the Foreign Trade Law, as well as the operation of several catalogues on export -restricted and dual-use items according to their field of application, the same technology could in practice be subject to several licensing systems.

Lastly, under the Anti-Foreign Sanctions Law[13], Beijing can prohibit Chinese nationals and domestic entities from engaging in transactions with foreign individuals or entities placed on the List of Unreliable Entities.[14] This system was further strengthened with

5. Export Control Law of the People's Republic of China (2020).
6. Foreign Trade Law of the People's Republic of China (2023).
7. Overview of relevant laws and regulations, 29 August 2025.
8. Regulations of the People's Republic of China on Export Control of Dual-Use Items (2024).
9. Catalogue of Technologies Prohibited and Restricted from Export (2023) [unofficial translation].
10. Administrative Regulations on the Import and Export of Technologies (2002).
11. Catalogue of the People's Republic of China of Technologies Prohibited or Restricted from Export (2025), unofficial translation.
12. Announcement No. 28 of 2025 Announcement on the adjustment and issuance of the 'Catalogue of China's Prohibited and Restricted Export Technologies' (2025).
13. Anti-Foreign Sanctions Law of the People's Republic of China (2021).
14. MOFCOM Order No. 4 of 2020 on Provisions on the Unreliable Entity List.

the introduction in 2026 of regulations on supply chain security[15] and extraterritoriality of foreign sanctions,[16] that allows Beijing to respond to actions by foreign actors, including foreign-owned businesses in China, that interfere with Chinas supply chains. The effect is, thus, double. On the one hand, it strengthens China's capabilities for countermeasures against perceived economic coercion. On the other hand, it aims to ensure stability and resilience in Chinese supply chains.

The enforcement and administration of export controls are spread across several government agencies, including MOFCOM, GAAC, the Ministry of Industry and Information Technology, the State Administration of Science, Technology and Industry for National Defense (ASTIND), and the Equipment Development Department of the Central Military Commission. The Export Control Law falls generally under the control of the State Council and the Central Military Commission, ensuring that strategic decision-making remains close to the party. Within this cluster, MOFCOM is generally responsible for dual -use items, while ASTIND oversees the export of military goods.

The adoption and implementation of the Foreign Trade Law, the Export Control Law, and the Anti-Foreign Sanctions Law reflect the wider securitisation of economic policy under Xi's thought of law-based governance. In recent years, Beijing has used these instruments in combination to protect China's sovereignty and national security and pursue wider economic development objectives.

In recent years, China's dominance in mining and processing critical raw materials has become central to its industrial power. According to the US Geological Survey (2024), China accounts for roughly 69 per cent of global rare earths mining and 85–90 per cent of global processing capacity. While China has long managed these sectors through quotas and licensing, only in recent years has the use of export controls become explicitly strategic, particularly for rare earths and other technology-critical minerals (Yang, 2025).

4.1.1 From retaliatory to long-term strategic tool

China has long deployed trade restrictions as instruments of economic coercion in response to actions by foreign governments that challenge core political interests (Appendix II). A prominent recent example is the range of measures imposed on Lithuania following the opening of a Taiwan representative office in Vilnius, combining formal sanctions, export controls, and informal administrative practices such as customs authorities refusing to clear imports (Cha, 2026). More broadly, the politically motivated use of trade restrictions, both against states and firms, is well documented.

Export controls have played a central role in this toolkit. The 2010 suspension of rare earth exports to Japan following a maritime dispute near the Senkaku/Diaoyu Islands remains a key example (Bradsher, 2010). Despite the absence of formal restrictions, shipments of rare earth oxides, salts, and metals critical to Japan's high-tech industries were effectively halted, illustrating China's capacity to weaponise administrative controls (Yang, 2025). Similar dynamics are evident in more recent cases, including the tightening of export controls on gallium and germanium in 2023 in parallel with U.S. semiconductor restrictions, and the imposition of export controls on rare earths and permanent magnets in 2025, widely interpreted as a response to U.S. tariff measures and used as leverage in subsequent negotiations (Bradsher, 2025). Reports of renewed

15. Order of the State Council of the People's Republic of China No. 834 on on the security of industrial and supply chains.
16. Order of the State Council of the People's Republic of China No. 835.

restrictions on critical raw materials exports to Japan in early 2026 further underscore the continued relevance of export controls as retaliatory tools.

It is in this context important to distinguish coercive uses from precautionary measures aimed at safeguarding domestic supply. For instance, China has considered or implemented export restrictions on fertilisers, including urea and nitrogen-based products, during periods of rising energy costs. While these measures can affect global markets, they are primarily linked to domestic supply concerns and input price volatility, and should be distinguished from the strategic deployment of export controls as instruments of economic statecraft.

While the retaliatory function remains central, there has been a notable shift towards the use of export controls as forward-looking strategic instruments. This evolution has become more pronounced in recent years, particularly in sectors such as rare earths, battery inputs, and critical processing technologies, but extends to a broader set of commodities, including fertilisers, chemicals, and industrial inputs. What distinguishes this strategic use is the pursuit of long-term objectives, such as technological self-reliance, industrial upgrading, and the consolidation of supply chain dominance, rather than immediate retaliation.

The adoption of the Export Control Law in 2020 has strengthened China's capacity to deploy such measures by providing a flexible legal framework for their rapid implementation. Since its introduction, both the scope and frequency of export controls have increased (US–China Economic Security Review Commission, 2025). These controls serve multiple, mutually reinforcing purposes.

First, they secure preferential access to inputs for domestic firms. By restricting exports, China can maintain lower input costs for domestic industries in sectors such as batteries, photovoltaics, and semiconductors, while simultaneously incentivising foreign firms to relocate production to China, thereby facilitating technology transfer and industrial upgrading (USTR, 2012).

Second, export controls allow China to influence global price dynamics. Its dominant position in rare earth extraction and processing enables Beijing to affect global supply and prices, potentially discouraging investment in alternative supply chains. Similar effects have been observed in fertiliser markets, where export restrictions in 2021–2022, late 2025, and early 2026 contributed to global shortages and price increases (Lorimer, 2025). While the extent of China's pricing power remains debated (Yue-Zhen, 2025), such cases illustrate the difficulty of disentangling economic from strategic motivations.

Third, export controls serve developmental objectives by encouraging domestic upgrading along value chains. For example, export quotas have at times exempted processed rare earth products, suggesting an intention to shift production towards higher value-added activities (Duan, 2022). This mirrors policies in other resource-rich economies but, in China's case, is closely integrated with broader industrial strategies, particularly in green technology sectors.

Fourth, export control regimes provide detailed information on global supply chains. Licensing requirements often mandate disclosure of end-use, ownership structures, and technical specifications, giving Chinese authorities granular insight into foreign production networks (McMorrow, 2025; US–China Economic Security Review Commission, 2025). This enhances China's capacity to monitor and influence global value chains.

Geopolitically, export controls function as instruments of calibrated pressure. Unlike reactive measures aimed at punishing specific actions, strategic controls are designed to reshape bargaining dynamics over time. They enable China to impose costs on trading

partners that are difficult to replicate, strengthening its negotiating position in contexts such as the U.S.–China technology rivalry (Posen, 2025). While such measures may be triggered by external actions, such as U.S. export controls or tariff increases, their purpose extends beyond retaliation to the restructuring of global economic interdependence.

Institutionally, these measures are administered by MOFCOM through licensing systems and quotas that determine export volumes, pricing conditions, and authorised firms, often favouring state-owned enterprises or firms aligned with industrial policy goals (Gunter and Arcesati, 2025). This reflects a broader governance model in which resource allocation is politically directed, with revenues from strategic sectors channelled into state-led investment.

China has also expanded the extraterritorial reach of its export controls. Measures introduced in October 2025 on permanent magnets require export licences for products manufactured abroad if they incorporate even minimal amounts of Chinese-origin inputs or processing technologies. Such provisions extend China's influence across entire value chains, ensuring continued leverage even when production is relocated.

The effectiveness of export controls varies across sectors, with the strongest impact in highly concentrated and state-dominated industries such as rare earths (Vekasi, 2021). Taken together, these developments illustrate a clear shift: while export controls continue to serve as tools of economic coercion, they are increasingly embedded within a broader strategic framework aimed at shaping global markets, securing technological leadership, and enhancing China's long-term economic and geopolitical position.

4.1.2 A full-value-chain approach

The recent rare earth export controls stand out because they explicitly link raw materials to dual-use technology and national security. Export controls on dual-use items traditionally target advanced technologies that could enhance another country's military capabilities. In China's case, these controls have been extended upstream to raw material inputs at the lower end of the value chain. This represents a significant

shift. Rather than restricting sophisticated components, Beijing is leveraging its dominance over upstream resources to shape global access to foundational materials essential for high-tech manufacturing under the guise of national security.

Indeed, the 15th Five-Year Plan indicates deeper integration of Chinese economic and national security interests (Lenk, 2026). This not only acknowledges Beijing's existing dominance in, among others, critical raw material value chains, but also signals a strategic willingness to exploit existing dominance and build new forms of dominance.

4.1.3 Economic effects of export controls

China's increasingly assertive use of export controls generates wide-ranging economic effects, both domestically and internationally. These effects stem not only from the criticality of the restricted materials, but also from their position within the value chain and the structure of global supply and demand. Export controls influence price formation, industrial competitiveness, supplychain configuration, and investment decisions, making them among Beijing's most consequential geoeconomic instruments.

For China, a central effect arises from the interaction between upstream export restrictions and downstream industrial policy. By limiting exports of raw materials and intermediate inputs, Beijing lowers domestic supply costs for strategically important industries. Energy-intensive and technology-dependent sectors, such as batteries, photovoltaics, permanent magnets, and semiconductors, benefit directly from cheaper inputs. This creates a structural cost advantage over foreign producers, particularly when combined with substantial domestic subsidies. In practice, such interventions contribute to overcapacity, enabling Chinese firms to expand aggressively into global markets and fuelling recurrent trade frictions.

At the same time, export controls reduce export revenues, fragment markets, and can exacerbate inefficiencies in sectors already prone to overcapacity. Because they are most effective where China dominates global supply, their use inevitably entails revenue losses, an important concern given China's export-dependent growth model. These costs fall disproportionately on Chinese firms, which bear the operational burden and lost sales associated with the export control regime (Yue-Zhen, 2025).

Export controls can also generate frictions between central priorities and local incentives, complicating enforcement and fostering rent-seeking in licensing procedures. When applied to goods with broader societal relevance, such as fertilisers or pharmaceuticals, they may also damage China's reputation as a reliable supplier (US–China Economic Security Review Commission, 2025). While strategically valuable, export controls therefore impose tangible domestic costs.

