European Union
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CHINA – A FRAGILE POWER?

How Europe can use its economic leverage over Beijing

By
Alicia Garcia-Herrero and Tim Rühlig

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CONTENTS

EXECUTIVE SUMMARY

This *Chaillot Paper* argues that Beijing's foreign policy today is shaped not only by economic and technological strength but also by domestic economic vulnerability. China faces an economic slowdown driven by multiple factors: a rapidly ageing population, falling returns on investment, a collapsed real-estate sector, mounting public debt and constrained fiscal space. These pressures will continue to erode China's 'growth dividend', with significant implications at home and abroad. Officially, China's gross domestic product (GDP) grew by 5% in 2025. In reality, this figure may be lower and is likely to fall below 2.5% in less than ten years and to around 1% after 2035. Domestically, this downturn challenges the social contract that the Chinese Communist Party (CCP) offers its citizens. On the international stage, it weakens – and may even constrain – Beijing's ability to convert economic weight and technological progress into global influence.

China's structural challenges point to a twofold and mutually reinforcing shift in CCP strategy aimed at shoring up societal and political stability.

Firstly, to enhance its crisis resilience, the CCP has already tightened and centralised Party control over Chinese society and the economy – a trend that is likely to continue. From this perspective, China's push for greater economic and technological 'self-reliance', including selective decoupling, appears logical. Even if deeper centralisation further dampens growth by distorting capital allocation, the CCP appears set to continue down this path, as political and social stability take precedence.

Secondly, partly to divert attention from economic problems, the CCP is likely to double down on assertive nationalism, including more confrontational diplomacy. This reflects a broader shift in Beijing's narrative: away from concern about China's global reputation and towards claims of relative gains, with China portrayed as outperforming its Western competitors.

Although these are primarily domestic choices, they will inevitably shape China's diplomacy and its relations with the EU. Beijing's drive for crisis resilience, despite the costs to an already slowing economy, has a number of consequences for the EU.

1. The Chinese market will offer fewer opportunities for European firms – both for exporters and for companies operating in China, where demand is weak and competition fierce.
2. Subdued domestic demand will sustain industrial overcapacity, prompting Chinese firms to export cheaply and undercut non-Chinese competitors, including in Europe.
3. The EU's growing dependence on imports increases China's leverage and its capacity for economic coercion.
4. China's ramping up of aggressive nationalist rhetoric to distract from domestic economic grievances heightens the risk that tensions in East Asia could escalate into a hard security conflict.
5. China will continue to differentiate its economic model from that of the West, promoting the 'superiority' of its own approach.

Under these circumstances, China's international economic influence relies less on attractiveness and more on coercive leverage. Rather than offering market access to build appeal, Beijing seeks to expand manufacturing dominance and create chokepoints that can be weaponised. Another pillar of coercive power is innovation lock-in: China invests heavily in applied innovation and exports it, notably through spending on infrastructure projects. Combined with Beijing's growing influence over global and regional technical standards, this deepens other countries' dependence on China's innovation ecosystem. And while the internationalisation of the renminbi remains at an early stage given the dollar's dominance, Beijing clearly aims to reduce its exposure to the US currency, which it views as a strategic vulnerability.

These policy shifts are political choices, not inevitabilities. The vulnerabilities resulting from China's lower growth can translate into economic strengths in the international arena. Hence, China's economic fragility is unlikely to make it a more benign actor internationally. The EU therefore needs to double down on its efforts to de-risk against these accelerating threats.

At the same time, China's vulnerability creates opportunities for the EU. To address its economic slowdown, China partly relies on access to the single market, European technological capabilities and EU research. As China's dependencies on Europe decline, the EU should work to preserve them and make use of its leverage while it still can. This means conditioning access to the market or investment in high technology sectors. China is likely to retaliate. But the EU needs to understand that costs are inevitable and the cost of inaction is likely to be even higher.

The EU should strengthen its resilience to growing risks by working with global partners to build collective leverage, engaging both like-minded countries and states in the wider Plural South, depending on the issue at hand. This will require not only faster de-risking but also efforts to build up the EU's own strengths and convert them into bargaining assets through a more pragmatic, leverage-based diplomacy with Beijing. More concretely, we propose four policy pillars for the EU's China policy.

1. **Build on existing strengths**. Rather than starting from vulnerabilities and trying to tackle an endless list of dependencies, the EU should focus on preserving and creating technological chokepoints. Targeted industrial policy, combined with export controls and outbound investment screening, can support this effort.

2. **Use diversification as the default de-risking strategy**. Instead of pursuing 'buy European' approaches that struggle with high labour and energy costs, Europe should prioritise diversifying both supply chains and export markets. This requires incentives for European firms to invest in the Plural South, backed by trade and investment agreements, expanded Global Gateway funding, tax incentives for European companies that diversify their supply chains, tightening procurement rules prohibiting single sourcing in key technologies and stricter market-access criteria that emphasise non-price factors, creating greater predictability in demand even if at higher cost. While many partners are reluctant to 'choose sides', pragmatic engagement can raise the EU's standing.

3. **Establish credible escalation control**. The EU should adopt an 'escalate to de-escalate' approach similar to those used by the US and China. It must be capable of deploying its strongest tool – the Anti-Coercion Instrument (ACI) – to defend core interests. We propose effectively shortening the investigation phase and reversing the current rule, so that a qualified majority of EU

Member States is needed to block – not approve – a Commission proposal to activate the ACI in cases of economic coercion by China or any other trade partner. The best way to defend European interests is to empower the Commission to negotiate from a position of maximum strength.

4. **Pursue leverage-based diplomacy**. Having built up its negotiating position the EU could then recalibrate its diplomacy with Beijing and move beyond treating diplomacy as an end in itself. The EU should set realistic but meaningful demands that reflect core interests, paired with unilateral measures if no agreement is reached.

INTRODUCTION

CHINESE LEVERAGE IN TRANSITION

The European Union's policy towards the People's Republic of China (PRC) rests on a widely shared assumption: China's global power is here to stay and may even continue to grow. In its 2019 Strategic Outlook, the EU described China's economic power and political influence as expanding [(1)]. China's international reach has long been rooted in its economic weight and technological capabilities. For years, many expected China to overtake the United States in GDP terms, although this expectation has weakened since the pandemic. Building on this economic and technological base, Beijing has expanded its military capabilities and its ability to convene diplomatically, whether at the United Nations (UN), the Shanghai Cooperation Organization (SCO) or the expanded BRICS grouping. This more assertive foreign and economic policy has reinforced a broader shift towards an international order where relative power, not rules and institutions, is decisive.

This view of inexorably rising Chinese influence contrasts with a growing body of analysis highlighting China's structural economic weaknesses. Proponents of the 'Peak China' argument point to demographic decline, falling productivity, rising debt and strategic overreach. China's growth may decelerate steadily to 2–3% by 2035 [(2)]. Some analysts argue that growth is not as high as the official figure of 5% but has already fallen into this range and could be as low as 1% in 2026 [(3)]. After 2035, when rapid urbanisation comes to an end, growth could weaken further [(4)]. China is no longer the fast-growing market or low-cost manufacturing hub that once made it so attractive. As a result, China's economy has likely peaked as a share of global output, with 2021 marking the high point [(5)]. Recent field research suggests that domestic perceptions of the economy are increasingly pessimistic [(6)]. Slowing growth and rising pessimism within Chinese society pose a major challenge for the PRC

(1) European Commission and High Representative of the Union for Foreign Affairs and Security Policy, 'EU-China – A strategic outlook', JOIN(2019) 5 final, 12 March 2019 (https://commission.europa.eu/system/files/2019-03/communication-eu-china-a-strategic-outlook.pdf).

(2) Garcia-Herrero, A., 'Can Chinese growth defy gravity?', Bruegel, June 2023 (https://www.bruegel.org/sites/default/files/private/2023-06/PB%2014%202023_1.pdf).

(3) Rosen, D. et al., 'China's economy: Rightsizing 2025, looking ahead to 2026', Rhodium Group, 22 December 2025 (https://rhg.com/research/chinas-economy-rightsizing-2025-looking-ahead-to-2026/).

(4) Garcia-Herrero, A. and Xu, J., 'To what extent can urbanisation mitigate the negative impact of population ageing in China?', Bruegel, 9 October 2023 (https://www.bruegel.org/working-paper/what-extent-can-urbanisation-mitigate-negative-impact-population-ageing-china).

(5) Wright, L. 'China's economy has peaked. Can Beijing redefine its goals?', Rhodium Group, 1 September 2024 (https://rhg.com/research/chinas-economy-has-peaked-can-beijing-redefine-its-goals/).

(6) Anonymous author interviews with diverse Chinese actors, Beijing, December 2024 and November 2025.

leadership and are likely to push Beijing to seek new ways to preserve social stability[7].

STRUCTURAL CONSTRAINTS AND MOUNTING EXTERNAL PRESSURE

External pressures compound these domestic problems. The policies of US President Donald Trump have created diplomatic opportunities for China, including recent cooperation with Canada. But the unpredictability of trade relations with the US has also added further difficulties for Beijing. China has shown notable resilience in the face of US economic pressure. Nevertheless, renewed tariff escalation, tighter trade restrictions and stricter US technology export controls have increased uncertainty and further weighed on China's economy. This continuation and intensification of economic and technological containment reflect a broader US strategy to constrain China's rise in the international order, adding external pressure to China's internal structural constraints.

China's domestic challenges incentivise Beijing to pursue policies that deepen global dependencies on Chinese manufacturing.

None of this means that China will cease to matter as a global influence in the twenty-first century. Regardless of its growth rate, Beijing wields significant coercive power because many countries depend heavily on Chinese manufacturing and technology[8]. In fact, China's domestic challenges incentivise Beijing to pursue policies that further deepen global dependencies on Chinese manufacturing. Across business cycles, China also retains substantial diplomatic capacity to shape norms, narratives and institutions. China's military has also evolved significantly. The Chinese Communist Party (CCP), well aware of the challenges ahead, continues to project confidence. Xi Jinping's assertion that 'the East is rising and the West is declining' encapsulates this narrative. Yet China's economic difficulties carry major strategic implications for at least three reasons.

First, economic and technological strength underpins Beijing's current international influence. Since the death of Mao Zedong, China's international position has rested on two economic pillars: access to a vast and rapidly growing market, and an abundant supply of cheap and skilled labour that turned China into the world's workshop. Both pillars are now under strain, with potential consequences for China's global influence.

Second, China's leadership is likely to become increasingly preoccupied with domestic risks, meaning that its actions are not driven solely by confidence in the country's strength. Beijing will bolster its resilience by doubling down on economic and technological 'self-reliance', including selective decoupling. For foreign firms, this means tougher conditions as market opportunities shrink while weak domestic demand sustains industrial overcapacity, prompting Chinese companies to export at low prices and undercut

(7) Anonymous author interviews with party-state officials, Beijing, December 2024 and November 2025.

(8) Campbell, K. M. and Doshi, R., 'Underestimating China: Why America needs a new strategy of allied scale to offset Beijing's enduring advantages', *Foreign Affairs*, 10 April 2025 (https://www.foreignaffairs.com/china/underestimating-china).

foreign competitors. At the same time, the CCP could increasingly resort to forceful nationalism and adopt a more confrontational diplomatic stance to divert attention from economic problems.

Third, the assumption that China's influence will only continue to grow, and that this risks locking the EU into a largely reactive and defensive posture, is false. While rising pressure on Beijing may heighten the need for de-risking to protect European interests, China's vulnerabilities could also open a window for a more proactive European strategy.

It is clear that EU policy rarely plays more than a limited role in Beijing's calculations. China's investments have deepened economic and technological dependencies abroad while reducing its own reliance on foreign actors. This approach is likely to continue, as reflected in the proposal for China's forthcoming 15th Five-Year Plan (2026-2030), which is expected to be adopted with few amendments in March 2026.

China's share of global manufacturing, already around 30%, is likely to rise further[9]. Beijing is also working to advance the adoption of its technologies internationally, not least through the Belt and Road Initiative (BRI), creating lock-in dependencies on Chinese firms. It has shown a willingness to exploit such leverage, as illustrated by several rounds of rare earth export controls in 2025, among other examples. However, what appears to be a sign of strength internationally is partly the result of domestic economic vulnerability, giving the EU and its partners greater room for manoeuvre than they often assume. To strengthen its own resilience, Beijing is also promoting the use of the renminbi (RMB) in international trade settlement, partly to hedge against the weaponisation of the US dollar. Together, these trends highlight the far-reaching impact of evolving US-China trade and technology tensions on the global economy, including the EU.

A QUESTION OF LEVERAGE

Against this backdrop, this *Chaillot Paper* argues that the EU should adopt a more proactive approach that recognises China's vulnerabilities and combines de-risking with leverage-based diplomacy. To manage its domestic challenges, China benefits particularly from access to the European single market and the high purchasing power of European consumers. By contrast, the US market has become more restrictive and accounted for only around 16% of China's exports in 2025 (down from more than 19% in 2018). Hence, China's dependence on the EU for the export of more sophisticated and higher priced goods that it cannot easily sell at high margins in Asian, African and Latin American markets. Beijing also continues to rely on access to European technology and research, from semiconductor manufacturing equipment to cooperation on 6G development.

This leverage will not last indefinitely. Without a change in policy, China will continue to gradually reduce its reliance on European technology. The EU therefore needs to act now to preserve this advantage and use it to reinforce its medium- and long-term economic and technological position.

(9) United Nations Industrial Development Organization, *The future of industrialization: Building future-ready industries to turn challenges into sustainable solutions*, 2024 (https://www.unido.org/sites/default/files/unido-publications/2024-11/The%20Future%20of%20Industrialization%20-%20Building%20Future-ready%20Industries%20to%20Turn%20Challenges%20into%20Sustainable%20Solutions.pdf).

Before setting out specific policy recommendations, this paper examines China's economic vulnerabilities in greater detail, the broader threats they pose to the CCP, and Beijing's responses to these challenges, including the resulting changes in the structure of Chinese economic power. We put forward a three-part hypothesis:

> first, that China is now acting primarily from a position of vulnerability rather than confidence in its own strength;

> second, that vulnerability does not make China either irrelevant or more benign;

> third, that these vulnerabilities create scope for a more proactive, leverage-based EU diplomacy.

A full analysis of US–China trade and technology tensions would be required to assess these dynamics in depth, but this lies beyond the scope of this paper, which focuses on the domestic factors shaping Beijing's policy.

Our analysis covers the period since Xi Jinping came to power in autumn 2012, with particular attention to developments since 2022, when China's structural vulnerabilities became more visible. Even before then, Beijing recognised the scale of the looming economic, political and social challenges. The analysis draws on multiple sources to shed light on policy choices beyond the official narrative. These include quantitative data on China's economy, qualitative analysis of official documents and speeches issued by party and state institutions, and anonymised interviews with Chinese officials and affiliated research institutions.

The aim of this *Chaillot Paper* is not to predict China's future global role, or its precise impact on the EU. Rather, it seeks to make the case for a more proactive agenda that capitalises on China's current economic and structural transition through leverage-based diplomacy, drawing on existing strengths to make realistic yet substantial demands. For Beijing, a lot is at stake, and it is likely to retaliate. However, the EU needs to understand that inaction would also carry costs and accelerate Europe's deindustrialisation. A policy shift would also open the way for a more pragmatic form of diplomacy, allowing the EU to defend its core interests through leverage while preserving a stable framework for coexistence. This could ultimately lead to a new basis for EU-China relations, rather than the current trajectory of gradual deterioration at the EU's expense.

