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China Surplus Meets EU Defense

MORGAN STANLEY ASIA LIMITED

Robin Xing
Chief China Economist
Robin.Xing@morganstanley.com +852 2848-6511

Jenny Zheng, CFA
Economist
Jenny.L.Zheng@morganstanley.com +852 3963-4015

Zhipeng Cai
Economist
Zhipeng.Cai@morganstanley.com +852 2239-7820

Harry Zhao
Economist
Harry.Zhao@morganstanley.com +852 2239-7229

EU-China trade tensions are building. As the secular decline in housing-related investments lifts the current account structurally, Beijing will likely manage pressure through selective concessions and countermeasures. Meaningful RMB appreciation is not the preferred adjustment channel.

EU reacts to rising trade deficit with Beijing — gradual, institutionalized, bounded: Recent EU remarks point to a tougher trade line: de-risking with an economic-security overlay beyond the 2024 EV playbook. Pressure should concentrate where the EU runs widening bilateral deficits but still has globally competitive industries — autos, machinery & electrical equipment, and chemicals.

The toolkit has widened: Beyond anti-subsidy and anti-dumping cases, the EU now uses the Foreign Subsidies Regulation in procurement, the International Procurement Instrument on reciprocity, CBAM on energy-intensive sectors, and tougher local-content rules in clean tech. This makes escalation more institutionalized and sector-specific.

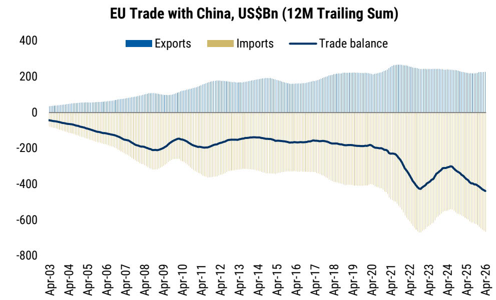
China's macro backdrop may keep tensions alive: China's surplus is not just growth policy; it is the external counterpart of weak domestic demand, as housing and "old" infrastructure investment are in secular decline; meanwhile, savings remain high. Without a more decisive shift toward consumption, part of the excess saving is likely to be reflected in elevated external surpluses.

China's response is likely tactical, not transformative: However, a real consumption pivot would be costly and institutionally hard. Beijing may offer selective concessions — import commitments, market access, further cancellation of export VAT rebate, or negotiated remedies around subsidies. Frictions can be managed, not resolved.

But escalation is two-way bounded: China retains retaliation levers, including pork, dairy and brandy probes, plus market access in aviation, autos and luxury. The EU still relies on China in rare earths and clean-tech supply chains. Expect a legal escalation, not a rupture.

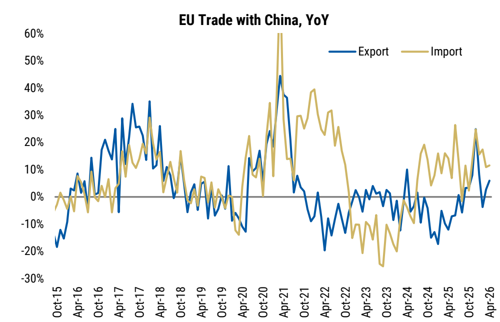
RMB — meaningful appreciation not warranted: We do not expect rapid RMB appreciation in the coming quarters as the housing downturn persists, while a decisive consumption-led rebalance appears unlikely. Without stronger domestic demand, rapid appreciation would mainly squeeze exporters, profits and employment, reinforcing deflationary pressure rather than resolving the underlying imbalance.

Exhibit 1 : Widening EU trade deficit with China since 2021



Source: CEIC, Morgan Stanley Research

Exhibit 2 : Europe faces a dual headwind from China: rising competitive pressure domestically and weak export demand externally.



Source: CEIC, Morgan Stanley Research

EU-China Trade Tensions: A Primer

Latest EU remarks on global imbalance and domestic industrial policies

Read-out of the College orientation debate on EU-China relations - 29 May 2026

- The Commission's overarching approach remains de-risking, not decoupling.
- China is a critical partner, and engagement and dialogue will continue. At the same time the current state of the trade and investment relationship is *not sustainable*.
- As economic and security interests become ever more intertwined, both dimensions will require *a more robust and coherent response*.

G7 leaders' statement on geopolitical issues - 17 June 2026

- We reaffirm our common interest in *converging with other large economies on the causes of large and persistent global imbalances and on the need to address them*. We will continue these efforts within the G20 under the United States' host year and in other relevant fora.