Internationally, distorted price signals are particularly significant. Lower input costs for Chinese firms, combined with restricted export volumes, alter global price formation and weaken the competitiveness of foreign producers. At the same time, uncertainty over China's policies discourages investment in alternative supply chains, especially in capital-intensive sectors with volatile demand. Even when prices rise, investors face the risk that China may later relax controls and flood markets, undermining new projects, a pattern observed in rare earths and other critical minerals.

The European Central Bank (ECB) estimates that 80 per cent of European producers are no more than three intermediates away from Chinese rare earth suppliers (Banin et al., 2025), highlighting the exposure of European industry. This vulnerability is compounded by the presence of U.S. intermediaries and the extraterritorial application of Chinese export controls, resulting in delays and disruptions across supply chains.

However, the effects of export controls are highly material-specific and depend on their position in the value chain. The case of antimony illustrates this complexity. Following China's restrictions, exports effectively halted (Jackson, 2025), yet EU exposure remained limited because imports largely consisted of forms available from alternative suppliers, while Europe is a net exporter of higher-value antimony oxides (JRC, 2025). This underscores the need to assess dependencies at specific stages of the value chain rather than at the level of broad commodities.

By contrast, sectors in which China dominates both upstream extraction and downstream processing are far more vulnerable. This is evident in rare earths and permanent magnets. After export controls introduced in April 2025, Chinese exports of relevant materials fell by more than 76 per cent overall, and by over 90 per cent to the United States and Japan (Bloomberg, 2025). Such declines highlight the extent of dependence in advanced manufacturing and defence supply chains, as well as China's capacity to translate upstream dominance into geoeconomic leverage.

Export controls also have broader macroeconomic effects. Supply disruptions can generate significant price volatility, as seen during fertiliser restrictions in 2021–2022. In markets with limited buffers, even modest reductions can trigger sharp price increases, disproportionately affecting import-dependent economies. Where controls depress domestic Chinese prices, foreign firms face cost disadvantages that propagate through global value chains and reshape trade patterns.

At the same time, export controls can accelerate diversification and substitution, often at significant cost. Firms must reconfigure supply chains and source alternative inputs, typically at higher prices.

Overall, the economic effects of Chinese export controls are multifaceted and context-dependent. However, they consistently alter price dynamics, affect industrial competitiveness, reinforce overcapacity, and drive costly adjustments in global supply chains.

4.1.4 Policy reactions to export controls

China's increasingly assertive use of export controls has prompted a range of policy responses from major economies. These responses vary in scope and ambition, but they share two overarching objectives: reducing exposure to China-centred supply chains and strengthening domestic or allied production capacity in critical sectors. While some measures focus on short-term crisis management, others aim to achieve longer-term structural diversification, technological upgrading, and strategic autonomy.

One of the most consequential diplomatic developments has been the moratorium negotiated between the United States and China to suspend certain export controls for one year. The suspension provides temporary relief but does not materially address the underlying structural tensions or the long-term trajectory of Chinese dominance over rare earth value chains. It nonetheless demonstrates that export controls have become significant bargaining instruments in U.S.-China relations and that China can use them to extract important strategic concessions.

Other strategies have been more structural. Japan offers one of the most notable cases of successful diversification. Following China's informal halt of rare earth exports to Japan in 2010, Tokyo implemented a comprehensive strategy to reduce its dependence on Chinese rare earths. This included investments in overseas mining projects, long-term offtake agreements, strategic stockpiling, advances in recycling technologies, research into substitution, and partnerships with resource-rich countries. As a result, Japan reduced its reliance on Chinese rare earth imports from around 90 per cent in 2010 to below 60 per cent by 2025 (Meredith and Butts, 2025). Japan's experience illustrates that diversification is possible but requires sustained investment, policy coordination, and technological innovation over the longerterm.

More recently, the U.S. has pursued an even more interventionist approach. Recognising the strategic vulnerabilities inherent in dependence on Chinese-controlled supply chains, Washington has taken direct stakes in critical mineral and technology firms. The acquisition of equity in domestic rare earth and battery producer Mountain Pass has enabled federal support for scaling up refining capacity and integrated battery manufacturing, while the establishment of a price floor for critical minerals aims to ensure long-term commercial viability for domestic producers (US–China Economic Security Review Commission, 2025). Earlier in 2025, President Trump also announced that he would take a stake in Intel as part of a broader effort to secure domestic semiconductor production capacity. These moves reflect an increasingly interventionist industrial policy that seeks to rebuild strategic industrial capabilities and reduce exposure to Chinese export restrictions and coercive leverage.

These policy responses must be understood against the backdrop of earlier disputes between China and its major trading partners over export restrictions. Already in the early 2000s, China introduced export controls on materials such as bauxite, fluorspar, coke, and certain rare earth elements. These measures triggered formal complaints at the WTO by the United States, the EU, and Japan.[17] The WTO DSB ultimately found the restrictions incompatible with China's obligations, concluding that Beijing's purported environmental and resource conservation justifications were pretextual and that the measures were designed to favour domestic industry. Yet despite these rulings, China did not abandon its resource strategy. Instead, it adjusted its approach by relying on alternative administrative mechanisms, such as licensing, approval-based quotas, and industry consolidation, to achieve similar outcomes while navigating WTO constraints.

A key example of this adaptation is the 2022 consolidation of China's largest rare earth producers into the state-owned China Rare Earth Group. This entity was tasked with coordinating export strategies, investment flows, and pricing behaviour across the sector (Vekasi, 2021). Consolidation not only strengthened state control over upstream extraction and midstream processing but also enhanced Beijing's capacity to influence global market prices and impose export controls more uniformly and effectively. This move illustrates how China has internalised lessons from the WTO disputes. By embedding control within domestic industrial structures, Beijing can shape export flows without relying exclusively on formal export restrictions.

4.2 Industrial subsidies and their effect on export industries

Subsidies are one of Beijing's most prominent instruments of economic and industrial governance. The Party's model relies on a blend of central planning and decentralised implementation to continuously mobilise resources towards politically prioritised sectors, particularly high technology, green industries, and defence-related production. Fiscal and credit policy are deployed not only for macroeconomic stabilisation, but also as tools of industrial planning and strategic upgrading (Box 3), a practice reflected in China's persistently rising indebtedness (section 3.1). Under Xi Jinping, these practices have been reinforced and linked under the rubric of 'new quality productive forces', which explicitly prioritises rapid technological upgrading even at the cost of efficiency and profitability (section 3.2).

17. China – Measures Related to the Exportation of Various Raw Materials (DS394); China – Measures related to the Exportation of Rare Earths, Tungsten and Molybdenum (DS431).

Over the past two decades, China's subsidy system has evolved into a vast and complex architecture. Subsidies flow through an array of channels, including direct cash transfers, tax benefits, subsidised credit, subsidised land allocations, and access to below-market-price energy (Garcia-Macia et al., 2025). These resources are often allocated through various layers, including state-owned banks, LGFVs, state-controlled investment funds, and opaque mechanisms such as preferential input pricing. While the central government defines strategic objectives, provincial and municipal governments compete intensely to attract investment and meet growth targets. The incentives created for provincial governments sustain China's investment-heavy growth model and exacerbate overall indebtedness (Pettis, 2025). They also explain why local governments account for a significant share of subsidies (Gunter et al., 2025; Boullenois et al., 2025).

Empirical evidence from the IMF (Garcia-Macia, et al., 2025) shows that subsidies are pervasive and structurally embedded. Total subsidies amounted to an estimated 4.4 per cent of GDP in 2023, placing China far above the OECD average. Cash subsidies account for the largest share, though their relative importance has declined, while corporate tax benefits have increased across all major supported industries, including semiconductors, technology hardware, automobiles, pharmaceuticals, biotech, and software and ICT. Private enterprises receive more cash subsidies and tax benefits relative to profits than SOEs, although SOEs, particularly centrally administered ones, benefit far more from subsidised loans. Land subsidies are also substantial: prices for manufacturing land are, on average, discounted by two thirds relative to land allocated to other industries.

Subsidies are generally associated with the misallocation of resources according to political rather than market principles. In China, subsidies exacerbate both cross-sector and within-sector misallocation, with the most significant distortions occurring between sectors, where subsidies prop up saturated or low-productivity industries. Industrial policy-induced misallocation is estimated to reduce aggregate TFP by 1.2 percentage points, of which 1.0 percentage point stems from between-sector distortions. Accounting for endogenous capital adjustment, this could imply a loss of up to 2 per cent of GDP (Garcia-Macia et al., 2025). Additionally, subsidies tend to favour well-connected firms rather than the most efficient ones, creating barriers to entry and reinforcing local protectionism. China's decentralised model amplifies this tendency as local governments allocate subsidies to local champions and then shield them from competition, producing overinvestment, overcapacity, and underutilised assets (Parikh, 2025).

Following 2014, China's imports of semiconductors by value exceeded its imports of oil. To address this dependency on foreign technology, the state launched the National Integrated Circuit Industry Investment Fund ('Big Fund') in 2014 with USD 20 billion, followed by a second round exceeding USD 30 billion in 2019 (OECD 2023). Hundreds of provincial and municipal industrial guidance funds complement the Big Fund's activities. Support spans research grants, tax reductions, subsidised land and electricity, and preferential procurement policies.

Mercator Institute for China Studies estimates that MIC 2025 could involve as much as USD 1.4 trillion in total support for the semiconductor industry. These efforts have produced significant results. Within five years, domestic production of semiconductors increased from under 10 per cent to an estimated 50 per cent of domestic demand. Although this still falls short of the MIC 2025 goal of 70 per cent, it represents substantial progress towards self-reliance (Hai, 2025; European Union Chamber of Commerce in China, 2023). China has achieved dominance in mature-node and legacy chips, which are widely used in automobiles, industrial equipment, and defence applications. Indeed, China has become an important global exporter of these chips.

However, these achievements reveal clear limitations. China remains heavily dependent on imports of high-end equipment and materials such as lithography tools and specialised chemicals. U.S. and allied export controls on these chokepoints have sharply constrained China's push for self-reliance at the higher end of the technology value chain. That said, recent evidence indicates that China is catching up quickly, especially with respect to Graphics Processing Units (GPUs) and integrated circuits applicable to AI inference. Indeed, China is today trailing closely behind the most advanced Western-designed GPUs.

The 15th Five-Year Plan commits further resources to propel China even higher up the value chain and increase industrial capacity in the most advanced technological sectors.

4.2.1 The effects of state subsidies on international trade

China's industrial subsidies have profound effects on global trade and competition. Subsidies create artificial cost advantages, particularly in downstream sectors (Ambaw and Thangavelu, 2022). According to the Kiel Institute, around 30 per cent of China's export value originates from heavily subsidised sectors (Bickenbach et al., 2024), while the IMF estimates that 77 per cent of exports are affected by industrial subsidies (Rotunno and Ruta, 2024). Subsidised firms tend to export more, at lower prices, and with higher market shares than competitors, without corresponding productivity improvements. In industries characterised by chronic overcapacity, such as steel, aluminium, photovoltaics, and electric vehicles, the effects are especially pronounced. Chinese exporters reduce global export prices by between 10 and 20 per cent, squeesing margins for foreign producers. Consequently, industrial subsidies are estimated to account for more than half of the increase in the EU's trade deficit with China since 2018 (Bickenbach et al., 2024; Gunter et al., 2025).