CHAPTER 1

CHINA'S ECONOMIC VULNERABILITIES

Understanding the structural slowdown

China's international influence rests overwhelmingly on its economy and technological prowess. Despite the rapid build-up of military capabilities, including its nuclear arsenal, the People's Liberation Army (PLA) still lacks strong extra-regional power-projection capabilities beyond the Western Pacific. Much of China's international power derives from Beijing's ability to leverage its economic weight and impose costs on its opponents. This is particularly true given China's push to expand its industrial base, which is critical to global supply chains, including in military or dual-use sectors such as shipbuilding and critical minerals:

> *We cannot compete with US [military] capabilities. Even in Asia, we expect the US to deploy more in the coming years. [...] This is no reason to be concerned. Everyone, even the US Army, depends on our industrial base. This is why we are strong* [(1)].

Similarly, China has accumulated significant soft and diplomatic influence over recent decades. But, as with its military capabilities, these forms of power remain firmly anchored in the country's economic and technological strength:

> *Most countries engage with us primarily because we offer economic opportunities and good technology with no political strings attached. They like that China is pragmatic and predominantly concerned with economic advancement. [...] The US may be hypocritical, but people around the world are fascinated by US pop culture and hail the ideas of democracy and freedom. [...] We are concerned that we would have very few friends if we were no longer [seen as] an economic opportunity* [(2)].

For decades, China's international economic influence was based on two pillars. First, China functioned as an indispensable market for international firms. Its market is not only vast but, until recently, grew at extraordinary speed. This dynamic began to slow in 2022 (see Figure 1).

Second, China became the world's workbench. Its export-led growth model relied on a large, cheap and well-educated labour force, whose productivity increased

(1) Anonymous author interview with a former high-ranking official of the People's Liberation Army, Beijing, November 2025.

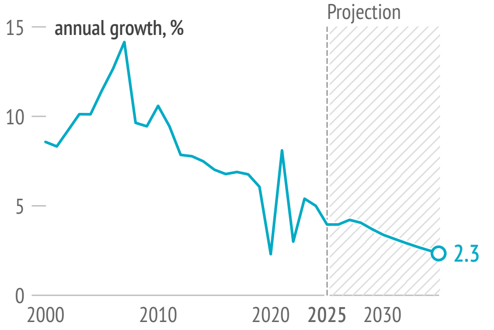
(2) Anonymous author interview with a senior researcher of a government-affiliated Chinese think tank, Beijing, November 2025.

as the country urbanised. This combination of factors attracted substantial foreign direct investment, including from Europe. High domestic savings coupled with financial repression, whereby the state caps returns on household savings and channels these resources into the banking system, enabled the state to finance the massive investments required to build the infrastructure and logistics underpinning China's manufacturing and export sectors.

This model is running out of steam, especially since 2022, and the trend is set to accelerate once urbanisation tapers off after 2035. China's GDP growth has been on a steady downward trajectory and is expected to continue to decelerate. We cautiously project growth of around 3.6% in 2026–2030, falling to 2.3% in 2030–2035 (see Figure 1)[(3)]. Other analysts expect growth to drop as low as 1.0–2.4% as early as 2026[(4)].

1 | China's growth is in steady decline

China's projected GDP growth under a convergence scenario



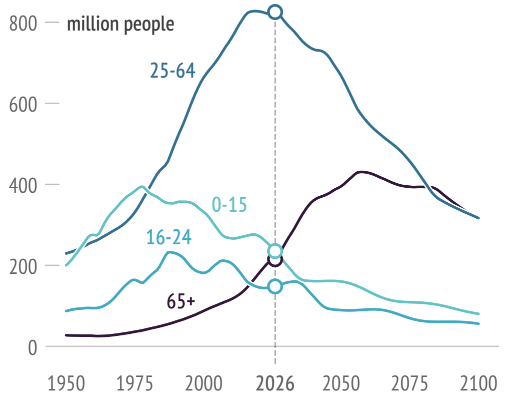
Data: Natixis; Bruegel; United Nations, 2025

The drivers of this slowdown are structural and difficult for China's leaders to address.

The first structural factor is China's rapidly ageing population and the shrinking overall workforce (see Figures 2 and 3). While the one-child policy is a key driver of this trend, fertility has continued to decline and is expected to recover only very modestly (Figure 4). These demographic shifts will not only place additional pressure on public finances, as pension and healthcare spending rises, but are also likely to weigh on productivity, as the Japanese experience clearly shows.

2 | China's society is ageing rapidly

China's population by age group



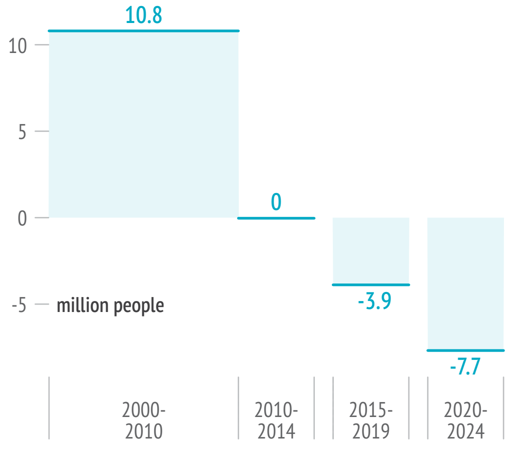
Data: Natixis; United Nations

For the Chinese government, however, the problem is that the current slowdown is not yet driven by demographic pressures. On the contrary, demographics still support growth, as the urban population continues to expand. Urban workers are typically far more productive than their rural counterparts. Once urbanisation peaks, around 2035, population decline will affect not only rural areas but cities as well. This could reduce China's GDP growth by a further 1.3 percentage points per year[(5)].

(3) 'Can Chinese growth defy gravity?', op. cit.
(4) 'China's economy: Rightsizing 2025, looking ahead to 2026', op. cit.
(5) 'To what extent can urbanisation mitigate the negative impact of population ageing in China?', op. cit.

3 | **China's workforce is shrinking**

Net change in workforce

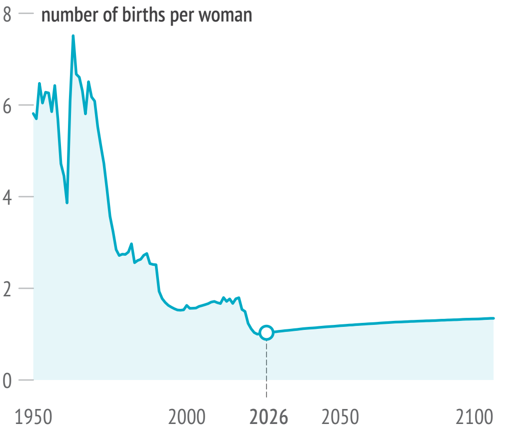


Data: Natixis; National Bureau of Statistics;

NB: Workforce is identified as population aged between 16 and 59.

4 | **China has fewer children**

China's total fertility rate



Data: Natixis; United Nations

The second structural challenge is chronically low domestic consumption. Household income is stagnant and consumer confidence is at record lows. In an interview, a state official confirmed:

> *Our economy is a depressing subject. [...] When we give people more money, they just save it, put it in the bank. Nobody consumes. Our savings rate is over 40%. [...] No idea [how we can address this issue]. The problem is that people are either poor or afraid of becoming poor soon. It simply doesn't work* (6).

A key reason for low consumer confidence is the property sector, which accounts for around 80% of household wealth and remains in the doldrums four years after the collapse of China's largest real estate developer, Evergrande. According to surveys, households prefer saving to investing (Figure 5). Real estate, once a major engine of GDP growth, no longer contributes to economic expansion (7). Investment has instead shifted from property to manufacturing. But with domestic consumption subdued, much of the resulting output must be exported.

Even more challenging is the persistently high level of household savings driven by the absence of a robust social safety net, which the Chinese government has little intention of introducing. One reason may be President Xi Jinping's reservations about 'welfarism', referring to more comprehensive welfare systems like those existing in Europe or Latin America (8). Beyond ideology, China also has very limited fiscal space to expand social spending, given a large fiscal deficit and public debt close to 100% of GDP. Interviews with Chinese experts confirm that several factors stand in the way of the emergence of a comprehensive welfare state:

(6) Anonymous author interview with a Chinese state official, Beijing, December 2024.

(7) AI-Haschimi, A. and Spital, T., 'The evolution of China's growth model: Challenges and long-term growth prospects', European Central Bank, 2024 (https://www.ecb.europa.eu/press/economic-bulletin/articles/2024/html/ecb.ebart202405_01~a6318ef569.en.html).

(8) 'Correctly understand and grasp the major theoretical and practical issues in China's development', CPC News, 16 May 2022 (http://dangjian.people.com.cn/n1/2022/0516/c117092-32422119.html).

> *The leadership has grown accustomed to having enormous capacity for control. The population brings its money to the banks, almost all of which are controlled by local governments. The capital is therefore available for investment by state-owned banks. And so it is the state, not consumers, that decides where investment goes, maintaining macro-economic control. […] Another problem is that there is no money to be made from building up social security funds. Infrastructure investment offers far greater opportunities for rent-seeking. […] For many years this was a win-win situation. China really did need a lot of modern infrastructure. It also created employment. But now we've reached a saturation point in infrastructure development* (9).

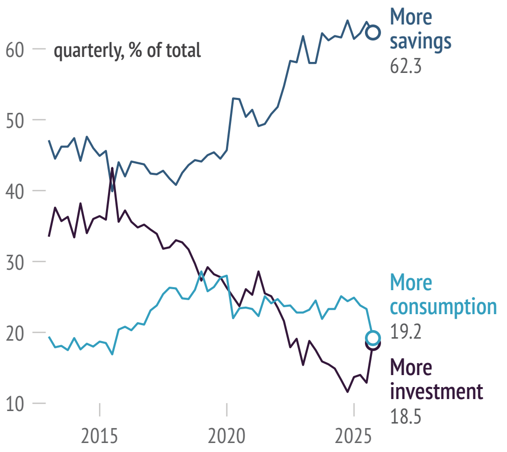
Without a major policy shift that provides citizens with greater financial security, household savings will remain tied up and consumption will not become the main driver of growth. Although China's forthcoming 15th Five-Year Plan highlights the need to boost domestic consumption, even Chinese officials privately express scepticism:

> *Everyone has understood that boosting household consumption is necessary. […] Companies are cutting salaries or withholding pay from employees for months at a time. […] Only structural reforms could change this, but they cost a lot of money, take time and carry political risks. It is highly unlikely we will see such reforms* (10).

This situation has implications far beyond China. Weak domestic demand, combined with sustained supply-side subsidies, have produced large manufacturing overcapacities. Chinese firms export this excess capacity at ever lower prices, fuelling growing concern among political leaders worldwide about overcapacity and price distortions. The response has extended beyond the US and the EU (so far, in the EU's case, limited to electric vehicles) to other jurisdictions, including emerging economies, which have also begun to take action.

5 | **Chinese households are saving more**

Chinese household sentiment
on the use of resources



Data: Natixis; People's Bank of China; WIND

This brings China to its third structural challenge: rising international economic and technological barriers. Beyond shrinking export opportunities, Beijing faces a US-led effort at technological containment. Since the first Trump administration, Washington has erected significant obstacles to China's technological ambitions, notably through export controls on semiconductors, quantum technologies and biotechnology. The US has also weaponised its Entity List, blacklisting major Chinese technology firms to cut them off from critical American and European components and software.

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(9) Anonymous author interview with a senior researcher of a government-affiliated think tank, Beijing, November 2025.

(10) Anonymous author interview with a mid-level Chinese state official, Beijing, November 2025.

While the second Trump administration appears less consistent or even overtly kleptocratic in its China policy, the drive towards technological decoupling is likely to remain in place.

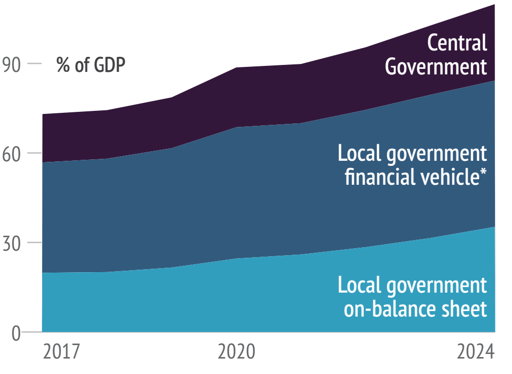
The fourth and final structural challenge is China's diminishing capacity to continue supporting its economy through public spending. For many years, the country was praised for its apparent fiscal room for manoeuvre. Most notably, during the 2008 global financial crisis, Beijing deployed a massive stimulus package that successfully shielded the domestic economy from the collapse in global demand. The legacy of that intervention, however, combined with subsequent rounds of stimulus, has been a sharp accumulation of public debt. As a result, total government debt rose from a manageable 73% of GDP in 2017 to around 100% by 2025. While this level remains below that of some advanced economies, such as the EU or the United States, it is exceptionally high for a country at China's level of per capita income.

The central role of banks in allocating resources in China is crucial.

The core of the debt problem lies not with the central government but with local and regional authorities. In particular, vast amounts of debt have been accumulated off-balance sheet through local government financing vehicles (LGFVs) (see Figure 6).

6 | **Most of China's debt is at the local level**

China's outstanding government debt



Data: Natixis, China Ministry of Finance, China National Bureau of Statistics, IMF, CEIC, WIND

* Local government financial vehicle data is estimated by IMF

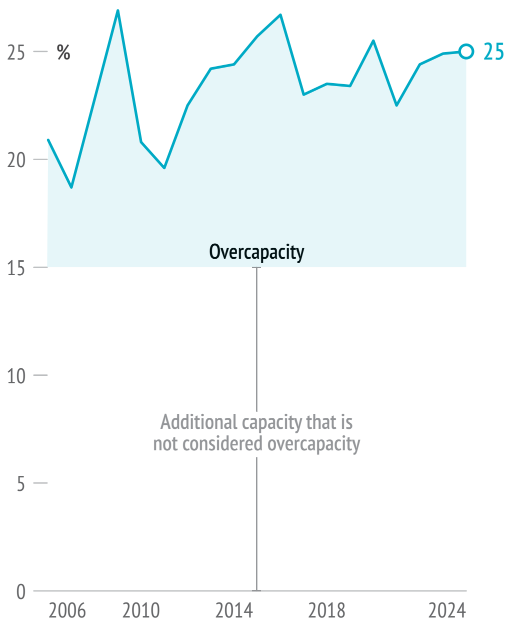
The growing debt burden reflects a persistent misallocation of resources, resulting in extensive overcapacity and mounting deflationary pressures [11]. China's manufacturing capacity utilisation rate stood at just 75% in 2024, indicating significant excess capacity and discouraging new investment (Figure 7). As export markets close, surplus capacity is redirected inward, further intensifying deflationary pressures. These dynamics have led to a steady decline in the average return on capital (ROC) across the corporate sector. Most alarmingly, even privately owned enterprises (POEs), usually the most dynamic and efficient segment of the economy, are experiencing falling returns (Figure 8). This broad-based decline points to a systemic problem of capital misallocation, with vast resources channelled into projects of diminishing profitability.

Against this backdrop, the central role of banks in allocating resources in China is crucial. The banking system is dominated by state-controlled institutions, most of them owned by local governments. Lending decisions are driven primarily by political guidance rather than risk assessment. As a result, banks overwhelmingly favour state-owned enterprises

(11) Davis, J.S. and Kelly, B., 'China manufacturing overcapacity boosts output, stagnation fears', Federal Reserve Bank of Dallas, 30 December 2025 (https://www.dallasfed.org/research/economics/2025/1230).