European Council conclusions on competitiveness and global economic challenges - 19 June 2026

- strengthen EU competitiveness and strategic autonomy, increase resilience and economic security, promote technological innovation
- fostering Europe's industrial renewal and innovation and reducing dependencies

Potential China-EU trade pressure points

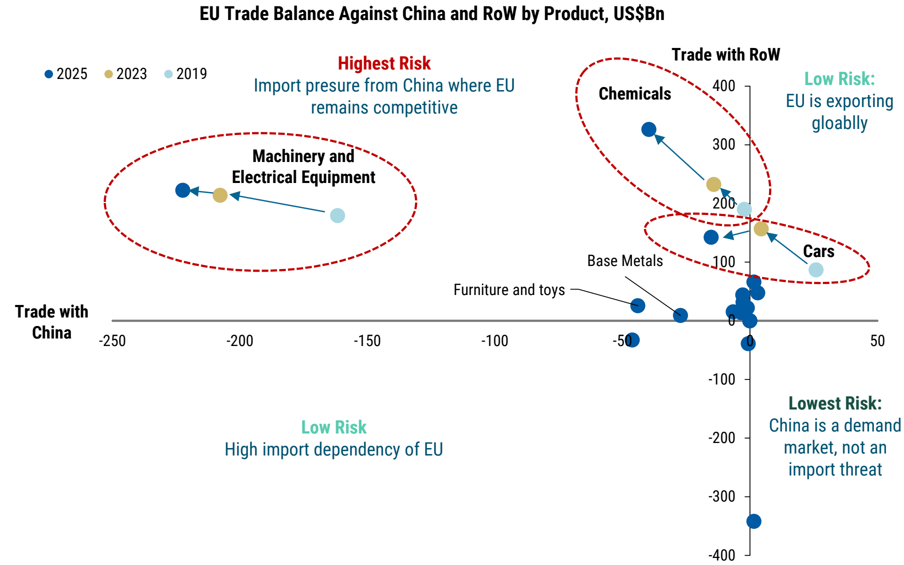
Our simple framework consists of two elements:

- By-sector level and trajectory in EU trade balance with China. A large deficit with China shows where the pressure is already big; a fast-worsening balance shows where political concern is likely rising fast.
- The overlay would be Europe's own competitiveness that it wants to defend.

The sectors most exposed to tougher EU trade actions are machinery and electrical equipment, autos, chemicals, and steel/base metals. To further categorize:

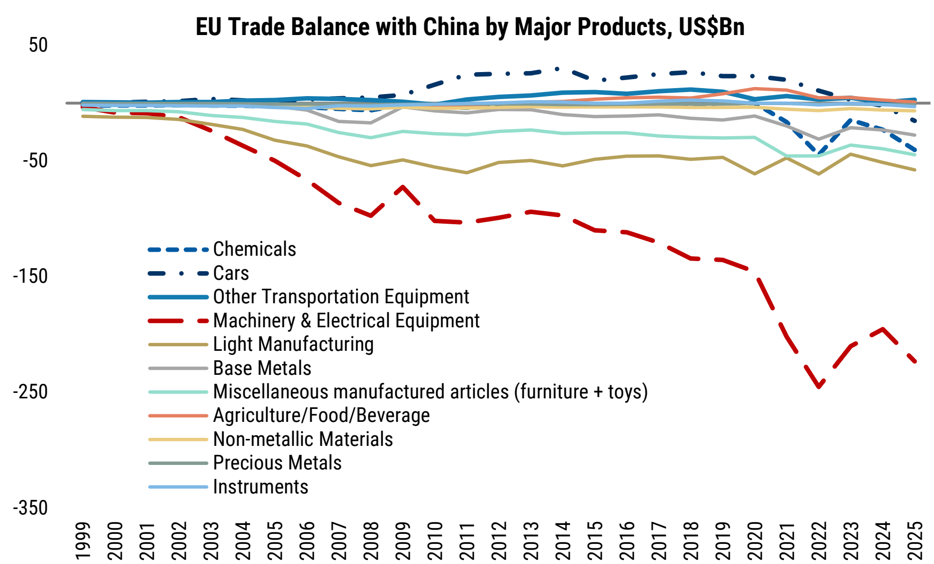
- **Competitive EU industries being challenged:** Autos, machinery and electrical equipment, chemicals. This is most visible in autos, where Europe's longstanding competitiveness is being challenged by Chinese EVs. Media reports suggest the European Commission is considering additional duties on Chinese PHEVs, following the countervailing duties imposed on BEVs in 2024.
- **Overcapacity amid China's structural transition:** Steel and base metals. The EU has already started to move toward broader steel protection, likely due to the sector's implications for jobs and industrial security.