Box 3. Examples of industrial subsidies

Photovoltaics and wind power: China now accounts for more than 80 per cent of global solar panel production. Subsidies have led to global price suppression and substantial overcapacity. Chinese prices today are 40–50 percent lower than European manufacturers' production costs (IEA, 2026; Gunter et al., 2025). Subsidies in the solar and wind industries are estimated to have increased China's market shares rather than improved productivity (OECD, 2025).

Electric vehicles and batteries: China's EV sector has been built through a combination of direct subsidies, tax exemptions, and state-backed credit. According to MERICS, tax exemptions for EV purchases between 2024–2027 amount to CNY 520 billion in total, equivalent to more than 0.3 per cent of China's GDP. These subsidies have resulted in substantial overcapacity, price compression, and aggressive export expansion (Gunter et al., 2025).

Semiconductors: The semiconductor sector is one of the most heavily subsidised industries globally. In China, the state-run Big Fund has invested more than USD 200 billion since 2014. Although productivity effects have been limited, market shares for subsidised firms have steadily increased – a pattern characteristic of state-directed capital allocation (OECD, 2025; Boullenois et al., 2025).

China's export surge in electric vehicles illustrates these dynamics clearly. Between 2020 and 2024, Chinese EV exports increased by more than 600 per cent, while domestic demand stagnated. Exports to the EU quadrupled and reached over 55 per cent of all EU EV imports in 2024, coinciding with an expansion of provincial EV subsidy programmes in Anhui, Jiangsu, and Guangdong (Boullenois et al., 2025). Similar dynamics have been observed in the photovoltaic sector, where Chinese firms, backed by central and local subsidies, now control more than 80 per cent of the EU's solar

supply chain (IEA, 2026). This pattern feeds into structural overcapacity in strategically prioritised sectors, where subsidised industrial expansion generates surplus output that is then offloaded onto global markets (section 3.2.4). This simultaneously depresses world prices, undermines foreign competitors, and reinforces China's technological dominance in strategic sectors.

4.2.2 WTO compatibility

Subsidies are regulated at the WTO level through the Agreement on Subsidies and Countervailing Measures (ASCM). Under Article 1, a subsidy must involve a financial contribution by the state or a public body and confer a specific benefit. Export-contingent or local-content-contingent subsidies are prohibited (Art. 3 ASCM), while other subsidies are actionable if they cause injury to another WTO member's domestic industry (Art. 5 ASCM).

Although most of China's subsidies fall under the ASCM definition, the framework's practical reach is limited. A central issue is the definition of what constitutes a public body, which has been contested in disputes concerning SOEs, state investment funds, and state-owned banks.[18] WTO jurisprudence requires evidence of meaningful government control,[19] creating a grey zone for entities that are formally commercial but politically guided, such as firms with embedded Party committees or those operating under state-directed credit flows (Bown and Hillman, 2019). Moreover, China's subsidy practices increasingly operate outside the scope of the WTO regime. Support is often funnelled through local governments, state banks, and industrial guidance funds, many of which lack clear disclosure obligations. WTO subsidy rules have struggled to discipline such indirect and opaque forms of state support. As a result, the EU, U.S., and Japan have initiated discussions on updating global subsidy rules to better address support to state-linked firms and systemic distortions.

For a WTO member to impose countermeasures, the support must also be quantifiable. As shown in previous sections, Chinese subsidies take both financial forms, such as credits, guarantees, write-offs, and tax concessions, and non-financial forms, such as access to land, energy, or other inputs at low prices, or preferential treatment in public procurement. Many of these forms of support are difficult to quantify, not least because China's economy in many areas lacks reliable market prices that are required as reference points. The OECD further estimates that only 15–20 per cent of Chinese subsidies are formally budgeted, while the remainder consists of tax exemptions or preferential credit (OECD, 2025).

To fall under the ASCM, the subsidy must also be specific within the meaning of Article 2, that is, directed at a limited number of firms, sectors, or regions. China's support measures can be described as broad in scope but targeted in effect, which makes it difficult to determine whether a given subsidy meets this criterion (IMF, 2024).

Zhou and Fang (2021) note that many of the problems identified in the application of the WTO's subsidy rules are general in nature and apply to all members. In other words, the insufficiency of WTO rules to effectively address industrial subsidies is systemic rather than China-specific. As discussed in previous chapters, China generally seeks to design its policies in accordance with WTO rules and jurisprudence. This should not, however, be seen as a genuine effort to comply with the spirit of the multilateral trading system, but rather as an effective utilisation of existing shortcomings and loopholes in WTO rules.

18. For example, US – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China (DS379); US – Countervailing Duty Measures on Certain Products from China (DS437)
19. Appellate Body Report, US – Countervailing Duty Measures on Certain Products from China, WT/DS437/AB/RW (adopted Aug. 15, 2019), [5.103].

What makes China particularly difficult to address, however, is the overall lack of transparency. Under Article 25 ASCM, WTO members are required to notify all subsidy programmes. China's notifications, by contrast, are irregular, and concerns have been raised regarding their completeness (Chimits, 2023). This lack of transparency is not incidental but constitutes a deliberate feature of China's governance model, in which flexibility and secrecy are considered to give the Party a strategic advantage (Gunter et al., 2025). For other members, this significantly complicates meeting the high evidentiary burden under the ASCM and limits the ability to justify countermeasures.

Overall, the Chinese subsidy model is, by its nature, difficult to capture within the ASCM, which was designed for market economies. Decisions on support are not taken within individual ministries, but within a party-state ecosystem in which the CCP, state and local authorities, and both state-owned and private enterprises interact. It therefore often becomes unclear who the responsible subsidy-granting authority is within the meaning of the ASCM (Bickenbach et al., 2024; Boullenois et al., 2025). Despite the clearly trade-distorting effects of China's industrial subsidies, they are difficult to address within the WTO framework.

4.3 Government procurement

Another area used strategically to advance the CCP's technological policy objectives is public procurement. Through a combination of the central 'Buy Chinese' programme, local content requirements, including domestic innovation, and designated supplier catalogues, the Party-state uses public procurement to favour Chinese firms, promote technological self-sufficiency, and control market access for foreign market participants.

China is not yet a party to the WTO Government Procurement Agreement (GPA), which gives the country considerable leeway to formally prioritise domestic suppliers in state procurement. The legal basis is found in the Government Procurement Law,[20] which stipulates that, under equal conditions, preference must be given to goods and services of domestic origin (Article 10). The Tendering and Bidding Law[21] requires non-discriminatory procurement procedures and suggests that no explicit advantage can be granted to domestic producers. However, since 2025, 'domestic' products have enjoyed a price advantage of up to 20 per cent of the bidding price[22], which in practice favours domestic participants in procurement processes.

To qualify for a price evaluation advantage as 'domestic', products must fulfil three cumulative conditions:

1) localisation of key components and production processes

2) final assembly in China

3) verifiable domestic content in accordance with established standards.

The stated purpose is to reduce regional protectionism, harmonise classification criteria, and create more predictable rules, but the effect is simultaneously to systematically prioritise domestic innovation and R&D activity within China (Zhou, 2025).

These practices build on earlier institutional developments under the Medium- to Long-Term Plan for Science and Technology (2006–2020) (section 3.2). The concept of

20. Government Procurement Law of the People's Republic of China (2002).
21. The Bidding Law of the People's Republic of China (1999).
22. General Office of the State Council on government procurement, Notice on the implementation of national product standards and related policies, Guo Ban Fa [2025] No. 34, September 2025.

'indigenous innovation', which featured prominently in the plan, was initially implemented largely at the local level. Provincial and municipal governments played a central role in operationalising the policy by issuing their own indigenous product catalogues. The main benefit of obtaining indigenous product certification was preferential treatment in government procurement. Because very few products produced by foreign-owned firms received certification, the programme was skewed from the outset in favour of Chinese-owned firms. Moreover, reflecting China's decentralised governance model, many provinces and municipalities, often financially invested in their own local industries, used the certification systems not only to exclude foreign products but also to disadvantage products originating from other provinces in order to favour local firms (CBR, 2010). This created an additional layer of fragmentation and discrimination within China's procurement landscape.

In practice, the new procurement guidelines amount to an institutionalisation of 'Buy Chinese' as an innovation policy tool. By linking preferential procurement treatment to the localisation of critical components and production processes, and indirectly to domestic innovation and intellectual property, the state creates guaranteed demand for strategic technologies, such as digital infrastructure, batteries, electric vehicles, and advanced manufacturing. International companies without production or R&D activity in China become less competitive on the Chinese market as a result. To compete for major contracts, foreign suppliers increasingly need to localise critical production steps in their value chain as well as research capacity within China. As discussed in the following section, this may involve direct or indirect requirements for technology transfer.

Since 2009, the Indigenous Innovation Catalogue has served as a formal instrument for identifying products and firms eligible for procurement based on domestically developed technology. Firms with foreign ownership or R&D conducted outside China have generally been excluded (Baark et al., 2021). In addition, preference scoring is used in evaluation processes, favouring companies with Chinese intellectual property, local R&D, and in some cases an established Party committee within the company leadership. Local quotas further ensure that a certain share of procurement volume is allocated to small and medium-sized domestic enterprises.

Discrimination does not, however, arise solely against foreign firms. At the provincial level, preference is often given to local firms in which provincial governments and other local actors may have financial interests (Tang, 2025). China's decentralised governance system therefore creates additional barriers for foreign companies and intensifies intra-national protectionism, inadvertently reinforcing industries prone to overcapacity.

The 2025 guidelines therefore reinforce China's broader strategy of tying market access to technological localisation, which aligns with the objective of reducing dependence on foreign technology. This logic is central to the country's Dual Circulation Strategy, under which foreign technology is expected to be gradually replaced with domestic alternatives as soon as China can produce equivalent technology at home (Garcia Herrero, 2023). Public procurement thus becomes an important mechanism for accelerating this substitution process by ensuring stable domestic demand for Chinese-made technologies.

It is also a central component of China's agenda for 'new quality productive forces', namely the use of public demand to build technological autonomy in critical sectors such as AI, 6G, cybersecurity and green energy (Gunter et al., 2025). Public procurement therefore functions as an indirect subsidy mechanism that guarantees market access for state-prioritised technologies while limiting effective competition from foreign suppliers. The purpose of these measures is to ensure a stable domestic demand base as the foundation for technological upgrading. Procurement is therefore not used solely to improve the efficiency of public purchasing, but as a policy instrument to shape and consolidate entire value chains within strategic industries.