7 | China has substantial overcapacity

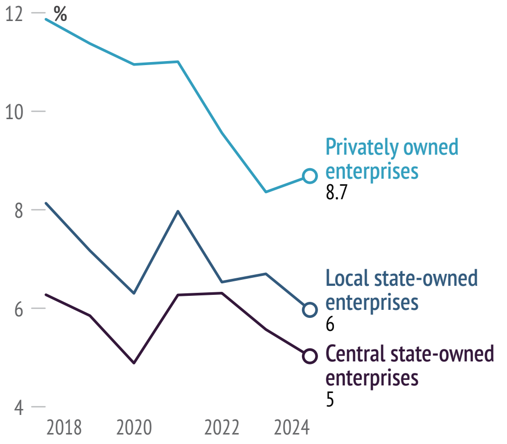
Distance from full capacity utilisation at year's end



Data: Natixis China National Bureau of Statistics; CEIC

8 | China's efficiency is declining

Average return on investment of Chinese firms



Data: Natixis; Financial Statements

(SOEs) despite their lower profitability.[12] Chinese bank managers have been well aware of the problem for a decade and identify this as a persistent structural weakness[13]. The result is not only rising debt but also a growing stock of non-performing loans. While the official non-performing loan ratio stands at around 1.5%, private conversations with Chinese officials suggest that even PRC authorities estimate the true figure to be as high as 15–20% [14].

All this illustrates the scale of the challenges facing the CCP leadership. China's old growth model, built on cheap labour, (infrastructure) investment and exports, is under growing strain. For many international companies, China is becoming a less attractive market. Weak domestic consumption combined with overcapacity creates an increasingly difficult operating environment for European firms at home, while in third markets they face competition from heavily subsidised Chinese exports that Chinese companies can no longer absorb domestically.

In principle, China could reverse this trajectory through structural reform. Beijing could leverage innovation to raise total factor productivity, supported by higher R&D spending. Realising these gains, however, would require a reduction in state intervention, the removal of subsidies that favour inefficient state-owned enterprises, and greater market entry and exit to improve resource allocation

(12) Lardy, N. *The State Strikes Back: The end of economic reform in China?* Columbia University Press, New York, 2019.

(13) Anonymous author interview with a former manager of a leading state-owned Chinese bank, Beijing, October 2016, cited in: Rühlig, T., *China's Foreign Policy Contradictions: Lessons from China's R2P, Hong Kong, and WTO policy*, Oxford University Press, New York, 2022, p. 143. Anonymous author interview with a bank manager, Beijing, December 2024.

(14) Two anonymous author interviews with mid-level Chinese officials, Beijing, November 2025.

– measures that remain highly unlikely. Policies to address population ageing, such as raising the retirement age or investing in AI and automation, could also extend China's 'window of opportunity' until around 2035. At present, however, there are few signs of such comprehensive reform. China's forthcoming 15th Five-Year Plan instead points to policy continuity rather than a decisive break with the past.

These challenges are not only economic. They also place growing strain on society, with potential implications for public acceptance of CCP rule. Addressing social grievances is politically fraught. Expanding the money supply could stimulate the economy but would risk fuelling inflation. Tightening policy to contain inflation, by contrast, could choke off growth. Efforts to ease demographic pressures by extending working lives would further weaken the already limited opportunities available to younger generations. Persistent structural youth unemployment would, in turn, undermine the sustainability of health and pension systems. Meanwhile, many young women are choosing not to have children, fearing they will never catch up in the fierce competition for education and employment while bearing the high costs of raising and educating a child. The next chapter examines these consequences in greater depth, along with the party-state's responses.

CHAPTER 2

TOWARDS CRISIS RESILIENCE

How China responds to vulnerabilities

China's structural economic challenges and deteriorating growth trajectory have far-reaching strategic implications for the CCP. For decades, domestic legitimacy rested on an unwritten social contract. After Mao Zedong's death in 1976 and the launch of the Reform and Opening-up policy, economic performance – rapid growth, rising prosperity and poverty reduction – supplanted communist ideology and nationalism as the Party's main source of legitimacy. This helps explain why the population stayed largely out of politics in exchange for steadily rising living standards, even though gains were unevenly distributed. China's improving international status reinforced this implicit bargain.

Today, slower growth rates – often dubbed the 'new normal' – raise doubts about whether economic performance can continue to sustain CCP rule. One might argue that, because China is not a democracy, the Party does not require public legitimacy. History, however, has instilled deep caution within the CCP:

> *Our leaders emphasise the importance of maintaining 'social stability' for very good reason. We are undergoing a deep transformation. If we get it wrong, our system will encounter the same fate as the Kuomintang in Taiwan, the Soviet Union or the Qing dynasty. [...] History tells us that power is not a given – no matter how stable it seems to be. And right now, we are undergoing turbulent times with potentially far-reaching consequences*[(1)]*.*

Even if short-lived, protests against the 'zero-Covid' policy – notably, but not only, in Shanghai, where citizens held up blank sheets of paper refencing state censorship of their grievances – have revived anxieties within the Party about social destabilisation. In several author interviews, officials and researchers at government-affiliated think tanks voiced concern that public discontent in some provinces could again reach levels sufficient to trigger similar protests. Gone are the days, prior to 2018, when Xi Jinping urged young people to 'dare to dream'. Since 2022, he has been preparing the country for what he describes as the 'inevitable encounter of various predictable and unpredictable risks, challenges, difficulties, obstacles and even stormy waves[(2)]', exhorting a disillusioned youth to 'endure hardship', 'struggle' and 'eat bitterness'[(3)]. Institutionally, the

(1) Anonymous author interview with a former party-state official now working as a senior researcher in a state-run think tank, Beijing, December 2024.

(2) Government of China, 'Xi Jinping delivered an important speech at the opening session of the seminar on studying and implementing the guiding principles of the 20th Party Congress', 7 February 2023 (https://www.gov.cn/xinwen/2023-02/07/content_5740520.htm).

(3) Government of China, 'The good youth of the new era in the General Secretary's mind', 3 May 2023 (https://www.gov.cn/yaowen/2023-05/03/content_5754025.htm).

Party is preparing for crisis by tightening party-state control and reinstating mechanisms designed for emergency conditions.

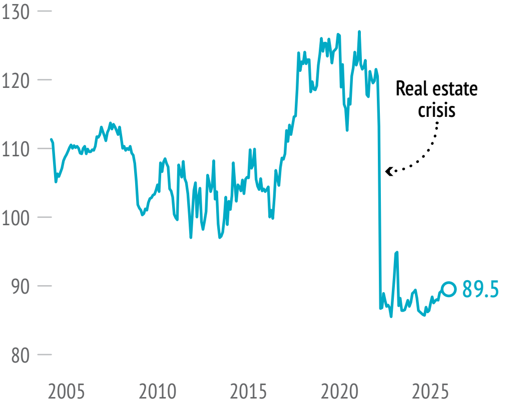
Yet the social consequences of slowing growth are significant. One example is youth unemployment, which officially reached 16.5% in December 2025. The true rate may be far higher. In an interview, a Chinese official speculated that real youth unemployment may have surpassed 50% [(4)]. While overall unemployment officially stood at 5.1% in November 2025, unofficial estimates – confirmed by state officials in private conversations– suggest that it is likely to be well above 20%, with significant regional disparities. These pressures are likely to intensify. The government's ambition to create 12 million urban jobs in 2025 does not even match the 12.22 million university graduates expected that year, let alone graduates from previous cohorts or those entering the labour market without a university degree [(5)].

Under these conditions, millions are forced to accept jobs below their qualifications. The high hopes of millions of families that invested their savings in their children's education risk being dashed. This, in turn, depresses consumer confidence, which collapsed after the end of Covid restrictions in China (see Figure 1).

Growing pessimism in a traditionally optimistic society has increased the risk of emigration and capital flight. The online catchphrase, 'the art of running away',

1 | **The real-estate collapse shattered Chinese consumer confidence**

Chinese Consumer Confidence Index, Mar 2004 - Dec 2025



Data: National Bureau of Statistics

gained traction during the Shanghai lockdown. China's authorities responded by tightening restrictions on 'non-essential' exits. Yet despite a growing middle class and rising wealth, China remains a country of net emigration (Figure 2). Globally, China now accounts for the highest number of wealthy individuals leaving their country [(6)]. Some of them migrate to Europe. Since 2015, 87% of applicants to Malta's residence-by-investment scheme have been Chinese [(7)].

China is also concerned about capital flight. Capital controls allow citizens to convert only USD 50,000 a year, although many circumvent these constraints through underground channels and fake invoices, commonly referred to as 'flying money'. The authorities have sought

(4) Anonymous author interview with a Chinese official, Beijing, November 2025.

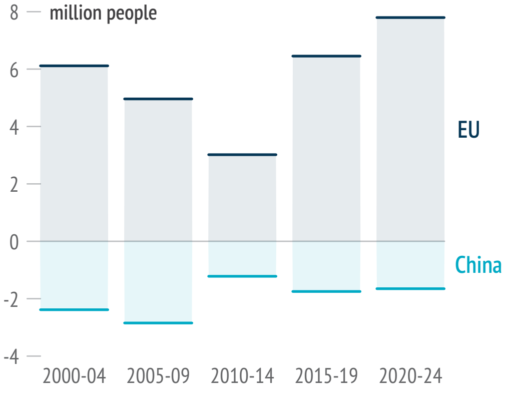
(5) State Council of China, 'China adds 6.95 mln new urban jobs in H1, achieving 58 pct of annual target', 22 July 2025 (https://english.www.gov.cn/archive/statistics/202507/22/content_WS687f25b7c6d0868f4e8f4562.html); Li, A., 'China's job market braces for record number of fresh graduates next year', *South China Morning Post*, 14 November 2024 (https://www.scmp.com/economy/china-economy/article/3286557/chinas-job-market-braces-record-number-fresh-graduates-next-year).

(6) 'The Henley private wealth migration report 2024', Henley & Partners, 18 June 2024 (https://www.henleyglobal.com/newsroom/press-releases/henley-private-wealth-migration-report-2024).

(7) Saliba Haig, A., 'Residency Malta Agency publishes MPRP statistics for the first time', CCMalta, 26 January 2022 (https://www.ccmalta.com/insights/residency-malta-agency-publishes-mprp-statistics).

2 | Despite rising wealth, China faces emigration

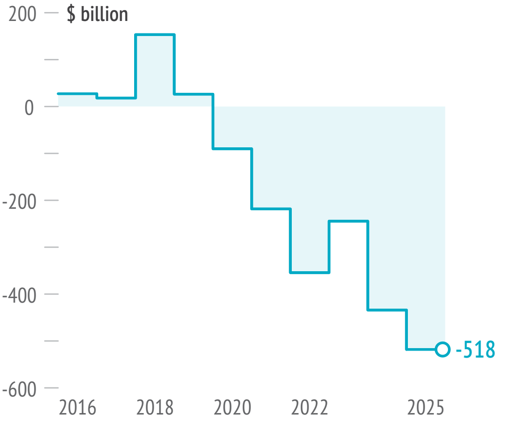
Net migration in China and the EU



Data: World Bank

3 | Capital outflows from China are accelerating

China's net capital flows



Data: State Administration of Foreign Exchange

to crack down on such practices. Yet the outflow continues (Figure 3).

These migration and capital flight figures are widely interpreted within the political establishment as evidence of growing pessimism, often linked to a well-known internet meme. Luo Huazhong, a 31-year-old former factory worker, posted a photo of himself lying in bed with the caption: 'Lying flat is justice.' He invoked the ancient Greek philosopher Diogenes, who famously rejected Athenian high society by living in a wine barrel. The post spread rapidly, inspiring online communities of 'lie-flatters' who shared their sense of disillusionment. Although censors shut down these discussions, the phrase has endured, especially among urban youth, and remains popular to this day. In interviews, lecturers at China's top universities report that a large share of their students – estimates range from a half to two thirds – are seeking psychological treatment [8]. Increasingly, even Chinese officials who act only on instructions, for fear of disciplinary action, are described as 'lying flat'.

We cite these examples not to predict the downfall of the CCP. The Party has demonstrated its capacity for adaptation more than once. While the concentration of power may make adaptation more difficult, our argument is that, regardless of whether one believes that CCP rule is under imminent threat, the Party itself is deeply concerned. Anxiety about social stability is a key factor shaping policy debates in Beijing:

> *This [crisis] is about everything for us, whether we like it or not. Essentially, everyone has understood that. [...] At this point, my greatest hope is that we can get agentic artificial intelligence to increase our productivity and get us into a new growth dynamic* [9].

Beyond investing in innovation, the CCP is responding in two overlapping ways with far-reaching implications: first, by increasing party-state control; and second, by drawing on nationalism as a source of legitimacy.

(8) Anonymous author interviews with lecturers and professors teaching at leading Chinese universities, Beijing and Shanghai, December 2024.

(9) Anonymous author interview with a Chinese state official, Beijing, December 2024.

CRISIS MODE (1): PRIORITISING CONTROL OVER GROWTH

From the 1980s onwards, the party-state prioritised economic growth. To this end, it adopted a pragmatic approach that oscillated between varying degrees of centralised control and decentralisation, allowing policies to adapt to China's diverse local conditions. The central leadership encouraged local experimentation. Liberalisation measures, for example, were tested in Special Economic Zones, and successful approaches were then rolled out nationwide. Five-Year Plans no longer prescribed economic development in detail but instead signalled broad strategic direction from the centre. On the basis of such signals, economic stimulus largely came from local, state-controlled banks. Another example is the role of privately owned companies, which drove large parts of China's digital innovation. Firms such as Huawei, Tencent, Alibaba, Baidu, Xiaomi, ByteDance, JD and BYD benefited extensively from party-state support but were essentially privately owned, although state institutions have since acquired some 'golden shares'.

The CCP has shifted from growth-oriented to control-focused policies aimed at strengthening crisis resilience.

This approach changed under Xi. The CCP has shifted from growth-oriented to control-focused policies aimed at strengthening crisis resilience. Economic self-reliance is intended to shield the People's Republic of China from external shocks. Beijing has also increased the visibility and reach of the Party across the economy, the media, society and the political system.

> **Economy**: Long-running rebalancing towards the state sector has recently hardened into explicit governance doctrine and enforcement. Credit allocation and 'enhanced policy roles' for state-owned banks further institutionalise preferential treatment for SOEs [10], while Party cells in major private firms normalise CCP presence inside corporate decision-making. The 2025 guidance on the 'modern corporate system with Chinese characteristics' marks a step change: it openly ties corporate governance 'modernisation' to party-state objectives rather than market performance alone. The previous clampdown on powerful private tech firms – alongside the policy push towards hardware and 'strategic' industrial priorities – signals less tolerance for autonomous business models and confirms that private sector dynamism is increasingly conditional on political alignment.

> **Media**: Media and propaganda management have shifted from periodic tightening to sustained, campaign-style enforcement, supported by new institutional and technical infrastructure. The early 2025 deletion of over a million items as part of a crackdown on online 'rumours" and the spread of 'bad culture' shows the greater tempo and reach of censorship

(10) 'China state banks: Q&A on enhanced policy roles', Fitch, 14 April 2025 (https://www.fitchratings.com/research/banks/china-state-banks-q-a-on-enhanced-policy-roles-14-04-2025).

operations [11]. Ideological content has also been upgraded from emphasis to requirement, as illustrated by the November 2025 instruction to promote 'Xi Jinping's Diplomatic Thought Learning Outline' in cadre training. Meanwhile, control is increasingly embedded in digital platforms: extensive keyword and nickname blocking and platform liability rules narrow the scope of permissible debate even in the absence of visible crackdowns [12]. The July 2025 rollout of an enhanced, centralised internet ID system marks an infrastructure shift – pushing real-name governance from platform compliance toward state-level standardisation.