Exhibit 3: EU-China trade balance by product



Source: UNComtrade, Morgan Stanley Research

Exhibit 4: EU trade balance with China is worsening over time



Source: CEIC, Morgan Stanley Research

How would potential tensions unfold? Navigating preferences, dependencies, and chokepoints

A gradual, institutionalized approach, rather than sudden and massive escalation: The EU appears to be adding a more systemic economic-security overlay onto the prevailing case-by-case trade defense framework. However, the overall approach, as repeatedly affirmed by EU, would remain "de-risking not decoupling" — pursued through two complementary tracks: diversifying critical supply chains away from China, and selectively restricting Chinese access to the EU single market where strategic, security or level-playing-field concerns arise.

The toolkit has expanded in recent years: Anti-subsidy and anti-dumping investigations (EVs, biodiesel, mobile cranes, tinplate); the Foreign Subsidies Regulation (FSR), now actively used to screen Chinese bids in public procurement, M&A and green-tech tenders; the International Procurement Instrument (IPI), first deployed against Chinese medical devices; Carbon Border Adjustment Mechanism covering steel, aluminum and chemicals; and hardening local-content and "Made-in-Europe" criteria in clean-tech subsidies and auto procurement.

But potential tensions will likely be bounded by the following forces:

- **Managing differences in internal interests:** The Commission must assess whether measures are consistent with the *broader* economic interests in the EU, and consensus building takes time. Take the countervailing duties on EVs as an example: the investigation was announced by the EU in Sep-23 and only finished by Oct-24.
- **Strategic goals rely on inputs from China:** For example, the EU's preferred EV transition still depends heavily on China-linked battery supply chains, where China holds a dominant position. Aggressive restrictions on Chinese autos could therefore trigger retaliation or supply-chain friction in batteries and related inputs, potentially slowing EV penetration in the EU.
- **Two-way leverage.** The constraints run both ways. China retains meaningful retaliatory tools such as anti-dumping probes on EU pork, dairy and brandy; Airbus order pipelines; and discretionary market access for European firms in autos, luxury and financials.
- **Chokepoints:** EU sources all of its heavy rare earth elements (REEs) and 85% of its light REEs from China, as well as 98% of its rare-earth magnets (per European Parliament). This dependency caps how far Brussels can escalate before risking self-harm.

China’s reaction function: tactical accommodation, commensurate countermeasures, no decisive rebalancing towards consumption

China’s macro backdrop: excess savings amid transition of growth drivers: The surplus is not just industrial or trade policy, in our view. The property downturn has reduced demand for housing-related investment, while the scope for another round of “old” infrastructure-led stimulus looks increasingly constrained. At the same time, household confidence remains fragile and precautionary savings are still high, keeping domestic demand soft. The increasing gap between desired saving and investment is reflected in elevated external balance in recent years. Without a more decisive consumption-led rebalancing, the surplus is likely to remain relatively persistent as the economy converges to a new growth path.

China’s response to EU escalation is likely to be tactical: But a decisive consumption pivot would be costly and institutionally hard, requiring a larger redistribution of income. Beijing may seek to manage frictions through selective concessions — import commitments, targeted market access, further cancellation of export VAT rebates, price undertakings, or negotiated remedies around subsidies and procurement. At the same time, China's reaction function will likely feature calibrated reciprocity: offer concessions where cost is manageable, and retaliate where leverage is high and escalation remains controllable. This points to probes or restrictions in politically sensitive European sectors — agriculture, spirits, autos, aviation, luxury goods — rather than a broad rupture.

Near-term impact manageable, but trade flows could be reoriented in the long run. We think the near-term growth impact would be modest, considering (1) potentially gradual EU enforcement, and (2) resilience of China's exports amid US trade escalations — anchored by market diversification, supply chain lengthening, and continued value-chain upgrading. In the long run, if Europe gradually tightens market access through local content rules, procurement restrictions, tariffs, and anti-dumping levies, China’s potential response could be to reroute exports, accelerate offshore production, and invest more directly in Europe (subject to mutual investment treaties) to preserve market access. The result would be redistribution of trade flows and value-added, instead of a meaningful deterioration in China's trade position.

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