4.4 Technology transfer

Technology transfer has always been central to China's industrialisation strategy. In the early stages, the priority was to absorb Western technology through foreign direct investment (FDI), licensing agreements, and joint development projects to secure economic growth. Under Xi Jinping, policy has gradually shifted from a model emphasising integration into global value chains to one aimed at achieving technological independence and strategic control over critical technologies. Technology transfer has, however, always functioned as an instrument of state-directed innovation policy rather than emerging as a natural market-driven outcome. The explicit political objective is to build domestic technological capacity and reduce dependence on foreign actors in sectors deemed strategically sensitive.

The legal framework governing technology transfer in China consists of several overlapping laws and regulations that govern both the import and export of technology, as well as the conditions for technology transfer in the context of foreign investment. The Technology Import and Export Regulations classify technologies as freely exportable, restricted, or prohibited, thereby shaping both inflows and outflows of technology. A 2019 reform formally abolished the provisions that had previously required foreign companies to license technology to Chinese partners on non-exclusive terms. Article 22 of the Foreign Investment Law also prohibits administrative bodies from coercing technology transfer, thereby codifying principles long requested by the EU and the United States.

In practice, however, indirect technology transfer requirements persist. Rather than using formal coercion, local authorities and state-owned enterprises frequently negotiate conditional incentives, offering tax reductions, subsidies, or market access in exchange for companies establishing joint R&D, sharing technology, or localising engineering activities, especially in sectors such as electric vehicles, semiconductors, and biotechnology. A growing number of EU firms operating in China report that political considerations influence decisions to localise R&D or transfer technology to Chinese partners (European Union Chamber of Commerce in China, 2023). For Swedish firms, market conditions create incentives to localise production and product development in China, although localisation of R&D remains comparatively rare, particularly in industrial manufacturing (Business Sweden, 2025).

Until recently, foreign firms in key sectors such as automotive, rail, and ICT were required to form joint ventures, often capped at 49 per cent foreign ownership, with domestic partners. Regulators frequently conditioned joint-venture approvals on local content requirements or the disclosure of proprietary technologies. The USTR's 2018 investigation documented how China 'uses foreign ownership restrictions, such as joint venture requirements, to require or pressure technology transfer from U.S. companies,' even when such requirements were not explicitly written into law. Foreign firms often reported that sharing know-how was necessary to retain market access. This practice has been widely criticised by the US and EU as contrary to WTO principles that prohibit conditioning market access on technology transfer. Although Beijing agreed in the 2020 Phase One deal to refrain from forced technology transfers, enforcement remains difficult, and China often presents such transfers as voluntary commercial arrangements, even though affected companies consistently describe pervasive political and administrative pressure.

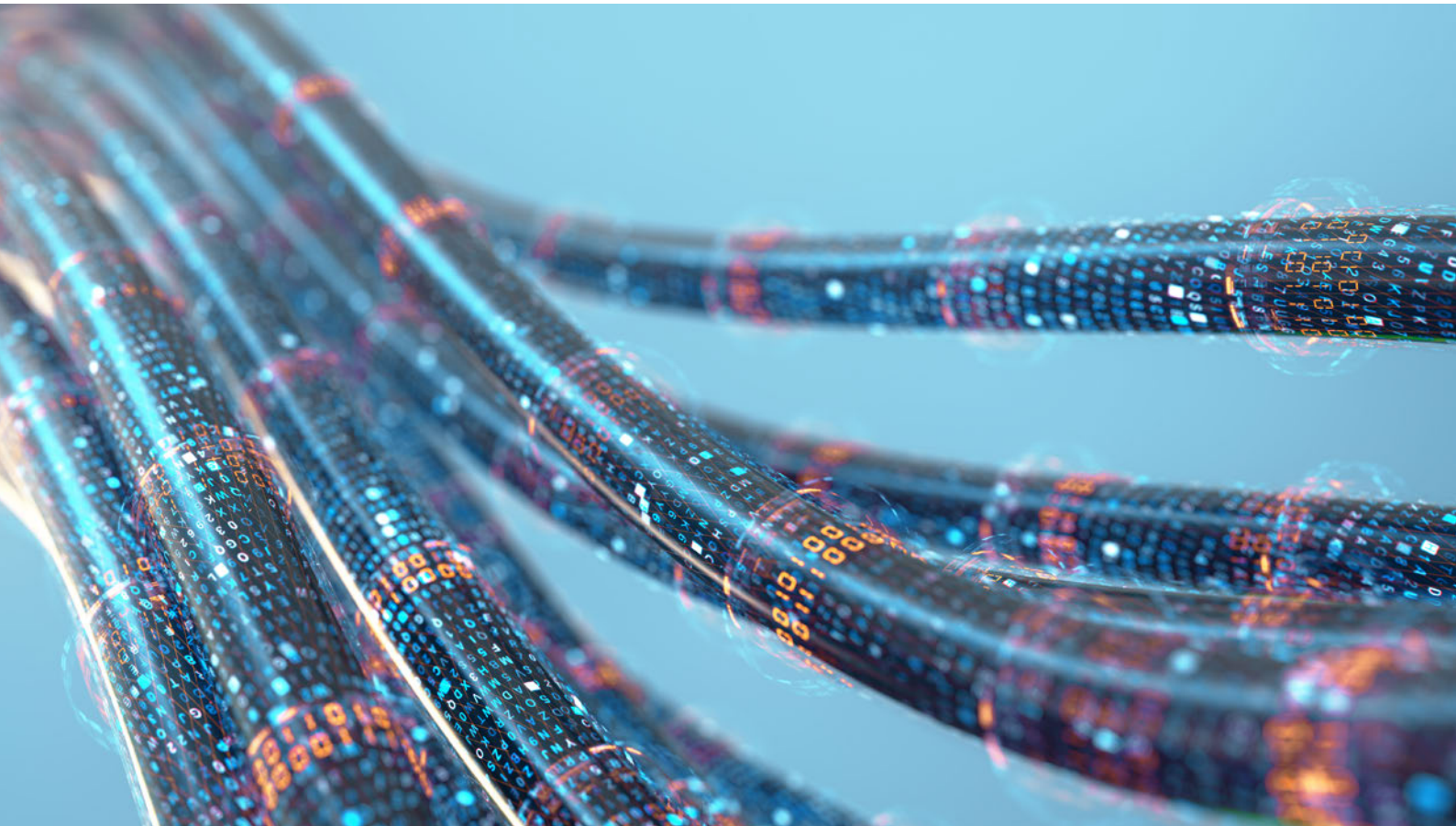
Moreover, technology transfer has at times been driven by China's broader geopolitical and industrial strategies. Following China's rare earth embargo on Japan in 2010, Japanese firms increased investment in magnet production through joint ventures in China to avoid future supply disruptions. While this approach mitigated short-term

vulnerability, it also enabled Chinese joint-venture partners to learn and internalise more advanced Japanese manufacturing technologies, contributing to China's current dominant position in permanent magnet production (Yang, 2025).

China's technology-transfer strategy is closely linked to its broader innovation policy, which rests on a dual logic of absorption and substitution. In the early phase, foreign technology is used to rapidly build industrial capacity (Prud'homme et al., 2018). Once the technology has been internalised, foreign suppliers are gradually replaced by domestic actors, facilitated by preferential treatment for Chinese technology and innovation in public procurement. This logic was evident as early as 2006 with the revival of industrial policy: unless products were certified as 'indigenous products' under the Medium- to Long-Term Plan for Science and Technology (2006–2020), foreign firms were effectively excluded from procurement. Crucially, obtaining certification required companies to register trademarks and other IP in China, which, in combination with insufficient IP protection, created risks of further technology leakage to Chinese industry.

China's approach to IP protection and competition policy has also played a role. Chinese courts have issued anti-suit injunctions to prevent foreign patent holders from enforcing their rights abroad when their cases target Chinese firms, prompting an EU WTO complaint in 2022. This is widely viewed as a means of shielding domestic firms from legitimate IP enforcement actions and adds to broader concerns about China's strategic use of legal institutions to support industrial upgrading.

Alongside formal and informal transfers, illicit means have also been reported. Officials from the Five Eyes intelligence alliance have described Chinese state-sponsored IP theft, via hacking and economic espionage, as occurring on 'an unprecedented scale in human history,' affecting sectors ranging from aviation to biotechnology. U.S. agencies have accused China of cyber intrusions aimed at stealing commercially sensitive technologies aligned with China's industrial policy priorities. These activities have been condemned as circumventing the high costs of domestic R&D, prompting Western governments to



tighten investment screening, enhance cybersecurity requirements, and prosecute espionage cases. China denies such accusations and describes them as politically motivated, but the consistent alignment of high-profile cyber intrusions with strategic industrial targets has fuelled growing mistrust.

China's technology-transfer model is firmly embedded in national programmes such as MIC 2025, the National Medium- and Long-Term Plan for Science and Technology Development (2021–2035), and the 14th Five-Year Plan, and is also reflected in the Military-Civil Fusion strategy. These programmes induce institutional arrangements that make it rational, if not necessary, for foreign firms to localise technical expertise and intangible assets in China.

Within local industrial clusters, municipal authorities combine the implementation of central policy goals with regional development strategies, effectively making technology transfer an embedded condition in regional industrial programmes. In strategic sectors such as semiconductors and batteries, local governments have increasingly begun to require joint patent ownership or shared research results as a condition for access to financing or industrial park agreements (Boullenois et al., 2025).

In recent years, this has produced a more asymmetric regulatory environment in which China increasingly restricts the export of technology and data while simultaneously encouraging inflows of foreign expertise. This has resulted in a one-directional structure in which foreign firms are expected to localise technical know-how in China, while Chinese technology exports are subject to stringent controls (see also section 2.5).

China's approach to technology transfer has been repeatedly criticised within the WTO and by major trading partners. WTO rules are weak when it comes to addressing informal technology-transfer requirements. Article 3 of the TRIMS Agreement prohibits local-content requirements, and Article 40 of the TRIPS Agreement prohibits abuses of intellectual property rights. Joint-venture requirements fall outside the scope of WTO rules; licensing of technology in such structures is typically contractual rather than legally mandated. The CCP has therefore successfully shifted technology transfer from the legal to the institutional sphere, where state incentives and administrative processes can shape corporate behaviour without formally violating WTO rules.

4.5 FDI

China's FDI regime functions as a core instrument of its broader political-economic strategy, combining selective openness with targeted control to channel capital and technology into sectors aligned with state priorities. Foreign investment is frequently tied to localisation requirements, including R&D activities and knowledge transfer, with the explicit objective of strengthening China's domestic innovation base. At the same time, investment is restricted in sectors where foreign participation is deemed to threaten national security, economic stability, or core political interests. Rather than facilitating market opening, the FDI regime operates as a calibrated filter that directs foreign capital towards strategically prioritised sectors while preserving state control over critical industries (Breslin, 2025; US Department of State, 2025).