The broader pattern is that coercive capacity is being further institutionalised and strengthened.

> **Society**: China's surveillance expansion is not only continuing; it is becoming more standardised and legally codified. The introduction in 2025 of new regulations on public security video images and new facial recognition rules reflects an effort to streamline, scale and normalise the collection and use of biometric-enabled monitoring technologies. Reports of ongoing local DNA sampling and database updates indicate that biometric governance is becoming embedded in routine administration, rather than confined to high-profile security operations. At the community level, 'grid management' appears to be evolving from a Covid-era tool of emergency mobilisation into a permanent system of micro-governance, integrating routine surveillance and information control into everyday neighbourhood life [13]. After residents in Shanghai sang from their balconies in protest against zero-Covid measures, a video circulated of a drone hovering above a residential compound broadcasting a dystopian directive: 'Control your soul's desire for freedom. Do not open the window to sing.' Numerous cultural institutions that once provided space for alternative art have been closed in recent years, while human rights lawyers have faced repeated waves of arrest. The broader pattern is that coercive capacity is being further institutionalised and strengthened – through rules, systems, and dedicated personnel [14].

> **Political system**: The post-2013 trend towards greater Party visibility is now reinforced by new nationwide campaigns and tighter elite discipline, suggesting consolidation rather than mere continuity. The March 2025 education campaign on the Party's 'eight-point decision' is a concrete example of a recurring 'campaign format' used to reaffirm loyalty and behavioural discipline across the system. Re-centralisation is also evident in the October 2025 Fourth Plenum communiqué, which urged cadres to rally around the centre 'with Comrade Xi

(11) Cyber Administration of China, 'Platforms publish results and typical cases from the "Clear and Bright" special crackdown on the 2025 Spring Festival online environment', 13 February 2025 (https://www.cac.gov.cn/2025-02/13/c_1741063712043835.htm).

(12) 'Xiaohongshu Censorship Encyclopedia: Xi Jinping Sensitive Words Database', *China Digital Times*, 20 July 2022 (https://chinadigitaltimes.net/space/%E5%B0%8F%E7%BA%A2%E4%B9%A6%E5%AE%A1%E6%9F%A5%E7%99%BE%E7%A7%91%EF%BC%9A%E4%B9%A0%E8%BF%91%E5%B9%B3%E6%95%8F%E6%84%9F%E8%AF%8D%E5%BA%93).

(13) Pei, M., 'Grid management: China's latest institutional tool of social control', *China Leadership Monitor*, Vol. 67, 1 March 2021 (https://www.prcleader.org/post/grid-management-china-s-latest-institutional-tool-of-social-control).

(14) An, Y. and Zhang, T., 'Pandemic state-building: Chinese administrative expansion since 2012', *Yale Law & Policy Review*, 2024 (https://yalelawandpolicy.org/sites/default/files/YLPR/an_zhang_pandemic_state-building_ylpr_2024.pdf).

Jinping at its core', underscoring the renewed emphasis on political signalling at key moments. Finally, the anti-corruption drive has evolved from a signature initiative into a standing enforcement mechanism: the reported disciplining of 983 000 officials in 2025 alongside continued purges that took place in January 2026 targeting Zhang Youxia and Liu Zhenli – the vice-chairman of China's Central Military Commission and its Chief of Staff, respectively – indicate sustained pressure on cadres and the security apparatus.

The cumulative change lies less in the direction of travel than in the intensification and routinisation of mechanisms of central control – campaigns, discipline and cadre management. This contrasts with China's previous multi-centred power structure, in which local governments and state agencies visibly implemented policy and exercised a degree of decentralised authority.

While this concentration of power at the top of the Party may reinforce loyalty, it also entails inherent risks. Greater centralisation increases the likelihood that citizens will hold the Party directly responsible for policy failures. In previous decades, the Party tended to become visible only in moments of crisis, intervening to correct shortcomings that the public associated with state institutions rather than with the CCP itself. Today, heightened visibility has turned this mode of episodic crisis intervention into a permanent feature of governance.

China's leaders tend to prioritise Party control to strengthen crisis resilience.

Developments in recent years indicate that China's leaders tend to prioritise Party control to strengthen crisis resilience, even when this comes at the expense of growth. Crucially, this is not merely a response to the post-Covid period of economic weakness: the Chinese leadership has put many of these policies in place over the past decade in anticipation of a looming crisis.

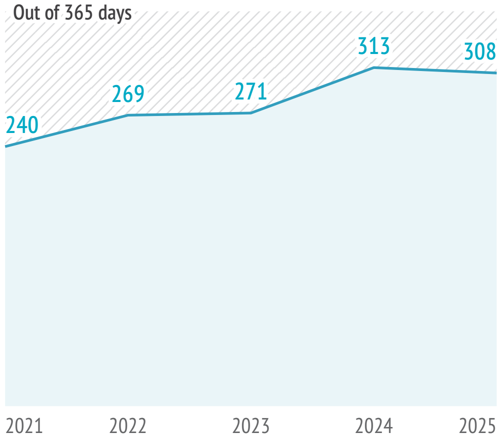
CRISIS MODE (2): PRIORITISING NATIONALISM OVER REPUTATION

For decades, the CCP has argued that it ended China's 'century of humiliation', from the mid-nineteenth to the mid-twentieth century, when the country suffered semi-colonial subjugation and civil war. The Party maintains that China has since regained its international standing as a responsible, civilised and reliable actor through economic growth and global integration. Concepts such as China's 'peaceful rise' and its status as a 'responsible major power' have encapsulated this emphasis on the country's international reputation.

References to national pride have become increasingly assertive and overtly nationalist in recent years. At the military parade marking the 80th anniversary of victory over Japan in September 2025, Xi praised the People's Liberation Army (PLA) as a 'heroic force' and described the 'great rejuvenation' of the nation as

4 | China is increasing military pressure on Taiwan

PLA median-line violations



Data: Ministry of National Defence of Taiwan

'unstoppable'[15]. Xi has repeatedly called for a stronger sense of community and a shared Chinese identity across the nation, while warning that 'various hostile forces will by no means allow us to smoothly realise the great rejuvenation of the Chinese nation'[16]. Nationalism is thus closely intertwined with his call on citizens to subordinate individual interests to collective goals. This rhetoric mirrors a more assertive Chinese foreign policy.

> **Military operations in East Asia:** While China's claims over Taiwan are longstanding, the PLA has increasingly violated the median line in the Taiwan Strait. Chinese military aircraft crossed the median line on more days in 2024 than in any previous calendar year; this figure has remained broadly stable in 2025 (see Figure 4). Xi Jinping has declared that 'China must and will be reunited'[17]. Most recently, at the end of December 2025, China's PLA conducted large-scale drills around Taiwan, including operations in multiple sectors around the island, and tested blockade-style and encirclement scenarios. These exercises underscore Beijing's coercive approach and reinforce its longstanding message that Taiwan must be 'reunified' under PRC control, framed by the PLA as defending 'national unification'.

> **Expansion of the PLA:** China is not only modernising the PLA; Xi has also signed a new Reservists Law. The law stops short of introducing universal conscription into the reserves, but it allows the PLA to expand without an immediately visible increase in headline force numbers. Instead, it formalises and broadens the legal framework for the selection, mobilisation, training and management of reservists, establishes mechanisms to recruit different categories of reservists, raises retirement ages and thereby extends the overall pool of available personnel[18].

> **Economic coercion:** China has also used economic coercion against several countries. Recent examples include China's export restrictions linked to the Netherlands' intervention in the Chinese-owned chipmaker Nexperia, as well as China's 2025 rare-earth export controls – notably the licensing requirements introduced on 4 April

(15) 'Xi Jinping: The great rejuvenation of the Chinese nation is unstoppable!', *People's Daily*, 3 September 2025 (https://cpc.people.com.cn/n1/2025/0903/c164113-40556222.html).

(16) 'Xi Jinping: Unity and hard work are the only path for the Chinese people to create great achievements in history', Xinhua, 30 June 2025 (http://www.xinhuanet.com/politics/leaders/20250630/f25e2b55ac7e4aefab415a888ce62362/c.html)

(17) 'Xi Jinping: The complete reunification of the motherland must be realized, and it certainly will be realized!', Disciplinary Commission of the Communist Party of China in Sichuan, 17 October 2022 (https://scjc.gov.cn/scjc/stdhesd/2022/10/17/5fd28697aec7438495a1702100925d88.shtml).

(18) National People's Congress, 'Law of the People's Republic of China on reserve personnel', 30 December 2022 (https://flk.npc.gov.cn/detail?fileId=&id=ff8081818556718601856116 3b860552&title=%E4%B8%AD%E5%8D%8E%E4%BA%BA%E6%B0%91%E5%85%B1%E5%92%8C%E5%9B%BD%E9%A2%84%E5%A4%87%E5%BD%B9%E4%BA%BA%E5%91%98%E6%B3%95&type=&utm).

2025 on multiple rare earths and magnets, which were later tightened in October 2025 to cover related technologies. These episodes reflect a broader pattern in which Beijing combines formal measures with opaque or informal tools — including consumer boycotts, administrative obstruction, export controls and threats of secondary consequences — to raise the economic costs of violating what China defines as its core interests.

Yet the CCP's turn towards nationalism again carries risks, as it raises public expectations that the Party will deliver on its promises:

> *[Slowing] growth comes with suffering. Nationalism helps to suggest that hostile foreign forces bear responsibility for it and suggests that the people should remain loyal to the Party that steers the entire nation through suffering to national glory and global power. […] There is a strong sense of nationalism in our society. The Party can only profit from it when it appears to be strong and forceful in defending national pride and national interest. Otherwise, its own rhetoric could backfire* [19].

All this is not to deny that China continues to care about its international reputation. Beijing, for example, repeatedly claims that its influence in the international arena differs fundamentally from what it portrays as US imperialism. The primary focus of such outreach is the Plural South. Even so, China's leaders now prioritise nationalism over the country's international reputation far more frequently than in previous decades. As with the turn towards control as a means of strengthening crisis resilience, this shift has been pursued over the past decade in anticipation of looming crises [20].

The CCP's efforts to address growth vulnerabilities have serious consequences beyond China. Tighter control to focus on crisis resilience is reducing opportunities for European businesses. At the same time, rising nationalism and the intensification of authoritarian rule are sharpening perceptions of systemic rivalry between European democracies and China's autocracy. Most importantly, the Party's twin responses to domestic vulnerabilities have two direct effects on China's foreign policy:

The CCP's efforts to address growth vulnerabilities have serious consequences beyond China.

1. The shift towards control as a means of strengthening resilience to economic crises is driving a focus on managing dependencies: reducing China's reliance on external actors where possible and, since full self-reliance is unrealistic, increasing the strategic dependence of foreign actors on China.

2. The turn towards nationalism is pushing Beijing to prioritise relative gains over absolute ones. China is no longer primarily focused on generating prosperity, but on outperforming the West.

Together, these dynamics complicate EU–China relations, as explored in the following chapter.

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(19) Anonymous author interview with a senior researcher of a state-run Chinese think tank, Beijing, December 2024.

(20) Anonymous author interview with a Party official, Beijing, November 2025.

CHAPTER 3

NOT BENIGN

Consequences for China's external behaviour

China's domestic drive to increase state control, combined with heightened nationalism, has implications for its external behaviour. Reflecting internal trends, China seeks to tighten control over economic dependencies — reducing its own reliance on other states while deepening others' dependence on China. At the same time, the turn towards nationalism pushes the PRC to focus more on relative gains, defined as performing better than the West. Together, these dynamics do not make China a more benign actor from a European perspective; instead, they further complicate EU–China relations. Put simply, China's internal vulnerabilities are not good news for the EU.

China's efforts to tighten control over economic dependencies, its increasingly assertive nationalism and its determination to preserve international economic power are shaping its external economic policies. This is evident in three key areas discussed below: (a) global dependence on Chinese industrial manufacturing; (b) international lock-in to Chinese technological innovation; and (c) de-dollarisation efforts that strengthen the renminbi.

INDUSTRIAL MANUFACTURING DEPENDENCIES

Chinese ambitions

Xi Jinping has explicitly called on China to become a 'manufacturing power' [1]. This ambition is longstanding: in 2015, when unveiling the 'Made in China 2025' initiative, Beijing openly declared its intention to transform China into a global leader in advanced industries. Xi's rhetoric makes clear that this goal is closely intertwined with China's embrace of nationalism and its emphasis on control as a source of crisis resilience. In numerous speeches, he frames manufacturing as the nation's 'lifeline', the foundation of statehood, and the bedrock of strength and national rejuvenation. This language elevates manufacturing from a technical economic policy to a core element of national power, dignity, pride and identity, making industrial achievement a political and symbolic objective as much as an economic one.

Industrial manufacturing is also explicitly linked to technological self-reliance as a

(1) 'Study guide on General Secretary Xi Jinping's important discourses on building a manufacturing powerhouse published', *People's Daily*, 24 January 2024 (https://paper.people.com.cn/rmrbhwb/html/2024-01/24/content_26038791.htm).

means of bolstering China's resilience to external shocks. Beijing has deliberately sought to enhance its strategic autonomy within global supply chains [(2)]. As a result, industrial manufacturing has become central to China's approach to crisis resilience through increased control.

China's achievements

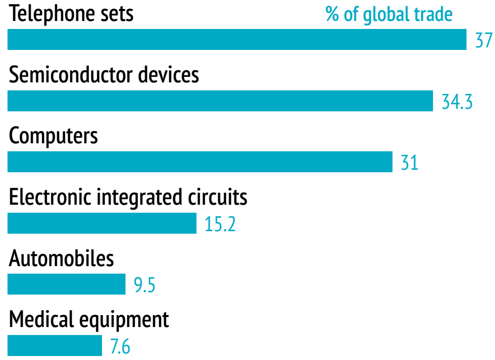
China is the world's largest manufacturer, having increased its global manufacturing share from around 6% in 2000 to roughly 30% in 2022 and is projected to reach 45% in 2030 [(3)]. The next four largest manufacturers – the United States, Japan, Germany and India – together account for a smaller share than China alone. China's domestic market absorbs only part of this output. Its share of global manufactured goods exports rose from 3% in 1995 to about 20.5% by 2024. At the sectoral level, China dominates many strategic industries, including the refining of critical raw materials and clean technologies such as electric vehicles, solar panels and batteries, among many other examples (see Figure 1).

Beijing has deliberately sought to enhance its strategic autonomy within global supply chains.

What turns these dependencies into sources of international economic power is China's willingness to coerce its trading partners. Beijing has strengthened its legal and institutional toolkit to exploit such dependencies. The Export Control Law of October 2020 grants broad powers to impose export bans or quotas on goods deemed strategically important, including, beyond military and dual-use items, 'other goods affecting national security and interests'. China has also created an

1 | **China holds high shares of global trade in strategic goods**

Export share of China's strategic industries, 2024



Data: Natixis; International Trade Centre

Unreliable Entity List to exclude firms from Chinese supply chains, mirroring the US Entity List.

China has used these instruments on several occasions, including export controls on industrial outputs such as chemicals and rare earths. The most drastic measures were adopted in April and October 2025, affecting a wide range of rare earths and related products and also impacting the EU. The latest export restrictions have been published in January 2026 targeting the export of dual-use items to Japan.

Factors of success

China has achieved this position through the interaction of several factors.

1. *Infrastructure and clustering:* Massive state-directed investment in transport

(2) 'China's Xi Jinping steps up calls for industrial self-sufficiency amid trade war', *Financial Times*, 20 May 2025 (https://www.ft.com/content/7485a549-4648-4c1b-885a-07b9616cf589).

(3) 'The future of industrialization', op. cit.

and industrial infrastructure has produced sprawling coastal manufacturing hubs with deeply integrated supply chains. Provinces such as Guangdong, Jiangsu and Zhejiang host dense networks of world-class suppliers, efficient seaports, modern highways and high-speed rail. This clustering, initially fostered through special economic zones and preferential policies, creates strong competitive advantages by sharply reducing logistics costs and accelerating production. Over time, this strategy has been systematically extended inland.

2. *Complete supply chains:* China has prioritised the development of complete domestic supply chains that few competitors can match. The battery industry, for example, spans all stages from raw material extraction to cell production and electric vehicles. Similar integration exists in solar power, from polysilicon to panels, and in steel, from mining to finished products. This tight internal integration reduces logistics costs, mark-ups and development cycles. In many cases, firms are vertically integrated within a single company. Backed by state finance, companies have absorbed low-margin production stages that others would outsource. While outsourcing may be more efficient in the short term, China has strategically used this approach to squeeze competitors out of the market.

China has prioritised the development of complete domestic supply chains that few competitors can match.

3. *Labour market and scale:* China's vast population initially provided an abundant and very low-cost labour force. Economic reforms triggered mass migration from rural areas to urban factories, sharply raising labour productivity. Combined with a huge domestic market, this labour supply enabled exceptional economies of scale. For decades, Chinese firms could outproduce competitors and undercut them on price.

4. *State support and industrial policy:* The state's role extends far beyond simple subsidies and involves a broad range of support instruments to nurture targeted industries. A cornerstone of the state-led model is the strategic use of financial levers [(4)]. The state-dominated banking sector reinforces this support through 'soft loans' and credit at below-market rates, amounting to a substantial indirect subsidy. In addition, the state acts as a major equity investor through government guidance funds. These not only inject capital into priority sectors but also serve as a signal of state endorsement that attracts further private investment.

   Beyond financial intervention, the state offers critical strategic support. Preferential access to land, which is entirely state-owned, confers a major advantage. Beijing has also leveraged its vast market to compel technology transfer from foreign firms, often through mandatory joint ventures, and has supported the acquisition of foreign technology companies. These measures have reduced China's import dependence in many strategic sectors [(5)].

(4) 'EU probe into Chinese electric vehicle subsidies stirs debate over "unfair" treatment', SCMP, September 27 2024 (https://www.scmp.com/news/china/diplomacy/article/3267687/eu-probe-chinese-electric-vehicle-subsidies-stirs-debate-over-unfair-treatment).

(5) Boullenois, C., Black, M. and Rosen, D.H., 'Was Made in China 2025 successful?', Rhodium Group, 5 May 2025 (https://rhg.com/research/was-made-in-china-2025-successful/).

5. *Innovation and R&D:* China has clearly shifted away from a purely cost-based advantage. Research and development spending in manufacturing has nearly tripled over the past decade, with a strong focus on high-value sectors such as electronics, machinery and telecommunications. The role of innovation is discussed in more detail below.

Hurdles and pitfalls

China faces relatively few obstacles to further consolidating its manufacturing dominance. Among the five factors underpinning its success, China is likely to retain a clear advantage in two: infrastructure and clustering, and complete supply chains. State support and subsidies are also likely to continue, although they may decline or become more selective as public resources grow scarcer. China can be expected to remain innovative, although the extent of future gains remains uncertain, as discussed below. Of the five factors, rising labour costs represent the most significant constraint on further expansion of China's global manufacturing share.

The rise of Chinese manufacturing has triggered protectionist responses.

To offset higher labour costs, China has invested heavily in automation and technological upgrading. It is now the world's leading market for industrial robotics [6]. Alongside hardware, Chinese firms are deploying artificial intelligence, the Internet of Things and 5G technologies in factories, further boosting efficiency.

At the same time, the rise of Chinese manufacturing has triggered protectionist responses. The United States has imposed tariffs and export controls, while the EU has introduced tariffs on Chinese electric vehicles. India, Brazil and Argentina have adopted import tariffs, anti-dumping measures and local content requirements to shield domestic producers. Initially, many developing countries limited such measures to steel and textiles. More recently, they have expanded them to sectors including machinery, electronics, transport equipment and renewable energy components. Even Russia, despite its heavy dependence on China, has taken steps to protect its domestic car industry [7].

Finally, China's policy-driven growth has produced waste and overcapacity in sectors such as electric vehicles, steel and solar panels. The result has been chronic price wars, falling profitability and idle capacity. Over time, these inefficiencies could erode China's cost advantage, particularly if economic growth slows and subsidies become fiscally unsustainable.

China's chances of success

Despite these challenges, Beijing is likely to further expand its already dominant position in global industrial manufacturing. The forthcoming Five-Year Plan aims to accelerate the translation of innovation into industrial application, further boosting China's global manufacturing share. Beyond intensifying competition with European industry, this trajectory

(6) International Federation of Robotics, 'Industrial Robots 2024', 2024 (https://ifr.org/img/worldrobotics/Executive_Summary_WR_2024_Industrial_Robots.pdf).

(7) Caruso, A. and Rühlig, T., 'The dependence gap in Russia-China relations', Analysis, EUISS, 2 October 2025 (https://www.iss.europa.eu/publications/analysis/dependence-gap-russia-china-relations).

implies that Europe's economic dependencies on China will continue to increase. A clear policy implication is that the EU will need to accelerate its de-risking efforts to prevent its exposure to China's expanding manufacturing-driven economic influence from deepening further.

INNOVATION LOCK-INS

Chinese ambitions

Under Xi Jinping, Beijing has intensified efforts to develop China into an innovation power. In 2016, Xi unveiled a three-step strategy: by 2020, China was to 'enter the ranks of innovation-driven countries'; by 2030, the PRC should be among the 'front ranks of innovation-type countries'; and by 2050, China should become a world-leading science and technology innovation power [8]. To support these goals, the 14th Five-Year Plan (2021-2025) set ambitious targets for research and development spending [9]. The forthcoming 15th Five-Year Plan (2026–2030) will likely retain this emphasis and seek to translate more innovation into industrial application [10].

Notably, the CCP explicitly links these objectives to its prioritisation of crisis resilience through control and to its embrace of nationalism. The 14th and the forthcoming 15th Five-Year Plans shift the framing of innovation policy from technological upgrading to 'self-reliance and self-strengthening' in core technologies. The CCP has made clear that such technologies must not be subject to external control and that the PRC needs sufficient autonomy to enhance its crisis resilience. This emphasis on institutional control over innovation is reflected in the creation of the Central Science and Technology Commission, established in 2023 under Xi's leadership. China's innovation ambitions are also closely tied to rising nationalism:

> *It is the nation's destiny to be innovation-driven. The core support of national strength is technological innovation capability. [...] A major cause of China's stagnation in the modern era was that it let previous technological revolutions pass it by, leading to technological and national weakness. To achieve the Chinese dream of the great rejuvenation of the Chinese nation, one must truly make good use of science and technology* [11].

In policy terms, the systematic integration of defence and civilian technologies under the Military-Civil Fusion strategy illustrates how cutting-edge civilian innovation is expected to feed directly into national power and military modernisation.

China's achievements

The PRC has emerged as a global innovation powerhouse. Measured by

(8) 'Outline of the National Innovation-Driven Development Strategy', Xinhua, 19 May 2016 (http://www.xinhuanet.com/politics/2016-05/19/c_1118898033.htm).

(9) National Development and Reform Commission, 'Outline of the People's Republic of China 14th Five-Year Plan for National Economic and Social Development and Long-Range Objectives for 2035', 12 March 2021 (https://www.ndrc.gov.cn/xxgk/zcfb/ghwb/202103/P020210323538797779059.pdf).

(10) Chinese Central Government, 'Recommendations of the Central Committee of the Communist Party of China on formulating the 15th Five-Year Plan for National Economic and Social Development', 28 October 2025 (https://www.gov.cn/zhengce/202510/content_7046052.htm).

(11) 'Outline of the National Innovation-Driven Development Strategy', op. cit.

international research output, it leads in 37 of 44 critical technologies [12]. China now occupies a leading position in terms of both the quantity and quality of research publications and granted patents. Although the novelty of Chinese patents still lags behind that of the United States, China is now ahead of Europe in this respect [13].

High levels of innovation do not mean that China dominates emerging and foundational technologies across entire value chains. The semiconductor sector illustrates this point. China accounts for 17.6% of global production, just behind the United States at 19.3%. However, measured by the location of company headquarters, the PRC's share is only 6.5% [14]. Even in terms of production geography, China's strengths are concentrated in specific areas such as pure-play foundries, photomasks and back-end production in outsourced semiconductor assembly and testing. Its market share remains limited, however, in raw wafer production, intellectual property and electronic design automation. China's role has therefore expanded significantly, but it does not dominate complete supply chains and remains dependent on other actors in critical technologies.

Despite these constraints, China has successfully exported elements of its innovation model to third countries [15]. Chinese firms now provide core infrastructure in many emerging markets. The government has announced plans to increase the number of joint research and development laboratories with BRI partners to 100 and to host foreign scientists for short-term projects. Chinese innovation is also spreading through infrastructure projects ranging from fibre-optic networks and data centres to 'safe city' systems and e-commerce platforms.

> **China has successfully exported elements of its innovation model to third countries.**

In many cases, this creates dependencies on Chinese technology and the technical standards that underpin it. In Africa, for example, Chinese firms have built much of the continent's telecommunications infrastructure and often bundle low-interest loans and training with these projects. This tilts digital architectures towards Chinese platforms, from cables and base stations to core networks that must be maintained and upgraded by Chinese firms, giving the PRC long-term leverage.

Technical standards are particularly important in creating lock-in effects. Economic research shows that once a dominant standard emerges, especially when reinforced by complementary technologies, it becomes difficult to replace [16].

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(12) Gaida, J. et al., *ASPI's Critical Technology Tracker: The global race for future power*, ASPI, Report no. 69, 2023 (https://ad-aspi.s3.ap-southeast-2.amazonaws.com/2023-03/ASPIs%20Critical%20Technology%20Tracker_0.pdf?VersionId=ndm5v4DRMfpLvu.x69Bi_VUdMVLp07jw).

(13) Garcia-Herrero, A., Krystyanczuk, M. and Schindowski, R., 'Radical novelties in critical technologies and spillovers: How do China, the US and the EU fare?', Bruegel, 20 May 2025 (https://www.bruegel.org/working-paper/radical-novelties-critical-technologies-and-spillovers-how-do-china-us-and-eu-fare).

(14) 'Economic analysis of the EU and international semiconductor ecosystem', *ICOS*, 12 December 2023 (https://icos-semiconductors.eu/wp-content/uploads/2024/07/Public-Version-ICOS-Deliverable-2.1.pdf).

(15) Fahy, L., 'China's AI rollout could rival the US', *Capital Economics*, 14 January 2026 (https://www.capitaleconomics.com/publications/china-economics-focus/chinas-ai-rollout-could-rival-us).

(16) Bonardi, J.P. and Durand, R., 'Managing network effects in high-tech markets', *The Academy of Management Journal*, Vol. 17, No 4, November 2003, pp.40-52; Arthur, W.B., 'Competing technologies, increasing returns, and lock-in by historical events', *The Economic Journal*, Vol. 99, No 394, March 1989.

Countries that rely on such standards in critical sectors face limited supplier choice. It is therefore no coincidence that Beijing actively promotes Chinese technical standards as part of the BRI [17]. The PRC signs memoranda of understanding and bilateral agreements on standardisation cooperation with BRI partners and implicitly diffuses its standards through infrastructure projects, including railway signalling systems.

Factors of success

For a long time, observers attributed China's technological advances to catch-up driven by imitation and intellectual property theft, assuming that China lacked the political and market conditions for genuine innovation [18]. Five structural conditions have instead enabled China's unexpected innovation performance [19].

1. *Porous protectionism in a large market:* China's vast market attracts foreign firms. Contrary to perceptions of complete closure, the PRC has pursued a form of semi-protectionism, shielding and nurturing domestic firms while remaining sufficiently open to allow the inflow of ideas, capital and technology deemed useful [20]. The deliberately porous nature of controls, exemplified by the Great Firewall, and loosely framed regulations have enabled local experimentation and adaptation.

2. *Attracting and appropriating knowledge:* Technology transfer has been central to China's rise. Talent return programmes have drawn skilled professionals back to the PRC [21]. Conditional market access has facilitated technology transfers through mechanisms such as joint ventures. Participation in global supply chains has brought in practical manufacturing know-how. At the same time, intellectual property theft has played a role.

3. *Links with Western technology and research:* Close cooperation with Western technology firms and research institutions has also been crucial. China has imported advanced technologies, acquired foreign firms and engaged in extensive collaboration with Western universities and research centres. These interactions have supported technology transfer and provided insight into how innovation ecosystems function in advanced economies.

4. *The guiding role of the party-state:* Unlike in a traditional planned economy, the party-state no longer exercises direct control over innovation, but it steers and stimulates it. Five-Year Plans signal priorities and mobilise finance through the state-dominated banking system [22]. This approach socialises a large share of investment risk, tolerates frequent failures and seeks to identify eventual scale winners. State investment in infrastructure further

(17) Silk Road International Chamber of Commerce, 'Standard-Connectivity Joint Action Plan for the Belt and Road Initiative (2018–2020)', n.d. (https://srcic.org/upload/newsletter/16/pdf_zh/5bfd0ba90de69.pdf).

(18) Abrami, R.M., Kirby, W.C. and McFarlan, F.W., 'Why China can't innovate', *Harvard Business Review*, March 2014 (https://hbr.org/2014/03/why-china-cant-innovate).

(19) Rühlig, T., 'The sources of China's innovativeness: Why China's "unstoppable" innovation powerhouse might falter', German Council on Foreign Relations, 31 October 2023 (https://dgap.org/en/research/publications/sources-chinas-innovativeness).

(20) Sheehan, M. 'The Chinese way of innovation', *Foreign Affairs*, 21 April 2022 (https://www.foreignaffairs.com/articles/china/2022-04-21/chinese-way-innovation).

(21) Weinstein, E., 'Chinese talent program tracker', Center for Security and Emerging Technology, n.d. (https://chinatalenttracker.cset.tech).

(22) Heilmann, S., *Red Swan: How unorthodox policymaking facilitated China's rise*, Columbia University Press, New York, 2018.

enables the deployment of new technological applications.

5. *Internal competition with Chinese characteristics:* China's innovation system is shaped by intense competition among private firms and between local party-state actors. Combined with highly adaptive consumers who rapidly adopt new technologies, this competition accelerates diffusion and iterative improvement[23].

Hurdles and pitfalls

Unlike in industrial manufacturing, China now faces challenges across all five factors that previously underpinned its innovation success[24].

1. *Growing protectionism:* China's semi-protectionist market is becoming more restrictive. The party-state is tightening internet controls, clamping down on virtual private networks and enforcing stricter data regulations[25]. These measures increase state control but reduce the openness that once fostered innovation. At the same time, Western economies are seeking to de-risk and diversify away from China.

2. *Knowledge barriers:* Tighter national security legislation and slower economic growth are discouraging foreign investment. Western export controls and limits on investment guarantees further reduce incentives to engage with China[26].

3. *A more hostile external environment:* Rising mistrust between China and Western countries has created an adversarial climate. Measures such as foreign direct investment screening, export controls and restrictions on research collaboration are becoming more common. China's Intelligence Law has heightened security concerns and discourages cooperation with Chinese partners[27].