This dual structure has evolved over time. Following the initial opening to foreign investment in the 1980s, when projects were subject to case-by-case Party approval, China introduced a more formalised system in the mid-1990s through sectoral catalogues classifying investments as encouraged, restricted, or prohibited (UNCTAD, 2022). While this framework enabled significant inflows of capital, particularly into manufacturing, it maintained strict limits in strategic sectors. Joint-venture

requirements in industries such as automotive manufacturing facilitated technology transfer to domestic firms, while heavy industry and upstream sectors remained protected through a combination of market barriers and state-directed investment.

These dynamics persist in updated form. Inbound investment in sectors such as critical raw materials remains tightly controlled, complementing export restrictions on rare earths and associated processing technologies (section 5.1). Together, these measures allow China to retain its dominant position in extraction and processing while managing the diffusion of relevant technologies both domestically and along the BRI. More broadly, foreign capital is permitted where it contributes to technological upgrading, but constrained where it risks diluting domestic control. While sectors such as green energy, advanced manufacturing, and parts of the digital economy have undergone partial liberalisation, areas including data governance, defence, critical infrastructure, and natural resources have become increasingly restrictive, particularly in response to geopolitical tensions.

The adoption of the Foreign Investment Law[23] in 2020 consolidated the legal framework governing inbound investment, introducing formal principles of national treatment, a negative-list approach, and a prohibition on administratively mandated technology transfer. While these provisions bring China's regime closer to international standards in formal terms, implementation remains highly politicised. Approval processes at both central and local levels continue to be shaped by strategic considerations rather than purely economic criteria (Boullenois et al., 2025).

The negative list has gradually been shortened, formally opening large parts of manufacturing to foreign ownership. At the same time, the Catalogue for the Encouragement of Foreign Investment (CEFI), [24]which now includes more than 1,000 sectors, has been expanded, with a strong focus on advanced manufacturing, energy transition technologies, digital services, and logistics. Approximately 40 per cent of inbound FDI between 2019 and 2024 has been directed towards sectors linked to batteries, electronics, and green technologies (Boullenois et al., 2025). As part of the implementation of the Dual Circulation Strategy, MOFCOM introduced measures in 2021 to facilitate foreign investment in higher segments of technology value chains.[25] Restrictions for foreign investors were reduced in sectors listed in the Catalogue of Encouraged Industries for Foreign Investments (2020 Version),[26] including advanced manufacturing, emerging technologies, and energy-saving and environmental protection industries. These developments suggest increasing openness, but in practice reflect a strategic effort to support vertical integration and technological upgrading in line with initiatives such as MIC 2025 and the Dual Circulation Strategy (Garcia Herrero, 2022).

In practice, foreign investment remains closely conditioned. Firms that localise production, research, or design activities benefit from preferential access to credit, tax incentives, and administrative support, while also being integrated into domestic supply chains. Even in sectors formally open to wholly foreign-owned enterprises, de facto control is often maintained through licensing regimes, technical standards, and procurement practices. Local and provincial governments reinforce this dynamic

23. Foreign Investment Law of the People's Republic of China (2002).
24. NDRC, 'Announcement on soliciting opinions on the Catalogue of Industries Encouraging Foreign Investment' (20 december 2024).
25. MOFCOM, 'Notice of the Ministry of Commerce on Focusing on Constructing the New Development Pattern and Doing a Good Job of Stabilising Foreign Investment' (商务部关于围绕构建新发展格局 做好稳外资工作的通知), 25 February 2021.
26. NDRC and MOFCOM, Catalogue of Industries Encouraged for Foreign Investment (2020 Version).

through targeted incentives, including subsidies and co-financing via industrial guidance funds, competing to attract technologically significant projects. FDI promotion thus operates less as a mechanism for market efficiency and more as a tool for technological absorption, embedding foreign firms within China's industrial upgrading strategy.

Investment restrictions play a complementary role. The Measures for the Security Review of Foreign Investment cover sectors such as energy, data, infrastructure, and advanced technologies, requiring review of transactions that may affect national security (Zhang, 2022). In practice, these reviews also shape ownership structures and operational conditions, often encouraging joint ventures or requiring the disclosure of data and technological know-how. While formal joint-venture requirements have been relaxed, they remain prevalent in practice.

Conditionality can also take indirect forms. The approval of Tesla's wholly owned manufacturing facility in Shanghai, for example, was reportedly contingent on sourcing a substantial share of inputs locally. This requirement necessitated the transfer of technical specifications to domestic suppliers, upgrading the capabilities of China's supply chain and benefiting local competitors. Such arrangements illustrate how FDI can facilitate technology diffusion in strategically important sectors, consistent with broader theories of developmental state-led industrialisation.

Outbound investment further complements this framework. Chinese firms have used overseas investments to secure access to raw materials, markets, and technology, particularly across Southeast Asia, Africa, and Latin America (Sandklef, 2018; Garcia Herrero, 2023). BRI-related investments have strengthened logistical connectivity and expanded China's access to critical inputs, while embedding infrastructure and production networks within Chinese-led systems. At the same time, acquisitions in advanced economies have historically enabled Chinese firms to access foreign technology and intellectual property, although such flows have declined in response to increased investment screening in the EU and the United States (Meyer and Kratz, 2025).

Recent export controls on technologies related to batteries and critical materials further reinforce this outward strategy. By restricting the export of key technologies and industrial equipment, China can maintain control over strategic segments of value chains even when production is located abroad (Gherke and Oertel, 2025). This ensures that overseas manufacturing remains dependent on Chinese inputs, technology, or regulatory approval.

Taken together, China's FDI regime operates as an extension of its industrial and technological strategy. Inbound investment is selectively encouraged to support domestic upgrading, while restrictions preserve control over critical sectors. Outbound investment secures access to inputs and expands China's global industrial footprint. Combined with export controls and subsidies, FDI policy forms a central pillar of China's economic security architecture, ensuring that capital flows, technological development, and supply chain integration remain aligned with the strategic objectives of the Party-state.

4.6 Interim conclusion: trade and investment as political leverage

China's trade and investment policy is an integral component of a broader party-state-led strategy aimed at technological upgrading, economic security, and the reconfiguration of the global economic order. Across export controls, subsidies, technology transfer, public procurement, and investment regulation, a consistent logic emerges: economic openness is maintained where it serves domestic development, but systematically shaped to reduce external dependencies and create asymmetric interdependence.

For the European Union, this implies that trade relations with China cannot be assessed through the lens of conventional trade policy. Many of the observed distortions, most notably persistent overcapacity and resulting price pressures, are either intended or inevitable consequences of China's growth model rather than temporary structural imbalances. China's position in critical supply chains creates dependencies with increasing economic and security implications, which can no longer be separated from trade policy concerns.

Effective EU policy therefore requires an integrated approach that goes beyond traditional trade defence. It must combine defensive instruments with measures to strengthen domestic industrial capacity, diversify supply chains, and manage strategic dependencies.

5 Conclusions and policy recommendations

Underlying the following policy recommendations is a broader structural shift in the relationship between economic efficiency, resilience, and security. For decades, European economic policy largely operated on the assumption that market integration and efficiency maximisation would also produce resilience and stability. Increasing geopolitical fragmentation, strategic dependencies, and the growing use of economic instruments for political purposes have challenged this assumption (Lenk, 2026).

In an increasingly contested global economy, markets do not necessarily price systemic vulnerabilities, concentration risks, or exposure to economic coercion adequately. As a result, resilience, diversification, and security increasingly carry economic value in their own right, even where they may imply higher short- to medium-term costs or reduce economic efficiency. The central policy challenge is therefore no longer simply determining what markets can deliver autonomously, but identifying where targeted policy intervention becomes necessary to safeguard long-term competitiveness, resilience, and strategic autonomy.[27]

This shift does not imply a rejection of openness or market-based economics. Nor does it justify broad-based protectionism or economic decoupling from China. Rather, it requires a more differentiated and strategic approach in which openness is preserved where economically beneficial, while vulnerabilities linked to systemic dependencies and strategic sectors are managed more actively. In this context, effective policy towards China requires not primarily stronger defensive instruments, but a clearer understanding of when markets function efficiently, where strategic distortions emerge, and how different policy tools should be coordinated to address them.

5.1 Monitor

EU policy must be grounded in an understanding of, and differentiation between, the structural drivers of China's growth model and their external effects on global trade and development. Industrial overcapacity is not a temporary imbalance but a persistent structural feature, spanning entire value chains and reinforced by domestic incentives, state-directed finance, and industrial policy. As domestic demand remains constrained, excess production is increasingly channelled into global markets. While access to EU and US markets may tighten, exports are redirected towards third markets, reshaping competition, supply chains, and technological ecosystems in ways that directly affect Swedish and European firms. Effective policy therefore requires improved monitoring of both upstream policy signals in China and downstream effects in global markets.

Monitoring should not be limited to the effects of Chinese overcapacity on the EU internal market. Competitive pressures increasingly materialise in third markets, where redirected Chinese exports may displace European firms, weaken market positions, and erode long-term industrial competitiveness globally. Monitoring frameworks should therefore assess both internal market impacts and the external competitive position of European industries across strategically important regions and value chains.

Monitoring should not, however, function as a purely analytical exercise. On the contrary, insights generated through trade, industrial, and economic security monitoring should be systematically integrated into operational decision-making, including trade defence, procurement, industrial policy, investment screening, and competitiveness

27. National Board of Trade (2025) Tools for Resilient Supply Chains: An overview of EU policy.

assessments. This will allow EU institutions and member states to shift more effectively from reactive policy instruments to a system-level strategy that anticipates how China's domestic policies translate into global market outcomes, with a focus on emerging and strategic sectors.