4. *Centralisation of control:* State steering that once supported innovation risks tipping into excessive control. The creation of the Central Science and Technology Commission reflects a broader shift towards greater centralisation[28]. Combined with Western anti-subsidy measures, this trend may undermine the flexibility and dynamism of China's innovation system.

5. *Growing insecurity:* Regulatory crackdowns on major technology firms such as Alibaba, Tencent and Didi, along with the anti-corruption campaign and pandemic policies, have created uncertainty among entrepreneurs and officials. This environment

(23) Dychtwald, Z., 'China's new innovation advantage', *Harvard Business Review*, May-June 2021 (https://hbr.org/2021/05/chinas-new-innovation-advantage).

(24) 'The sources of China's innovativeness', op. cit.

(25) Ye, J., 'China tightens great firewall by declaring unauthorised VPN services illegal', *South China Morning Post*, 23 January 2017 (https://www.scmp.com/news/china/policies-politics/article/2064587/chinas-move-clean-vpns-and-strengthen-great-firewall); Creemers, R. et al., 'Translation: Outbound data transfer security assessment measures', *DigiChina*, October 2021 (https://digichina.stanford.edu/work/translation-outbound-data-transfer-security-assessment-measures-draft-for-comment-oct-2021/).

(26) For the example of Germany, see: 'Strategy on China of the Government of the Federal Republic of Germany', Federal Foreign Office, 20 June 2023, p. 38 (https://www.auswaertiges-amt.de/blob/2608580/49d50fecc479304c3da2e2079c55e106/china-strategie-en-data.pdf).

(27) National People's Congress, 'National Intelligence Law of the People's Republic of China', 27 June 2017 (http://www.npc.gov.cn/zgrdw/npc/xinwen/2017-06/27/content_2024529.htm).

(28) Mok, C., 'The Party rules: China's new Central Science and Technology Commission', *The Diplomat*, 23 August 2023 (https://thediplomat.com/2023/08/the-party-rules-chinas-new-central-science-and-technology-commission/).

discourages risk-taking [29], even though entrepreneurial dynamism has been a key driver of innovation.

China's chances of success

Beijing's prospects for deriving further economic influence from innovation remain strong. However, its ability to lock third countries into Chinese innovation ecosystems will depend on domestic policy choices and on the responses of partner countries. China continues to benefit from European technological inputs. Whether Europe offers credible technological alternatives to countries in the Plural South will shape the extent to which these partners become dependent on Chinese innovation. Finally, Beijing must convince partners in Europe and beyond that it is willing to transfer technology in ways that support local development. Without this assurance, Chinese firms may increasingly face resistance in recipient countries.

PROMOTING THE RMB AS AN INTERNATIONAL CURRENCY

Chinese ambitions

The campaign to internationalise the renminbi (RMB) began in 2009 amid the global financial crisis, which exposed the vulnerabilities of a unipolar monetary system dominated by the US dollar. Since then, the initiative has pursued a clear objective: to establish a stable and resilient global circulation of the RMB, thereby insulating China's domestic and international economic activity from dollar volatility.

Chinese policy documents and speeches leave little doubt about Beijing's ambitions. As early as 2013, China set an official goal of gradually internationalising the currency. It seeks to achieve orderly capital account convertibility, wider RMB convertibility and use, and aims to steadily advance its internationalisation [30]. Party-state pronouncements consistently reinforce this objective. In 2025, President Xi Jinping reaffirmed the need to 'orderly advance RMB internationalisation' as China deepens its high-level opening-up [31]. In financial-sector speeches and reports, People's Bank of China (PBOC) officials frame these goals within a broader blueprint for 'building a financial superpower'. One senior PBOC official has argued that a 'strong

(29) Creemers, R., 'The great rectification: A new paradigm for China's online platform economy', *SSRN*, 10 January 2023 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4320952).

(30) 'The Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Long-Range Objectives Through the Year 2035', National Development and Reform Commission, March 2021 (https://www.ndrc.gov.cn/xxgk/zcfb/ghwb/202103/P020210313315693279320.pdf).

(31) Government of China, 'Xi Jinping: Resolutely advancing high-level opening up', 15 July 2025 (https://www.gov.cn/yaowen/liebiao/202507/content_7032136.htm).

currency' is the cornerstone of a financially powerful country and that this requires RMB internationalisation[32].

These ambitions are driven by strategic and ideological considerations as well as economic ones. A central objective is to enhance China's crisis resilience and autonomy. Beijing argues that excessive reliance on the US dollar exposes countries to US monetary policy shocks and sanctions. Chinese analysts cite recent unilateral US sanctions, including against Iran and Russia, as evidence of the risks of 'financial hegemony' and contend that a more diversified currency system would mitigate them. From this perspective, an internationalised RMB would offer an alternative settlement and reserve currency if access to dollar-based systems were curtailed. PBOC Governor Pan Gongsheng has explicitly linked the promotion of the RMB to reform of the international monetary system and to preventing the dominance of any single currency[33].

Nationalistic and ideological undertones are also evident. Official discourse ties RMB internationalisation to China's international status and leadership. State media cite Xi Jinping to argue that China's growing global role must be underpinned by a correspondingly strong currency. Analysts present a higher profile for the RMB as a contribution to 'international fairness and justice' and as a way of amplifying China's voice in international affairs'[34].

Official discourse ties RMB internationalisation to China's international status and leadership.

Chinese achievements

To meet its objectives, the RMB must strengthen its role across four functions: payments, investment, financing and reserves. China has made tangible progress in all four.

> *Payments:* As a direct indicator of international uptake, the RMB's share of global payments processed through SWIFT rose to 3.75% by the end of 2024, up from 2.15% in 2022, ranking it fourth behind the US dollar (49.12%), the euro (21.74%) and the British pound (6.94%). Within China's cross-border transactions, the RMB's share of total settlements, covering trade and financial flows, reached 51.3% in 2024, up from 6.7% in 2011.

> *Investment:* Sustainable international circulation requires a sufficient supply of attractive investable assets denominated in the currency. By June 2025, foreign investment in onshore RMB-denominated equities and bonds totalled RMB 7.3 trillion, a tenfold increase compared with 2013.

> *Financing:* The RMB's role as a financing currency has grown markedly, particularly as US dollar borrowing costs have risen. Between 2021 and August 2025, the RMB's share of China's total overseas lending increased from 17% to 48%. Over the same period, the outstanding value of offshore RMB bonds rose

(32) 'Steadily and prudently advancing the internationalisation of the renminbi to bolster the development of a financial powerhouse', *Qiushi*, 30 January 2024 (https://www.qstheory.cn/qshyjx/2024-01/30/c_1130069348.htm).

(33) State Administration of Foreign Exchange (SAFE), 'A few observations on global financial governance – Keynote speech by PBOC Governor Pan Gongsheng at the 2025 Lujiazui Forum', 18 June 2025 (https://www.safe.gov.cn/en/2025/0618/2309.html).

(34) 'Steadily and prudently advancing the internationalisation of the renminbi to bolster the development of a financial powerhouse', op. cit.

by 40%, from RMB 1.6 trillion to RMB 2.2 trillion.

> *Reserves:* In 2016, the RMB joined the International Monetary Fund's Special Drawing Rights basket as the fifth currency. Its share of global central bank reserves rose steadily thereafter, although momentum slowed following Russia's war of aggression against Ukraine. Heightened geopolitical tensions between China and the United States have led some central banks to reduce their RMB holdings.

Despite this progress, the RMB has not become a fully-fledged international currency. First, global holdings of RMB assets outside China remain limited. Foreign investors hold around seventeen times more US dollar assets in equities and Treasury bonds. This weak appetite for Chinese financial assets reduces incentives for non-residents to accumulate RMB and constrains its broader circulation.

Second, although RMB use in cross-border settlements has expanded, it remains uncommon as an invoicing currency. IMF estimates suggest that the RMB accounts for nearly 50% of China's export and import settlements but only about 10% of invoicing. As a result, roughly 80% of RMB-settled trade continues to reference US dollar prices, undermining the RMB's role as a unit of account.

Factors of success

A key driver has been the launch of the Cross-Border Interbank Payment System (CIPS), which allows offshore participants to settle RMB transactions onshore more quickly and at lower cost than traditional channels. CIPS transaction volumes have grown at a compound annual rate of 58% over the past decade, reflecting efficiency gains over SWIFT-based foreign exchange settlement and increasing the RMB's appeal. In parallel, China has gradually liberalised cross-border investment despite maintaining capital controls. Schemes such as Stock Connect, Bond Connect and the Qualified Foreign Institutional Investor programme have incrementally opened domestic markets, attracting global investors and supporting demand for the RMB.

In the bond market, Bond Connect is only one access channel. Foreign investors can also purchase RMB-denominated bonds offshore in Hong Kong through so-called dim-sum bonds or onshore through panda bonds, further reinforcing RMB internationalisation.

China has also pursued high-level bilateral agreements. Since 2013, the PBOC has established bilateral swap lines with foreign central banks, providing assured access to RMB liquidity in exchange for local currencies and bypassing the US dollar. These swap lines act as a safety net during periods of dollar scarcity. Between 2022 and 2024, as US liquidity tightened following Federal Reserve rate rises, foreign central banks drew RMB 1.2 trillion through these facilities. Since 2021, China has also concluded local-currency settlement agreements with countries including Indonesia, Brazil, Argentina and Russia, accelerating the use of RMB in bilateral trade.

US sanctions have, paradoxically, also supported RMB internationalisation. Although the RMB's global footprint remains small compared with the dollar or the euro, a shift may be under way if US–China relations continue to deteriorate and more countries seek to reduce exposure to dollar transactions. Avoiding sanctions is an obvious motive, but the trend could broaden if both Washington and Beijing demand clearer alignment from third countries.

China is also actively promoting RMB use in trade settlements. An agreement between China Mineral Resources Group and BHP to invoice Australian iron ore imports in RMB is a case in point. Given China's scale – around 20% of global GDP, 25% of global manufacturing value added and 15% of global trade – such arrangements could become more widespread, leveraging market power and supply-chain dependencies to accelerate RMB adoption.

Hurdles and pitfalls

RMB internationalisation faces significant structural and policy constraints [35]. Chief among these are limited convertibility and persistent capital controls, which Beijing maintains to protect financial stability and prevent disruptive outflows. China's capital account remains largely closed. Foreign investors access domestic markets through tightly regulated channels such as the Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor schemes, which impose quotas, approval requirements and restrictions on repatriation. While mechanisms such as Stock Connect and Bond Connect facilitate controlled inflows, they also limit liquidity and usability through daily trading caps and mandatory reliance on local intermediaries [36].

Domestic financial markets remain underdeveloped in depth and liquidity. Foreign holdings of Chinese bonds account for only about 2.7% of the market, far below levels associated with broad international adoption. The PBOC's managed exchange-rate regime, which stabilises the RMB against a currency basket dominated by the dollar, also creates confidence risks. The 2015 devaluation triggered capital outflows and damaged credibility. Without deeper market reforms and greater exchange-rate flexibility, these constraints will continue to limit the RMB's role, which by late 2024 accounted for around 2% of allocated reserves and less than 5% of cross-border payments.

External factors compound these challenges. The entrenched dominance of the US dollar, reinforced by institutions such as SWIFT and long-standing energy pricing practices, creates strong path dependencies in trade invoicing, reserves and debt issuance. The RMB's share of international debt remains about 0.8%. Intensified US sanctions, including measures adopted in 2025, have increased risks for RMB users, discouraging many Western and neutral investors while encouraging more selective uptake in sanctioned economies such as Russia and Iran. Concerns about opaque governance, party-state influence over monetary policy and weak rule-of-law protections further erode trust, making central banks cautious about holding RMB assets in times of crisis.

Operational issues also persist. CIPS remains only partially interoperable with global standards and processes a fraction of SWIFT's transaction volume, with activity concentrated among BRI partners. Fragmented regulation of initiatives such as the digital yuan further limits scalability. In an increasingly fragmented global economy, these constraints suggest that RMB internationalisation will advance slowly and unevenly, relying on bilateral and regional arrangements rather than broad multilateral uptake.

(35) Lee, L.C., 'Can RMB dethrone the dollar in the foreseeable future?', Asia Society Policy Institute, 25 September 2025 (https://asiasociety.org/policy-institute/can-rmb-dethrone-dollar-foreseeable-future).

(36) Amighini, A. and Garcia-Herrero, A., 'Third time lucky? China's push to internationalise the renminbi', *Bruegel*, October 2023 (https://www.bruegel.org/system/files/2023-11/PB%2020%202023.pdf).

China’s chances of success

As a reserve currency, the RMB’s prospects remain limited beyond its role in trade settlement. While it lacks the conditions needed to become a major global currency for borrowing and investment, it can still support China’s bid for greater economic influence alongside industrial manufacturing and innovation.

All three cases will contribute to China’s rising influence, albeit to differing degrees. Beijing is best positioned to derive influence from industrial manufacturing dependencies. The internationalisation of the RMB remains the most challenging pillar.

CHAPTER 4

EUROPE'S LEVERAGE OVER CHINA

Limited but real

The EU should recast its China strategy around three simple but consequential insights set out in this *Chaillot Paper*:

1. China's behaviour is now driven more by a sense of vulnerability than by self-assurance;

2. This vulnerability does not imply a more benign China, as the PRC depends on exporting its overcapacity, limiting its room for compromise with the EU; and

3. China's weaknesses create opportunities for the EU to pursue a more proactive course. We propose a leverage-based diplomacy that makes use of China's remaining, albeit limited, dependencies on the EU, as long as they exist.

The objective of such a policy cannot realistically be to fundamentally change China. Instead, the EU should strive for a form of coexistence that respects core interests, safeguards Europe's competitiveness, defends its civil liberties and avoids escalation. This implies a more robust defence of European interests across the economic, security, political and informational domains. China is investing more heavily than the EU in reducing its dependencies and boosting its resilience to crises. The scope for compromise is further constrained by the internal challenges facing the PRC. The EU should act unilaterally where it cannot defend its core interests through diplomacy.

A VULNERABLE CHINA IS LESS CONDUCIVE TO COOPERATION

China's domestic economic vulnerabilities and their societal repercussions are not good news for Europe. These domestic challenges have several economic and strategic spillover effects for the EU:

> **Shrinking market opportunities in China:** Low domestic demand in China reduces market opportunities for European firms, both for exporters to China and for European firms producing locally in the PRC. To support Chinese firms, China is also increasing local-content requirements, making

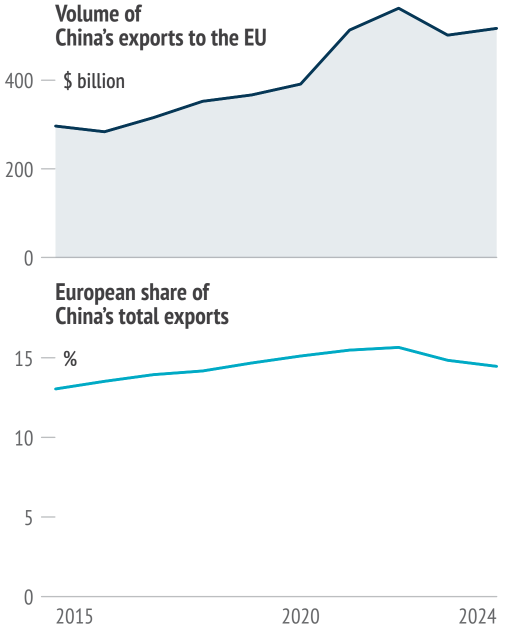
conditions more difficult for European companies [(1)].

> **Growing risk of deindustrialisation:** Slowing domestic consumption, coupled with continued supply-side subsidies, is driving China to export its industrial overcapacities, putting downward pressure on prices. The resulting distortion — including in the EU — undermines the competitiveness of European firms, across sectors ranging from electrical equipment and machinery to the automotive industry and chemicals. A new study has found that around one quarter of the EU's exports and up to 55% of the EU's domestic manufacturing output is at medium-term risk from Chinese competition [(2)]. Beyond efforts to lower prices and keep the RMB weak, China has also invested massively in innovation, leading to rapid improvements in product quality and a move up the value chain. As a result, European and Chinese firms increasingly compete in the same market segments, reducing the complementarity between the two economies. In other words, China's push towards industrial upgrading while exporting overcapacities heightens the risk of deindustrialisation in the EU.

> **Greater ability to use economic coercion:** China's efforts to reduce its own dependencies while keeping the EU reliant on Chinese technology and the Chinese economy are deepening existing dependency imbalances. Beijing could exploit these imbalances to exert economic pressure on the EU and disrupt supply chains.

> **Higher probability of a hard security crisis:** Partly as a result of efforts to deflect attention from domestic economic grievances, China is pursuing increasingly aggressive nationalist rhetoric that could spill over into a security conflict in East Asia — whether over Taiwan or competing territorial claims in the South China Sea. In the event of an escalating crisis, the EU and China could find themselves on opposing sides. As a result, the PRC could target European critical infrastructure, IT systems and cyberspace,

1 | **The EU's share of China's total exports remains stable**



Data: UN Comtrade

(1) Garcia-Herrero, A., Storella, T., and Xu, J., 'European companies operating in China: from digging in to rethinking their presence', Bruegel, 14 July 2025 (https://www.bruegel.org/working-paper/european-companies-operating-china-digging-rethinking-their-presence); Chinese Finance Ministry, 'Notice on soliciting public opinions from society regarding the 'Notice on matters related to domestic product standards and implementation policies in the field of government procurement', 5 December 2024 (https://www.ccgp.gov.cn/news/202412/t20241205_23796937.htm).

(2) Grjebine, T., Lefebvre, P., and Torres, M., 'L'industrie européenne face au rouleau compresseur chinois', Haut-commissariat à la Stratégie et au Plan, 9 February 2026 (https://www.strategie-plan.gouv.fr/files/files/Publications/2026/2026-02-09%20-%20Rouleau%20compresseur%20chinois/HCSP-2026-RAPPORT-CHINE-9fevrier11h.pdf).

causing major disruption to Europe's increasingly interconnected societies and economies. These risks would be compounded by major supply-chain disruptions caused by interruptions to trade routes in East Asia.

> **Accelerating risk of normative conflict:** To bolster regime security, Beijing continues to emphasise the weaknesses of the West and its democratic systems. China may therefore be inclined to intensify efforts to advance norms aimed at promoting an international order more conducive to authoritarian governance. This, in turn, risks accelerating the normative confrontation between the EU and China.

For China, it is difficult to make substantial compromises. No less than 23.8% of China's industrial firms are loss-making, up from 10.8% in 2016. China's leaders cannot afford a further deterioration of the current situation.

THE EU SHOULD USE ITS LEVERAGE WHILE IT LASTS

China's domestic vulnerabilities also create opportunities. The EU's leverage is limited, but more substantial than is widely believed. At a time of domestic economic stress, China depends on the EU in two key respects:

> **China's dependency on the EU's single market:** To maintain at least its current level of economic growth and avoid further deterioration in employment, China needs to offset low domestic demand with exports. The value of China's exports to the EU has grown; the EU's share of China's total exports has remained stable at around 15 per cent (Figure 1).

These figures underestimate China's real export dependence on Europe. Over the past two decades, the share of income from overseas markets among Chinese listed firms has risen from 3–4% to 15% by 2024 and is likely to increase further in the coming years [3]. A significant decline in this share due to tighter trade restrictions would severely harm the Chinese economy. Granted, Europe accounts for only part of this 15%. But other high-income markets are closing to Chinese exports, first and foremost the US market. In fact, Chinese customs data confirms that it has been primarily Southeast Asia and Europe that have absorbed the drastic decline of exports to the US since March 2025. From March to December 2025, Chinese exports to the US dropped by around USD 10 billion while exports to the EU grew by roughly USD 3 billion. Hence, China's reliance on the EU is becoming increasingly important.

Analysis of the automotive sector further illustrates how significant the European single market is for the profitability of Chinese firms. Before the EU imposed tariffs on EV imports from China, Chinese carmaker BYD had a profit margin of almost €13,000 in the EU compared to only €1,300 for domestic sales in China for its Seal U model. While the duties have brought the EU premium down, it is still substantial and growing again as the RMB depreciates against the euro. Exports to Europe remain far more lucrative for BYD, providing a crucial

(3) Zhang, Y., 'Chinese firms to further grow overseas income as share of revenue, UBS China research head says', Yicai Global, 15 January 2026 (https://www.yicaiglobal.com/news/chinese-firms-overseas-revenue-share-to-further-rise-after-quadrupling-in-20-years-ubs-china-research-head-says).

revenue stream to offset low domestic profit margins. Comparative analysis suggests that BYD's Seal U is not an outlier[4].

This comes at a time when Chinese industrial firms are experiencing declining profit margins across industrial sectors. Between 2021 and 2025, profit margins declined from 9.6% to 4.2% in the chemical raw material and chemical products industry. Similarly, in the same period, profits shrank in the chemical fibre (from 6.3% to 2.6%), ferrous metals (from 4.3% to 1.6%) and motor vehicles industries (from 6.2% to 4.4%)[5].

Overall, this suggests a high Chinese export dependency on the EU. Low-income economies can replace the EU as an export destination only to some degree. Hence, the EU is more important as a source of income for China's struggling economy than is often assumed.

The extent of China's dependence on European technologies remains underexplored.

> **China's dependency on European technology:** China's attempt to achieve technological self-reliance has led to stagnation in value-added imports from the EU in Chinese domestic final demand. Coupled with diversification measures, the PRC has also reduced the EU's relative share of value-added imports in final demand. Nevertheless the EU still accounts for more than 15%, indicating a shrinking but persistent overall dependence on technologically sophisticated imports from the EU.

In-depth analysis also suggests that China depends on European technological strengths in specific niches. To date, however, the extent of China's dependence on European technologies remains underexplored. In particular, it remains unclear whether – and to what extent – the technology dependencies identified across 35 key industries published by the official newspaper of the Chinese Ministry of Science and Technology in 2018 still persist [6]. Interviews conducted by the authors suggest that at least some of them remain in place [7].

Another study focusing on digital technologies found that European digital technologies are seldom indispensable, but that Chinese companies continue to benefit from access to European technology. The reason is not that China cannot replace these technologies, but that European digital solutions are efficient and high-quality, and Chinese firms may have embedded them in their supply chains. Apart from lithography for semiconductor manufacturing, the study identified access to European data (genomic data in particular), energy-efficient 6G technology, quantum sensing, space exploration technology and cooperation on technical standards as being of particular importance for the PRC. European strengths in areas such as

(4) Sebastian, G., Barkin, N. and Kratz, A., 'Ain't no duty high enough', Rhodium Group, 29 April 2024 (https://rhg.com/research/aint-no-duty-high-enough/).

(5) Goreichy, E. and Gunter, J., 'China overcapacity monitor', *Mercator Institute for China Studies*, 10 February 2026 (https://merics.org/en/china-overcapacities-monitor#msdynmkt_trackingcontext=8dc88b42-4f63-4083-856f-831732420100).

(6) Murphy, B., 'Chokepoints: China's self-identified strategic technology import dependencies', Center for Security and Emerging Technology, May 2022 (https://cset.georgetown.edu/publication/chokepoints/).

(7) Anonymous author interviews with Chinese state officials and staff of technology companies, November 2025.

AI applications for facial recognition, automotive chips and AI in healthcare are cited as examples of earlier dependencies that are now rapidly phasing out[8].

In addition, China benefits not only from access to European technology, but also from the European research and innovation ecosystem. The PRC has, as discussed above, become an innovation powerhouse. But this development did not occur in isolation; it is closely linked to integration into transnational research and innovation networks.

Data on Chinese scientific publishing indicates that around 8% of all publications related to artificial intelligence, machine learning and big data are co-authored with researchers working at institutions in geographical Europe, including not only the EU but also the United Kingdom, Norway and Switzerland. While this share may appear modest, it would hurt China significantly in the fierce technology competition with the US if co-publishing with European authors ended. The proportion of articles co-authored with Europe-based researchers is not declining but has remained stable. Moreover, 65% of these publications relate to applied sciences, especially artificial intelligence and telecommunications, which tend to generate more direct commercial benefits[9]. Co-publications with European researchers, as indexed in the Web of Science, overtook such cooperation with US-based researchers already in 2022. Interviews conducted by the authors suggest that cooperation with US researchers has decreased in recent years, while cooperation with European partners has remained stable or grown modestly[10]. This implies that China's relative dependence on research partnerships with European institutions has been gradually increasing.

None of this is to suggest that the EU has overwhelming leverage over China. Chinese research institutions and firms remain highly innovative even without access to European technology, innovation and research. However, Europe tends to overlook China's vulnerabilities and to underestimate the leverage it still retains. European research and technology are not indispensable. But drastically reducing such cooperation or even ending it would nonetheless be costly for China.

BEIJING'S GAMBLE: EUROPE WILL NOT WEAPONISE MARKET ACCESS

China's leaders are well aware of the country's dependence on access to the European single market, as well as European research and technology. This is one reason why Beijing is doubling down on technological self-reliance in the forthcoming Five-Year Plan. While China's reliance on European technology is

(8) Rühlig, T., 'Reverse dependency: Making Europe's digital technological strengths indispensable to China', Digital Power China, 6 May 2024 (https://dgap.org/en/research/publications/reverse-dependency-making-europes-digital-technological-strengths).

(9) Brugner, P. et al., 'Report on the results of the research cluster on EU-China research cooperation (co-patent/co-publication analysis)', Ghent University, 11 September 2023 (https://www.reconnect-china.ugent.be/2023/09/19/report-on-eu-china-cooperation-in-science-technology-and-innovation-published/).

(10) Anonymous author interviews with two Chinese state officials, November 2025, Beijing.

decreasing, its reliance on exports to the EU remains stable. Even so, it is far from certain that the EU will retain the limited degree of leverage it holds today. Europe should therefore make use of this leverage sooner rather than later.

For now, China's leaders appear convinced that the EU will not weaponise access to the single market or cooperation in technology and innovation. At the same time, Beijing does not expect to gain better access to Europe. In other words, China's leaders believe there is little to gain and little to lose, which leaves the EU in a weak negotiating position as Beijing's priority is to preserve the *status quo*. As long as the EU refrains from taking unilateral measures, any failure in negotiations serves Beijing rather than Brussels:

> *You [the EU] have enormous economic leverage, but you don't you use it – not against Washington and not against us. [...] We try to diversify our export reliance on the West expanding into Southeast Asia, Latin America and Africa. But nothing can replace the high purchasing power of the European single market. [...] We are highly innovative. But we can only keep our innovativeness if we continue to cooperate with the brightest minds. And they sit in many cases in the US and in the EU*[11]*.*

For the EU, this implies that it should recognise its leverage, prepare to use it, demand concessions (see concluding chapter) from Beijing and invest in its own strengths to preserve as much of its limited leverage as possible. The EU should both use unilateral instruments at its disposal and work closely with partners — not only like-minded countries, but also actors in the Plural South — to increase the economic and reputational costs for Beijing.

Without policy adjustments, China's dependence on European technology will diminish over time. The EU must therefore safeguard and enhance its leverage now, using its current comparative advantages to buy time and strengthen its medium- and long-term economic and technological capabilities.

(11) Anonymous author interview with a mid-level Chinese Party official, Beijing, November 2025.

CONCLUSION

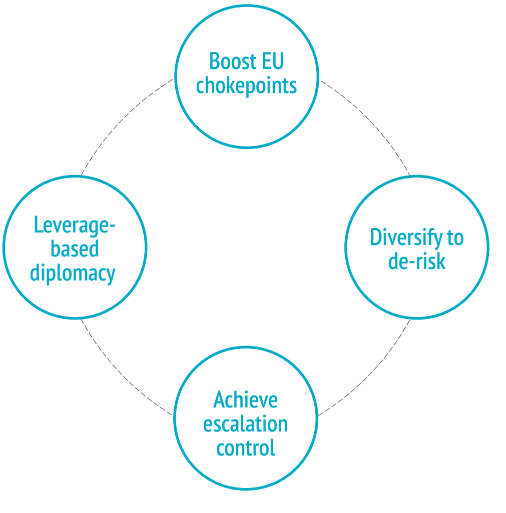
THE SOLUTION: LEVERAGE-BASED DIPLOMACY

Most fundamentally, the EU needs to understand that its interactions with China – and with the US under the Trump administration – are not cost-free. If the EU actively defends its core interests, it will harm Beijing's interests and can expect retaliation. But inaction also carries costs for Europe as it would likely accelerate the deindustrialisation of the continent. Over the medium term, high shares of domestic manufacturing across a broad range of EU Member States could be at risk, ranging from 81% in Slovakia to 78% in the Czech Republic to 68% in Germany, 59% in Italy, 50% in Spain and 37% in France [(1)]. Fear of retaliation, which currently often constrains political will and decision-marking within the EU, is therefore not a sufficient reason to maintain the current course. The cost of inaction is higher than if Europe defends itself – despite the high likelihood of Chinese retaliation.

A major EU policy shift towards China should start at an EU-China Summit, which has not resulted in any joint statements or substantive progress since 2019. With a robust mandate from a critical mass of Member States, the Presidents of the European Commission and the European Council could set out Europe's priorities and formulate specific demands *vis-à-vis* China, coupled with a credible plan to deploy unilateral instruments if no progress is achieved. After the Summit, China's interactions with Member States and EU institutions at working level could help to substantiate the EU's course, with the aim of securing concrete concessions from Beijing. While this may sound confrontational, it would not only reciprocate China's own behaviour but also reflect a pragmatic, interest-focused approach that is clearly not ideological.

1 | **Towards EU leverage-based diplomacy**

Four angles for proposed EU action



(1) 'L'industrie européenne face au rouleau compresseur chinois', op. cit.

We propose four general steps to facilitate such an approach (Figure 1):

Boost EU chokepoints

Instead of starting from its vulnerabilities and attempting to resolve an ever-growing set of dependencies, the EU should focus on maintaining and developing technological chokepoints. Previous efforts have done little to reduce Europe's vulnerability, not least because of the significant costs involved. The EU should therefore aim to remain relevant in critical areas and preserve Chinese dependencies on Europe.

To maintain such reverse dependencies, the EU should not only improve the overall conditions for competitiveness, but also launch targeted programmes to support the further development of European excellence in engineering and technology.

To this end, the EU could set quantitative and qualitative targets for a small, carefully selected set of technological strengths. To accelerate progress, it could create a temporary, dedicated EU-wide agency focused exclusively on promoting technological excellence. As the so-called Draghi Report on strengthening European competitiveness has proposed [(2)], modelled on the US Defense Advanced Research Projects Agency (DARPA) or the rapid deployment approach used for Covid-19 vaccines, such an agency would pursue multiple technological strategies in parallel – accepting high risks in pursuit of high rewards to speed development and hedge against failure. The EU could use the Strategic Technologies for Europe Platform (STEP) to coordinate and redirect existing funding towards supporting European technological strengths and preserving reverse dependencies. In clean tech in particular, the EU could draw on resources from the Emissions Trading System (ETS) Innovation Fund. The European Innovation Council Fund could also be an important starting point, including to mobilise venture capital for start-ups and scale-ups in areas aligned with these objectives. If adopted, the European Competitiveness Fund could play a major role in these efforts under the next multiannual financial framework, starting in 2028.