In particular:

- **The EU and its member states should strengthen their analytical capacity to systematically monitor and interpret Chinese industrial policy developments**. This is necessary because policy signals embedded in Five-Year Plans, sectoral strategies, and provincial implementation measures provide early indications of future capacity expansion and potential market distortions. While the European Commission, national authorities, and institutions such as the European External Action Service and various think tanks already analyse aspects of China's policy framework,[28] these efforts remain fragmented and insufficiently integrated into trade and industrial policy decision-making. Existing monitoring mechanisms could be improved through better coordination, centralisation of analysis, and closer linkage to operational policy tools, rather than requiring entirely new institutions. Strengthening this capacity would enable earlier, more targeted, and coordinated responses to emerging distortions rooted in China's policy-driven expansion.
- **The EU and its member states should develop a more systematic and granular framework to monitor the effects of Chinese overcapacity on European markets**, including both direct impacts on EU producers and indirect effects on downstream industries reliant on Chinese inputs. The Commission already monitors potentially harmful import surges due to trade diversion[29], with most registered cases relating to imports from China. Overcapacity does not, however, manifest only through import surges, but also through price suppression and shifts in input costs that affect competitiveness across entire value chains. Existing tools, such as trade defence investigations, sectoral studies, and the SCAN dashboard[30], provide important insights but are typically reactive, case-specific, and insufficiently forward-looking. Furthermore, risk assessments in many critical fields already exist or are currently being produced.[31] These mechanisms could be enhanced by integrating real-time trade data, firm-level information, and value-chain analysis into a more comprehensive and continuous monitoring system, without requiring fundamentally new instruments. Such an approach would allow policymakers to better capture the full economic impact of China's overcapacity and align responses with its systemic nature.
- **The EU and its member states should systematically assess third-country spillover effects of Chinese overcapacity, with particular focus on trade deflection resulting from the closure or restriction of major markets such as the United States**. This is necessary because Chinese exports diverted away from constrained markets are increasingly redirected towards third countries, often those with which the EU has trade agreements, thereby intensifying competitive pressure on European firms in external markets. The Commission already monitors some effects on trade diversion. However, this mechanism captures only import surges into the EU

28. e.g. Commission Expert Group on trade and investment relations with China
29. Monitoring trade diversion - Trade and Economic Security.
30. European Commission – SCAN Dashboard on product-level distress in selected supply chains.
31. C(2023) 6689 final, European Commission recommendation on critical technology areas for the EU's economic security for further risk assessment with Member States, 3 October 2023.

and remains country -agnostic.[32] In addition, impact assessments in the context of trade policy and free trade agreements provide important insight into the economic effects of the EU's large trade network.[33] Separately, these frameworks do not sufficiently capture dynamic trade deflection effects or their implications for EU global competitiveness. The insights gained could be strengthened through closer integration of trade flow analysis, partner country data, and a country-specific focus on China to provide a more systematic approach to monitoring trade deflection. This would allow the EU and Sweden to anticipate shifts in global competition and respond more effectively to the externalisation of China's overcapacity.

5.2 Categorise

Effective EU policy towards China requires a clear differentiation between economic challenges, economic security risks, and national security concerns. These categories increasingly overlap but remain analytically distinct. China's economic model blurs these boundaries by combining industrial policy, technological development, and strategic objectives, which complicates the application of policy instruments. A structured approach to categorisation is therefore essential to ensure that the appropriate tools are applied to the appropriate problems.

Preserving clear functional distinctions between policy instruments remains essential. Trade defence instruments should address market distortions, economic security instruments should mitigate strategically relevant dependencies and coercion risks, and national security tools should remain reserved for clearly defined security threats. Blurring these boundaries risks undermining legal certainty, weakening policy credibility, and encouraging both over-securitisation and disguised protectionism. The EU's geoeconomic toolbox already includes a wide range of instruments to address many of these challenges, but their application lacks a unified analytical framework. These mechanisms could be improved through the development of common criteria and clearer guidance at EU level. A more precise categorisation would enable the EU to better align various instruments and respond more effectively to the multifaceted challenges posed by China's state-driven economic model.

- **The EU should develop and apply EU-wide criteria for assessing systemic dependency risks across sectors and value chains**. This is necessary because not all dependencies are strategically relevant, yet some, particularly in critical inputs and dual-use technologies, can be leveraged for political or economic coercion. Existing efforts, including work under the European Economic Security Strategy[34] and sector-specific initiatives such as the Critical Raw Materials Act, provide a foundation, but remain partial and sector-specific. These frameworks could be strengthened by integrating criteria such as supply concentration, substitutability, and exposure to coercion into a consistent cross-sectoral methodology. Such an approach would allow the EU to better identify where China's structural position in global value chains translates into strategic leverage, and where interdependence remains economically beneficial.

32. Monitoring trade diversion - Trade and Economic Security.
33. European Commission - Impact Assessments.
34. JOIN(2025) 977 final, Joint Communication of the European Parliament and the Council on Strengthening EU Economic Security, 3 December 2025.

5.3 Respond

EU policy responses must reflect the structural nature of China's economic model, in particular the persistence of overcapacity and state-driven market distortions. While the EU possesses a broad set of policy instruments, their effectiveness depends on how they are applied, coordinated, and aligned with clearly defined objectives. The challenge for the EU, however, is not only to respond to existing overcapacity, but to anticipate how China's industrial policies may shape future technological ecosystems and global market structures.

The Commission's economic security strategy already calls for a 'more strategic and assertive use of the Union's tools – complementing their original policy objectives – to support Europe's economic security.'[35] It remains questionable how this would be achieved without broader reforms. Existing trade defence instruments are, by design, reactive and narrowly scoped. Rather than tackling the structural root problem of industrial overcapacity, they are necessary and effective in addressing its symptoms, namely its effects on global trade and competitiveness. In addition, trade defence instruments each retain important weaknesses (see Annex III). Anti-dumping and anti-subsidy investigations are lengthy. Their price effect on Chinese exports is often limited, not least because the undervalued renminbi practically offsets export price increases. Safeguard measures are, by design, non-discriminatory and are therefore ill-suited to address sustained structural overcapacity, a country-specific feature of the Chinese growth model.

Nonetheless, existing tools should be employed more strategically and coherently before the toolbox is expanded further. Existing trade defence instruments (e.g., anti-dumping, anti-subsidy, safeguard measures) are well established and legally robust, which is an advantage in itself. Additionally, the EU has already added several instruments to its geoeconomic toolbox (e.g., Foreign Subsidy Regulation, International Procurement Instrument, and Anti-coercion Instrument). These need to be tried and tested before being adjusted or expanded.

In particular:

- **The European Commission should apply trade defence instruments in a more integrated and forward-looking manner**. This can be achieved without fundamental legal changes. On the one hand, investigations could apply broader analytical frameworks that assess injury across value chains, including the effects of persistent excess capacity, subsidised inputs, and state-directed expansion in upstream and adjacent sectors. Such assessments could examine cumulative impacts on prices, investment, capacity utilisation, profitability, and technological upgrading throughout the value chain, thereby capturing systemic distortions that may not be apparent in product-specific investigations. This is necessary because China's overcapacity often spans complex value chains. Distortions are not always adequately captured through product-specific or case-by-case investigations. On the other hand, the monitoring recommended above could provide important data that would allow sectors prone to overcapacity to be identified early and import surges to be detected swiftly, minimising the length of investigations, making trade defence instruments more dynamic, and allowing the Commission to increase self-initiated investigations.

35. Ibid.

- **The EU should use economic security instruments in a targeted and proportionate manner, ensuring that they are reserved for clearly defined risks**. This is necessary to preserve legal certainty, maintain credibility, and avoid the expansion of security tools into areas more appropriately addressed by trade or industrial policy. The upcoming assessment of the effectiveness of the Trade Defence Instruments toolbox could provide important insight into the potential to further align trade and economic security policy objectives.[36] It is important, however, that while the effect of trade defence instruments could be further improved if they are coordinated with economic security and industrial policy instruments, especially where competitiveness and economic security concerns overlap, these objectives should not converge. A disciplined use of economic security tools ensures that responses to China's strategic behaviour remain effective without undermining the openness of the European economy.
- **The EU and member states should continue to explore the development of a dedicated instrument designed to address structural and persistent market distortions that are insufficiently captured by existing trade defence instruments**. Given the remaining gaps and weaknesses of traditional anti-dumping, anti-subsidy, and safeguard measures (Annex III), they are less suited to addressing system-wide overcapacity resulting from China's economic model. Discussions should in particular focus on persistent excess capacity, cumulative distortions across interconnected sectors, and market disruption linked to systemic state intervention, while preserving proportionality and compatibility with the broader rules-based trading system. It is important, however, that any instrument designed for such purposes remains targeted rather than sweeping, and is deployed only as a complement to existing trade defence instruments.
- **The EU should strengthen the strategic use of FDI screening and related instruments to manage risks associated with critical inputs, dual-use technologies, and systemic dependencies**. This is necessary because investment flows increasingly intersect with technological and industrial policy objectives, both in China and globally. It is therefore important that forward-looking economic security objectives, such as domestic industrial capacity building and resilience, are factored into screening decisions. Risk assessment should weigh import dependencies against FDI in critical sectors. Restrictive import policies, coupled with restrictive inward FDI policies could cause long-term harm for European competitiveness. The EU FDI Screening Regulation also provides an important framework for coordination. The EU's strategic response to China could be improved by focusing on deeper coordination, information sharing, and alignment of national practices, rather than expanding the regulatory scope. This would allow the EU to better manage the strategic dimensions of economic engagement with China while maintaining openness where appropriate.

36. 224980-2026 – Tender for an Assessment of the Effectiveness of TDI measures.

5.4 Innovate

Both the Draghi and Letta reports identified investment in innovation capacity as one of the EU's most important challenges. This is all the more true in its policy towards China. Indeed, the EU's only effective long-term response to China's economic model depends on its own capacity to innovate, scale, and compete. While external instruments can mitigate risks, they cannot substitute for strong internal economic foundations or fundamentally improve Europe's global competitiveness. Equally important, stronger innovation capacity will provide Europe with economic leverage, not to escalate trade tensions or frictions, but to establish itself as a relevant actor in an era where international relations are increasingly dominated by economic power. In this context, it is encouraging that Europe's competitiveness challenge lies less in generating innovation than in scaling and deploying it effectively across the internal market.

In particular:

- **The EU must further improve access to risk capital to enable businesses to scale innovation**. This is necessary because European businesses face structural constraints in financing growth, particularly compared with global competitors. Existing initiatives under the Capital Markets Union[37] have simplified access to bank loans. This provides an important foundation, but progress has been uneven and fragmented. The Savings and Investment Union[38] now aims to directly connect retail investors with profitable investments on the internal market, but structural weaknesses risk slow implementation and limited progress. These efforts could be strengthened through simplification of investment products and reduced administrative burdens for household investors. The EU needs to step up efforts to further integrate capital markets and remove cross-border investment barriers to increase liquidity and competitiveness. Improving access to capital would enhance Europe's ability to respond to competitive pressures arising from China's state-supported industrial expansion.
- **The EU must reduce regulatory fragmentation within the internal market to facilitate faster diffusion and deployment of technology**. This is necessary because fragmented regulatory environments limit firms' ability to scale across the Union, weakening overall competitiveness. Existing initiatives, including the Single Market Strategy[39] and sector-specific regulations,[40] address aspects of this challenge, but implementation remains incomplete. These mechanisms could be improved through stronger enforcement and simplification, giving particular attention to emerging and future strategic sectors where current industrial expansion may generate long-term structural dependencies or competitive distortions. A more integrated and dynamic internal market would enable European businesses to better compete in sectors where China benefits from scale and coordination.

37. E.g. Retail Investment Package under the Capital Markets Union.
38. The Savings and Investments Union: Connecting savings and productive investments.
39. COM(2025) 500 final, Communication from the Commission to the Euroepean Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Single Market: our European home market in an uncertain world: A Strategy for making the Single Market simple, seamless and strong, 21 May 2025.
40. E.g. Digital Europe.