In addition, the EU could put in place protective measures – especially export controls – for these technological advances and their underlying intellectual property. Such controls would not be intended to unduly restrict exports, but rather to enable monitoring and control, and to preserve the option of cutting off geopolitical competitors if deemed necessary. This is particularly relevant given that most of these frontier technologies are dual-use or have clear dual-use potential. Furthermore, such measures would reciprocate actions already taken by the US and China, notably with regard to rare earths. In parallel, the EU should set up an outbound investment-screening mechanism to make sure that key technologies are not transferred to China through European greenfield investments, rather than solely purely via exports.

Diversification – and not reshoring – as the default mode of de-risking

Contrary to the EU's current emphasis on 'buy European', the EU could make diversification the dominant de-risking paradigm. This is not to say that nothing should be reshored. But a shift in emphasis to diversification would have several

(2) European Commission, 'The future of European competitiveness', 16 September 2025 (https://commission.europa.eu/topics/competitiveness/draghi-report_en).

advantages. First, 'buy European' can easily become 'buy nothing [3]. Second, Europe's financial resources are limited, and it is not feasible to pursue industrial policy for comprehensive reindustrialisation across a broad range of sectors. Third, the drivers of deindustrialisation in many sectors cannot be addressed primarily through subsidies: technological and industrial ecosystems have moved elsewhere, talent is scarce, and labour and energy costs are high. Fourth, the EU needs to pivot towards the Plural South, not least to raise the reputational costs for China. A de-risking agenda that positions the EU not as a fortress seeking to reshore industrial capacity, but as an international investor in diversified supply chains, could win broader support.

The EU could make diversification the dominant de-risking paradigm.

Diversification does not imply that the EU would support only non-EU firms in other parts of the world; it could also help European firms expand in third countries. This would not necessarily require lengthy free trade agreement (FTA) negotiations, as the EU could instead set up sectoral investment agreements with third countries. The EU could also provide additional support to European and non-European companies alike that reinvest a certain share of their revenues in R&D within the EU.

One example of such strategic investment is generic drug production, which is highly concentrated in China and India. Reshoring generic drugs, which account for around 80% of medicines, is hardly feasible given Europe's high labour costs. The EU could expand existing instruments, such as the Global Gateway, to support European firms in scaling up production outside China and India, thereby diversifying European dependencies. Reinvestment of the resulting revenues could help preserve Europe's eroding comparative advantage *vis-à-vis* the PRC in the development of biotechnologies.

On top of such measures, the EU needs to speed up the conclusion and the ratification of FTAs with countries in the Plural South, from Indonesia to India to the Mercosur states.

The EU Member States could further use tax incentives to promote the substitution of Chinese-made critical technology in strategic sectors. Furthermore, public procurement rules could prohibit single sourcing of key technologies or key components. Where this is not immediately feasible, the EU Member States could foresee phase-out periods of single sourcing as preconditions for access to public procurement.

Rather than relying on investment alone, the EU could achieve greater impact by using trade and investment agreements to incentivise European firms to invest in the Plural South and ensure medium- to long-term demand for critical goods. To this end, the EU should establish stricter market-access criteria based on resilience standards and non-price factors that generate demand for non-Chinese supply. The Economic Security Standards, put forward in the Political Guidelines of

(3) Teer, J., 'European Ministers of Defence – Save Europe, invest in mining!', EUISS Commentary, 6 June 2025 (https://www.iss.europa.eu/publications/commentary/european-ministers-defence-save-europe-invest-mining).

the European Commission, could support such an approach[4]. This could open significant room for cooperation with like-minded partners such as Australia, Japan or South Korea. Cooperation with the US under President Trump could also be possible, but likely more on a case-by-case basis depending on specific issue areas.

Achieve escalation control

The EU should adopt an 'escalate to de-escalate' approach akin to that pursued by the US and China. Currently, the EU and its Member States often refrain from taking decisive action because Europe fears potential Chinese retaliation. Even actors that are, in principle, willing to respond forcefully to Chinese coercion question whether the EU is capable of delivering a swift and decisive response if retaliation occurs.

Addressing this dilemma requires action on two fronts: increasing political readiness and redesigning the EU's most powerful tool, the Anti-Coercion Instrument (ACI), so that it can be deployed more easily.

To enhance political readiness, the EU and its Member States must recognise a simple reality: dealing with great powers such as China, or the US under a Trump administration, is costly regardless of the strategy pursued. If Europe remains open and cooperative, it pays a price in terms of deindustrialisation (*vis-à-vis* China) and economic, security and possibly even territorial concessions (*vis-à-vis* the US). Neither China nor a Trump administration is a benevolent actor that will refrain from taking advantage of EU behaviour it interprets as weakness. If the EU defends itself and leverages the strengths it has, it is likely to face retaliation from China and the US. However, turning existing strengths into influence and leverage at least gives the EU a chance to defend its interests and limit the long-term costs of concessions. The alternative to accepting short-term costs due to retaliation is not cost-free; it is likely to entail even greater costs in the medium and long term. After all, a temporary trade war with China would be painful, but worth it if it helped prevent the EU's deindustrialisation. The EU and its Member States should communicate this reality clearly to their citizens.

To strengthen its most forceful tool, the EU should reform the Anti-Coercion Instrument.

To strengthen its most forceful tool, the EU should reform the ACI, which – at the time of writing – has never been used. That it has not been used is part of the problem. Although the ACI only took effect in December 2023, we suggest inverting the existing rule: rather than requiring a qualified majority of EU Member States to activate the ACI, a qualified majority should be required to block its use if so proposed by the European Commission in cases of economic coercion. Furthermore, the ACI should include the possibility for the European Commission to invoke export controls, rather than leaving this to Member States. Finally, given that the four-month investigation period before the ACI can be launched is quite lengthy, the EU should

(4) European Commission, 'Europe's choice: Political guidelines for the next European Commission 2024-2029', 18 July 2024 (https://commission.europa.eu/document/download/e6cd4328-673c-4e7a-8683-f63ffb2cf648_en?filename=Political%20Guidelines%202024-2029_EN.pdf); Rühlig, T. and Teer, J., 'A new transatlantic trade and tech agenda: Economic security standards can address the EU's and Washington's concerns about China', EUISS Commentary, 20 January 2025 (https://www.iss.europa.eu/publications/commentary/new-transatlantic-trade-and-tech-agenda-economic-security-standards-can).

enable the European Commission to apply the ACI provisionally during the investigation phase. This would allow for an immediate reaction to threats against the EU. Only such a change would send a clear message to China and the US that the EU is ready to defend its core interests effectively and respond to retaliation.

Leverage-based diplomacy

Advancing the first three steps would give the EU a stronger hand in negotiations. As China grapples with internal vulnerabilities, Beijing continues to benefit significantly from cooperation with the EU. At present, Chinese leaders believe they have not only little to gain but also little to lose in Europe, because the EU is not expected to decisively restrict access to its market or to technology, research and innovation. But if the EU made such access conditional on substantive concessions, it could wield more leverage than it currently assumes. Europe could then redefine its engagement with Beijing, moving beyond the notion that engagement is merely unavoidable. The EU's decision to condition access to the Horizon research programme is a first step in this direction.

Beijing has demonstrated sensitivity to the economic costs it could incur for supporting Russia.

Next, the EU should articulate realistic yet substantive demands aligned with its core interests, while recognising the policy constraints imposed on Beijing by the persistent vulnerabilities described in this *Chaillot Paper*. At the same time, the EU should insist on tangible progress in key areas of concern: China's geopolitical positioning; Chinese industrial overcapacities that threaten European competitiveness; and challenges to the EU's economic security, including conditions for investment in Europe and supply-chain resilience.

One example of a realistic yet substantive demand relates to Russia. For Beijing, abandoning its close ties with Moscow is unthinkable. However, as a first step, the EU could demand that China halts the transhipment of European-manufactured dual-use items via China (including Hong Kong) to Russia, followed by a broader reduction in exports of a clearly defined list of dual-use items manufactured in the PRC. If no progress is made, the EU could freeze exports of dual-use items at 2021 levels, treating those volumes as equivalent to China's domestic demand. In a subsequent step, the EU should broaden its demand to include curbing exports of Chinese-made dual-use items to Russia. Previous EUISS analysis shows that China has reacted sensitively to sanctions and export restrictions. Despite its ideological alignment with Russia, Beijing has demonstrated sensitivity to the economic costs it could incur for supporting Russia. Furthermore, our analysis indicates that the EU holds rather high import shares on a number of dual-use items supplied to the PRC. This suggests that freezing exports of these goods at pre-2022 levels could impose a tangible economic cost on China[5].

Another example concerns China's export controls on heavy rare earths and permanent magnets. While China has declared that the only target of its rare earth export controls is the US, they have in practice also been applied to the EU, at least until the US secured a one-year suspension which was also extended to the EU. Fully dismantling such export controls appears

(5) 'The dependence gap in Russia-China relations', op.cit.

unlikely, given that the licensing system is being put in place. Nevertheless, the EU should seek to, at least, recalibrate the framework away from narrow 'green channels', towards three-year general licences covering large quantities of imports for a broad group of certified European end-users. This would go beyond the limited concessions Beijing has so far granted to the EU and the US, which have involved only a small number of licences issued to a handful of importers for a period of just one year[6]. Such three-year general licences would create more supply-chain certainty than the current arrangements. For China to accept such three-year licences, it would not need to make any changes to its export control law. If no compromise were reached, the EU could treat China's behaviour as economic coercion and invoke the ACI.

To avoid unilateral measures against overcapacity, the EU could ask Beijing to agree to strict export quotas and price floors for selected goods such as steel or telecommunications equipment. These could be enshrined in voluntary restraint agreements (VRAs). This approach may be less suitable for electric vehicles (EVs), which are already subject to European tariffs[7]. But Chinese overcapacity affects a broad range of sectors that are not currently covered by tariffs, many of which involve strategic goods, including lithium-ion batteries or electrolysers. Ideally, China would conclude such VRAs with a wider group of countries, to address unfair trade not only within Europe but also in third markets. Otherwise, the EU could launch a package of measures, including the use of trade defence instruments (TDIs) – safeguards in particular – aimed at price undertakings, and possibly also activate the ACI. The most radical proposal put on the table recently by France is a general tariff of 30% on all Chinese imports[8]. Another option would be tariffs based on value-added content because this includes not only direct imports from China but also re-exports of Chinese components incorporated into manufactured goods from other countries. Chinese-owned manufacturing plants in third countries would likely be particularly affected since they often source heavily from manufacturing plants within the PRC.

Another reason for the growing import of overcapacities stems from significant distortions in real exchange rates, exacerbated by the euro's appreciation against the RMB and China's ongoing deflationary pressures. Since early 2023, the euro has appreciated by nearly 14% against the RMB in nominal terms. The European Commission could quantify the price advantage gained from inflation differentials, which would trigger bilateral consultations, requiring China to outline credible rebalancing plans, such as adjusting monetary policies to curb deflation. If unresolved after a set period, the EU could escalate its response, including through sector-targeted countervailing duties calibrated to offset the distortion.

A final example relates to Chinese investment. The EU should not revive the Comprehensive Agreement on Investment (CAI), which was in principle concluded between the EU and China in late 2020 before the European Parliament froze the ratification process after China had sanctioned Members of the European Parliament. Instead, Member States should support forthcoming proposals from the European Commission that set out specific conditions on localisation

(6) Anonymous author interviews with US officials, January 2026, Washington D.C.

(7) Garcia-Herrero, A. and Gros, D., 'Scant benefits for significant risks: Price undertakings for Chinese electric vehicles entering Europe', Bruegel, 22 January 2026 (https://www.bruegel.org/first-glance/scant-benefits-significant-risks-price-undertakings-chinese-electric-vehicles-entering).

(8) 'L'industrie européenne face au rouleau compresseur chinois', op. cit.

quotas, security safeguards and technology transfer, in exchange for sustained investment opportunities in the EU.

Leverage-based diplomacy would not only mark a shift in the EU's approach towards China but also signal a broader adaptation to new geopolitical realities. It could lead Beijing to take Brussels more seriously and signal to the Trump administration that the EU is prepared to defend its interests. This could open avenues for issue-based coordination on transatlantic China policy and strengthen the EU's position *vis-à-vis* Washington. Efforts to move closer to China during periods of transatlantic tension would undermine such an agenda. Both Washington and Beijing currently respond primarily to leverage, and the EU and its partners should therefore avoid allowing their relations with China or the US to depend on the state of relations with the respective other major power. Consistently defending European interests and using the EU's own leverage is a more effective strategy than allowing policy to be shaped by volatile relations with other countries.

Our proposal recalibrates the focus of the EU's China strategy. It is more proactive, emphasises preserving strengths rather than being obsessed with addressing weaknesses, favours cooperation with the Plural South over European reshoring, and advances leverage-based diplomacy underpinned by credible unilateral instruments. The essential shift required is not the creation or modification of tools, but a renewed political commitment across the EU – including Member States – to reorient China policy. Where consensus cannot be reached among all Member States, some can take the lead and cooperate with like-minded partners such as the United Kingdom, Norway, Japan or Australia. This, however, requires agreement on a basic premise: engaging with China under current geopolitical realities comes with associated costs, and making use of existing – albeit dwindling – leverage, is therefore necessary.

ABBREVIATIONS

ACI
Anti-Coercion Instrument

AI
Artificial intelligence

BRI
Belt and Road Initiative

BRICS
Brazil, Russia, India, China and South Africa

CCP
Chinese Communist Party

CIPS
Cross-Border Interbank Payment System

DARPA
Defense Advanced Research Projects Agency

EV
Electric vehicle

FTA
Free Trade Agreement

GDP
Gross domestic product

ID
Identification

IMF
International Monetary Fund

IT
Information Technology

PBOC
People's Bank of China

PLA
People's Liberation Army

POE
Privately-owned enterprise

PRC
People's Republic of China

R&D
Research and Development

RMB
renminbi

ROC
Return on capital

SCO
Shanghai Cooperation Organization

SOE
State-owned enterprise

SWIFT
Society for Worldwide Interbank Financial Telecommunication

UN
United Nations

USD
United States dollars

VRA
Voluntary restraint agreement

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China looks strong. Its factories dominate global supply chains, its firms set technological standards and its leaders speak the language of great power rivalry. Yet beneath this display of power lies a growing fragility.

This *Chaillot Paper* argues that China's foreign policy is now shaped as much by domestic economic weakness as by external ambition. Slowing growth, a rapidly ageing population, a debt-ridden property sector and shrinking fiscal space are eroding the 'growth dividend' that long sustained the Chinese Communist Party's legitimacy. As prosperity stalls, Beijing is tightening party control at home and pursuing economic and technological self-reliance, even at the cost of further distortion.

To deflect attention from domestic economic pressures, China is also engaging in more forceful nationalist rhetoric and increasingly confrontational diplomacy. Its international clout rests less on attraction than on coercive power: industrial overcapacity, technological lock-in and the creation of strategic chokepoints.

For the EU, China's economic fragility is no cause for complacency. It signals greater risk – and potential leverage. Europe must de-risk faster, strengthen its own assets and approach Beijing with greater confidence and resolve.

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