- **The EU should strengthen innovation ecosystems and industrial clusters in strategically relevant sectors**. This is necessary to translate research strengths into industrial capacity and competitive advantage. Existing instruments, including the Net-Zero Industry Act, the European Chips Act, and Horizon Europe, already support such efforts, but coordination and scale remain limiting factors. These initiatives are not about identifying winning technologies or undermining market mechanisms, but could could be instrumental in better funding coordination, and a focus on value chain integration. Strengthening innovation ecosystems would enhance Europe's capacity to respond to China's coordinated industrial strategy.

5.5 Cooperate

Despite increasing competition and strategic tensions, engagement with China and other global partners remains essential. Global value chains are deeply interconnected, and many of the challenges posed by China's economic model cannot be addressed through unilateral action. Cooperation should therefore be selective and driven by member states' interests, while remaining aligned with EU strategic objectives.[41]

In particular:

- **The EU should strengthen cooperation with like-minded partners on economic security policies**. This is necessary to limit trade diversion, reduce regulatory arbitrage, and increase the effectiveness of policy responses to China's global economic footprint. Existing frameworks, including trade agreements, economic security dialogues, and partnerships on critical raw materials, provide a basis for such cooperation. It is important, however, that these new fora are not merely talking shops but achieve tangible results. Coordinated action would enhance the EU's ability to address the global effects of China's overcapacity and strategic behaviour.

41. National Board of Trade (2026) Recommendations to Strengthen the EU's Economic Security Cooperation.

- **The EU needs to leverage its network of trade agreements more strategically to secure market access and support European competitiveness in third markets**. Existing free trade agreements already provide preferential access to key markets, but their strategic use in response to shifting global trade patterns remains limited. These frameworks could be strengthened through more proactive utilisation and alignment with industrial and trade policy objectives. This would enable the EU to better respond to the externalisation of China's domestic imbalances.
- **The EU and its member states need to operationalise investment agreements and investment facilitation frameworks more strategically to support technology diffusion, innovation spillovers, and industrial upgrading within Europe**. This is necessary because inward FDI can contribute positively to productivity growth, supplier upgrading, managerial capacity, and the diffusion of advanced technologies across European industrial ecosystems. Member State and EU investment agreements and investment facilitation initiatives primarily focus on market access, investment protection, and regulatory predictability, thus providing vital frameworks for inward FDI regulation. However, the broader developmental and innovation-related effects of FDI remain underutilised. At the same time, forced technology transfer, like those already proposed in industrial policy initiatives such as the Industrial Accelerator Act,[42] should be carefully weighed against the risk of restricting inward FDI in relevant industries. These frameworks should instead focus on local value creation, integration with European suppliers and research environments that attract FDI, and mechanisms that facilitate knowledge diffusion and absorptive capacity within the internal market to ensure value added for European industries. Such an approach would allow the EU to benefit more effectively from FDI, including investment originating from China, where it contributes to genuine technological upgrading and long-term European competitiveness.
- **The EU should pursue targeted cooperation with China in areas such as green and climate technologies, under clearly defined conditions**. This is necessary because cooperation in these areas can generate mutual economic benefits while contributing to global public goods. Existing cooperation frameworks provide a basis, but require stronger conditions related to reciprocity, intellectual property protection, and security considerations. These frameworks could be improved through clearer benchmarks and enforcement mechanisms, rather than expansion. A conditional approach to cooperation would allow the EU to benefit from engagement with China while managing associated risks.

42. COM(2026)100 - Proposal for a Regulation on establishing a framework of measures for accelerating industrial capacity and decarbonisation in strategic sectors (Industrial Accelerator Act).

5.6 Final conclusions

The EU's approach to China must reflect the increasingly blurred boundaries between cooperation, competition, and strategic rivalry. These dimensions are not separable, but often coexist within the same sectors, value chains, and even products. This multi-dimensional reality requires a holistic and coordinated policy response in which trade defence, industrial policy, and economic security instruments are applied in a coherent but differentiated manner towards a common and clearly defined objective.

At the same time, Europe's China policy must remain grounded in economic realities. Given the depth of integration that has developed over several decades, a broad-based decoupling from China is neither realistic nor desirable. China occupies a central position in global manufacturing ecosystems and remains a critical supplier of intermediate goods, components, raw materials, and industrial inputs across a wide range of European value chains. The competitiveness of many European downstream industries – including automotive, machinery, chemicals, pharmaceuticals, renewable energy technologies, and advanced manufacturing – depends not only on access to export markets, but also on reliable and cost-effective access to Chinese inputs.

Measures aimed at reducing vulnerabilities must therefore be based on careful risk assessments and targeted at clearly identified strategic dependencies rather than applied indiscriminately. Diversification, redundancy, and increased resilience should be pursued where risks are concentrated, while preserving the benefits of openness and economic integration wherever possible.[43] Policymakers must also account for the potential costs of restrictive measures. Escalating trade and technology tensions between the United States and China already generate significant collateral effects for European firms through disrupted supply chains, market uncertainty, and regulatory fragmentation. More extensive restrictions adopted by the EU itself could trigger Chinese countermeasures, further reducing market access, disrupting critical supply chains, and imposing substantial adjustment costs on European industries. The objective should therefore not be economic disengagement, but a calibrated strategy of risk reduction that strengthens resilience without unnecessarily undermining European competitiveness.

Most measures recommended in this chapter can be built on existing EU instruments. The challenge is therefore not primarily one of creating new instruments or institutions, but of strategic prioritisation, coordination, and effective implementation of existing ones. EU and national engagement must be anchored in structural realism, proceeding from the assumption that the structural features inherent in China's economic growth model will persist rather than assuming systemic reform.

43. National Board of Trade (2020). Improving economic resilience through trade – should we rely on our own supply?.

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Apendix I: Timeline of Chinese export controls

2023	**July** Export licensing requirements introduced for gallium and germanium to 'protect national security interests.' Both materials are used in semiconductors and defence applications.44
	October New licensing requirements imposed on the export of graphite. Although justified as an environmental measure, the announcement coincided with the United States' expanded semiconductor controls.
	December Restrictions and export prohibitions on gallium processing and extraction technology.
2024	**August** Export control on antimony is announced.
	December Export controls on gallium, germanium, antimony, and superhard materials were strengthened, virtually prohibiting export to the US.45
2025	**February** Export licensing requirements for bismuth, indium, molybdenum, tellurium, and tungsten.
	April Export licence requirements introduced for permanent magnets as well as americium, gadolinium, terbium, dysprosium, lutetium, scandium, and yttrium, essential inputs for permanent magnets.46
	July Export restrictions on battery technology, as well as gallium and lithium processing technologies.
	October: Beijing imposes additional licensing requirements for: • holmium, erbium, thulium, europium, and ytterbium;47 • certain super-hard materials;[48] • advanced semiconductor inputs;[49] and • products related to lithium batteries and artificial graphite anode materials.[50] Additional licensing requirements were introduced for certain rare earth processing equipment.[51] New export controls contained a general export restriction on rare earths for military end-use, and provisions extraterritorial application[52] under Article 49 of its export control regulation for dual-use materials.[53]

44. Announcement No. 23 of 2023 of the Ministry of Commerce and the General Administration of Customs of the People's Republic of Asia on the Implementation of Export Control on Gallium and Germanium Related Items
45. Announcement No. 46 of 2024 of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the strengthening of export controls on relevant dual-use items to the United States.
46. Announcement No. 18 of 2025 of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the decision to implement export control on some medium and heavy rare earth related items.
47. Announcement No. 57 of 2025 of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the decision to implement export controls on some medium and heavy rare earth-related items.
48. Announcement No. 55 of 2025 of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the decision to implement export controls on superhard materials-related items.
49. Announcement No. 61 2025 of the Ministry of Commerce announced the decision to implement export controls on relevant rare earth items overseas.
50. Announcement No. 58 of 2025, of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the decision to implement export controls on items related to lithium batteries and artificial graphite anode materials.
51. Announcement No. 56 of 2025 of the Ministry of Commerce and The General Administration of Customs of The People's Republic of China announcing the decision to implement export controls on some rare earth equipment and raw materials related items.
52. Announcement No. 61 of 2025 of the Ministry of Commerce of the decision to implement export controls on overseas rare earth items.
53. Decree of the State Council of the People's Republic of China No. 792 (中华人民共和国国务院令 第792号), 30 september 2024.

Apendix II: Incidents of economic coercion

The arrest of Huawei CFO Meng Wanzhou by Canadian authorities in December 2018 combined diplomatic pressure, detentions, and targeted trade restrictions. Following her arrest on a U.S. extradition request, Beijing summoned Canada's ambassador and warned of 'grave consequences' if she was not released. Within days, Canadian nationals Michael Kovrig and Michael Spavor were detained on national security grounds in cases widely interpreted as retaliatory. In parallel, China imposed restrictions on key Canadian exports, including canola, pork, and beef, citing technical and sanitary concerns, significantly reducing Canada's market access.

The Houston Rockets were subject to restrictive actions in 2019, illustrating how informal economic and commercial pressure can be deployed rapidly by the CCP in reaction to perceived political transgressions beyond traditional trade restrictive measures. After the team's general manager publicly expressed support for the Hong Kong protests, Chinese authorities and state-linked actors moved to curtail the Rockets' presence in the Chinese market. The Chinese Basketball Association suspended all cooperation with the team, while state broadcaster and social media platforms halted the airing and streaming of games. Major corporate partners in China terminated sponsorship agreements, and retailers removed Rockets merchandise from stores. These informal measures were coordinated across media, commercial, and institutional channels, resulting in an almost complete loss of the team's access to the Chinese market.

The Taiwanese Representative Office in Lithuania officially opened its doors in November of 2021. In the eyes of Beijing this reflected not only a deeper engagement with Taiwan but a recognition of its status as independent of China. Beijing responded to this diplomatic afront through a combination of formal and informal measures that severely disrupted bilateral trade.

- Chinese customs authorities de facto ceased clearing Lithuanian goods, leading to a near-total halt of Lithuanian exports to China without a formally announced legal basis.
- Approvals and licenses for Chinese exports to Lithuania were withheld, resulting in a sharp decline in trade flows in both directions.
- From early 2022, China formalised import bans on selected Lithuanian products – including alcohol, beef, dairy, and timber – on sanitary and phytosanitary grounds that were not substantiated in subsequent exchanges with the EU.

Beyond direct bilateral measures, Chinese authorities also signalled that goods produced in other EU member states containing Lithuanian inputs could face obstacles entering the Chinese market, prompting multinational firms to reconsider Lithuanian suppliers. Collectively, these actions amounted to a systemic restriction of trade flows, extending beyond Lithuania to affect broader EU value chains.

Apendix III: EU Trade Defence Toolbox

Instrument	Trigger conditions	Type of measure	Geographical scope	Strengths	Weaknesses	Relevance for Chinese overcapacity	Policy implications
Anti-dumping	Export price < normal value (domestic price or constructed value) + material injury + causation	Additional duties corresponding to the dumping margin	Country- and company-specific	Politically and administratively established; effective against price pressure; but lengthy and resource demanding	Addresses only price (the symptom); risk of trade diversion; limited systemic impact	Medium – captures the effects of overcapacity (low prices) but not the cause; very product-specific and therefore difficult to apply to entire sectors	Important first-line instrument; should be combined with other instruments to address structural effects
Countervailing duties	Financial contribution by the state conferring a benefit + specificity + injury + causation	Additional duties corresponding to the level of subsidisation	Country- and company-specific	Most direct link to state capitalism; can address distortions caused by industrial policy	Difficult evidentiary burden (hidden support, local level, state-owned banks); resource-intensive; under-reporting of subsidies	Medium – addresses central drivers behind overcapacity, but many subsidies are not captured in practice	Should be prioritised strategically; requires data capacity and coordination within the EU
Safeguard measures	Sharp increase in imports + serious injury	Additional duties - in some cases combined with quotas	In principle global (non-discriminatory)	Can address import shocks without proving dumping or subsidisation	Blunt instrument; also affects 'innocent' trading partners; risk of retaliation	Low – captures the symptom (import surge) but cannot be targeted at imports from a specific country	Limited usefulness against China specifically; more of a crisis instrument
Circumvention (anti-circumvention)	Circumvention of existing measures via third countries or product modification	Extension of existing anti-dumping or countervailing duties	Country-/product-adjusted	Protects the effectiveness of anti-dumping and countervailing measures	Reactive rather than proactive	Complementary – can strengthen the effectiveness of other tools	Important complement in an environment of trade diversion

Sammanfattning

Summary in Swedish

Denna rapport analyserar Kinas handels- och investeringspolitik som en integrerad del av landets politiska ekonomi och övergripande strategiska inriktning. Den utgår från att Kinas ekonomiska styrning inte kan förstås utifrån traditionella marknads- eller effektivitetsprinciper. I stället använder landet ekonomiska instrument systematiskt för att främja politiska mål, teknologisk utveckling och geopolitisk påverkan.

Rapportens huvudsakliga slutsats är att den ihållande industriella överkapaciteten och den omfattande statliga interventionen inte är cykliska marknadsstörningar eller en följd av ofullständiga reformer. De utgör i stället strukturella inslag i Kinas utvecklings- och tillväxtmodell. Dessa kännetecken berör de incitamentsstrukturer som präglar partistaten, där den ekonomiska politiken syftar till att upprätthålla tillväxt, säkerställa sysselsättning, bevara politisk stabilitet och stärka landets geopolitiska inflytande globalt. Kinas externa ekonomiska politik, särskilt inom handel och investeringar, återspeglar dessa systemegenskaper. Det är osannolikt att systemet kommer att utvecklas i riktning mot marknadsekonomiska modeller inom en överskådlig framtid.

Utvecklingen förstärks genom den femtonde femårsplanen, som prioriterar teknologisk självförsörjning, industriell uppgradering och robusta försörjningskedjor. Samtidigt ligger den investeringsdrivna tillväxtmodellen fast. Även om planen identifierar behovet av att stärka den inhemska efterfrågan förändrar den inte de grundläggande orsakerna till överkapaciteten.

Kinas politiska ekonomi präglas av centralstyrning och decentraliserat genomförande. Partistaten centralt fastställer de övergripande prioriteringarna, medan provinser och lokala myndigheter ansvarar för genomförandet. Denna styrmodell skapar starka incitament för lokala myndigheter att främja investeringar, öka produktionskapaciteten och stödja lokala företag, ofta genom subventioner, förmånliga finansieringsvillkor och regulatoriskt skydd.

Empiriska studier visar att det statliga stödet i Kina är både omfattande och mångfacetterat. Det innefattar direkta subventioner, skattelättnader, subventionerade krediter och mark till priser under marknadsvärdet. Det centrala är att stödet ofta fördelas utifrån politiska prioriteringar snarare än marknadssignaler, vilket leder till ineffektiv resursallokering och överdimensionerad produktionskapacitet.

Konsekvenserna är synliga i såväl traditionella som nya industrisektorer. Inom exempelvis stålindustrin har långvariga investeringsmönster skapat strukturell överkapacitet som överstiger den inhemska efterfrågan. Liknande tendenser kan nu observeras inom sektorer som elfordon och solenergi, där kapacitetsutbyggnaden har överstigit även den globala marknadens absorptionsförmåga. Dessa sektorer kännetecknas av fallande avkastning, växande lager och hårdnande priskonkurrens, vilket tyder på att överkapaciteten är strukturell snarare än cyklisk.

Kinas tillväxtmodell har historiskt varit beroende av extern efterfrågan för att absorbera överskottsproduktion. När den inhemska efterfrågan inte växer i samma takt som produktionen kanaliseras överskottskapaciteten till exportmarknader. Detta har bidragit till växande handelsöverskott och ökat konkurrenstryck på globala marknader.

De internationella effekterna är betydande. Omfattande export av subventionerade varor bidrar till global prispress, påverkar konkurrenter på tredjelandsmarknader och ökar anpassningstrycket på industrin i avancerade ekonomier, inklusive EU. Samtidigt

har Kinas roll i globala värdekedjor förändrats. Utöver att vara en ledande exportör av färdiga produkter har Kina etablerat en dominerande position inom bearbetning av kritiska råvaror och produktion av centrala insatsvaror. Denna dubbla roll skapar asymmetriska beroenden som kan användas för strategiska syften.

Handels- och investeringspolitiken spelar en central roll i detta system. Kina använder i allt större utsträckning ekonomiska instrument som verktyg för ekonomisk statskonst. Industrisubventioner möjliggör internationell expansion för kinesiska företag. Investeringspolitiken underlättar tillgång till teknologi och marknader. Standardiseringsinitiativ formar framtida tekniska ekosystem, medan exportkontroller av kritiska insatsvaror visar hur beroenden i värdekedjor kan användas strategiskt. Tillsammans bildar dessa instrument ett sammanhängande ramverk för att stärka Kinas ekonomiska motståndskraft, teknologiska kapacitet och internationella position.

Samtidigt står den kinesiska ekonomin inför växande inhemska utmaningar, däribland avtagande produktivitetstillväxt, höga skuldnivåer, demografiska påfrestningar och fallande investeringsavkastning. Den industriella överkapaciteten har en direkt inverkan på dessa problem genom att minska lönsamheten och öka de finansiella riskerna för kinesiska företag. Samtidigt begränsas företagens anpassningsförmåga av samma politiska och institutionella faktorer som skapar obalanserna. Lokala myndigheter förblir beroende av investeringsdriven tillväxt, medan hänsyn till sysselsättning begränsar utrymmet för kapacitetsneddragningar. De strukturella drivkrafterna bakom överkapaciteten bedöms därför bestå även framöver.

Mot denna bakgrund argumenterar rapporten för att EU:s och Sveriges politik måste utgå från en realistisk förståelse av Kinas ekonomiska system. De utmaningar som följer av Kinas handels- och investeringspolitik är strukturella snarare än cykliska och kräver därför en sammanhållen och proaktiv politisk respons. EU förfogar redan över många av de verktyg som krävs. Den centrala utmaningen ligger i hur dessa används, samordnas och genomförs.

Rapporten identifierar tre övergripande politiska prioriteringar:

- **Ökad förmåga att identifiera och förutse strukturella snedvridningar**

  EU bör gå från reaktiva åtgärder till ett mer framåtblickande och systematiskt förhållningssätt till Kinas ekonomiska modell. Detta kräver stärkt analyskapacitet för att följa kinesisk industripolitik, identifiera framväxande risker för överkapacitet och bedöma konsekvenserna för såväl EU-marknaden som europeiska företags konkurrenskraft på tredjelandsmarknader. Befintliga verktyg inom handelspolitik, ekonomisk säkerhet och industripolitik bör integreras i ett mer samordnat ramverk för att kunna hantera långsiktiga strukturella snedvridningar snarare än enskilda handelstvister.

- **Tydligare åtskillnad mellan ekonomiska risker, ekonomiska säkerhetsrisker och nationella säkerhetsrisker**

  När gränserna mellan handel, teknologi och säkerhet blir allt mer otydliga måste EU tillämpa ett mer differentierat och proportionerligt förhållningssätt till riskhantering. Handelssnedvridningar, strategiska beroenden och nationella säkerhetsrisker kräver olika typer av åtgärder och bör inte hanteras med samma verktyg. Ekonomiska säkerhetshänsyn kan motivera högre kostnader inom strategiskt viktiga sektorer. En bred ekonomisk frikoppling från Kina är däremot varken realistisk eller önskvärd. Kina kommer även framöver att vara en central aktör inom handel, investeringar och teknologisk utveckling. Fortsatt samarbete kommer att vara ekonomiskt fördelaktigt inom många sektorer där det inte finns överordnade säkerhetsintressen.

- **Stärkt europeisk konkurrenskraft och motståndskraft**

  EU:s långsiktiga svar på Kinas statsdrivna ekonomiska modell måste i grunden bygga på att stärka de egna ekonomiska förutsättningarna. Detta omfattar ökad innovationsförmåga, djupare kapitalmarknader, minskad fragmentering av den inre marknaden och snabbare spridning av ny teknik inom EU. Industripolitiken kommer sannolikt att spela en större roll, men bör fokusera på framtidsteknologier och långsiktig konkurrenskraft snarare än bred kapacitetsutbyggnad i utvecklade sektorer. Samtidigt krävs bättre samordning mellan handelspolitik, industripolitik och instrument för ekonomisk säkerhet för att säkerställa en samordnad och strategiskt sammanhållen respons.

Rapporten understryker även vikten av selektivt samarbete med Kina. Samarbete är fortsatt nödvändigt inom områden av gemensamt intresse, såsom klimatfrågor och delar av den globala ekonomiska styrningen. Ett sådant samarbete bör dock vara målinriktat, villkorat och baseras på en tydlig förståelse av de underliggande beroendeförhållandena.

Sammanfattningsvis visar rapporten att Kinas handels- och investeringspolitik är en integrerad del av en sammanhängande strategi där ekonomiska instrument används inom ramen för ett bredare politiskt och geopolitiskt ramverk. Ihållande överkapacitet, omfattande statlig intervention och strategisk användning av ömsesidiga beroenden är centrala kännetecken för denna modell.

För EU och Sverige innebär detta en långsiktig politisk utmaning. Effektiva åtgärder kräver en balans mellan öppenhet och motståndskraft, konkurrens och samarbete samt mellan kortsiktig anpassning och långsiktig strategisk positionering. Framför allt måste politiken utgå från en tydlig förståelse av de strukturella drivkrafter som formar Kinas ekonomiska politik och dess konsekvenser för den globala ekonomin.

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