



Global Markets Analysis

“China's Deflation Fight in an Era of
US and EU Trade Opposition”

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Introduction

China's struggle with persistent domestic deflation has emerged as a key factor influencing global economic trends. With households hesitant to spend, the property market in a state of structural decline, and monetary policy limited, China has turned to exports to manage industrial overcapacity and maintain growth. This approach extends domestic price weakness into international markets, resulting in a decrease in traded goods inflation globally.

Simultaneously, the international trade landscape has experienced a fundamental shift. The United States has taken a strong protectionist approach, imposing substantial tariffs on essential Chinese manufacturing sectors. The European Union, traditionally more reserved, has broadened its anti-subsidy measures, tightened procurement regulations, and targeted various Chinese industries, from electric vehicles to solar technology. What was once seen as cyclical has now become systemic: defensive trade policies are increasingly becoming standard practice rather than exceptions.

These two trends, China's export-driven deflation and Western protectionism, intersect at a time when global supply chains are already under pressure. US tariffs redirect Chinese products towards the eurozone and emerging markets, leading to imported disinflation while simultaneously increasing political pressure on Europe to respond. For emerging economies, these spillover effects present both challenges (competitive pressure) and opportunities (supply-chain shifts, foreign direct investment inflows).

This report analyzes how these developments interact with domestic macroeconomic conditions, global trade patterns, inflation trends, and financial markets. It details the mechanisms through which China's export strategy influences global pricing, examines the policy responses from the US and EU, assesses medium-term risks, and identifies tactical positioning strategies that align with the evolving global landscape.

Backdrop: China's Macro & Deflation Pulse

The export-led growth model China currently relies on is in direct response to persistent domestic macroeconomic weaknesses. This export push is a reactive measure rather than a proactive strategy; counteracting three important deflationary forces: weak domestic demand, a prolonged property sector crisis, and a monetary policy stance that has been too tentative to spark a durable reflation until recently. This fragile domestic backdrop is critical to understanding the escalating global trade tensions occurring now.

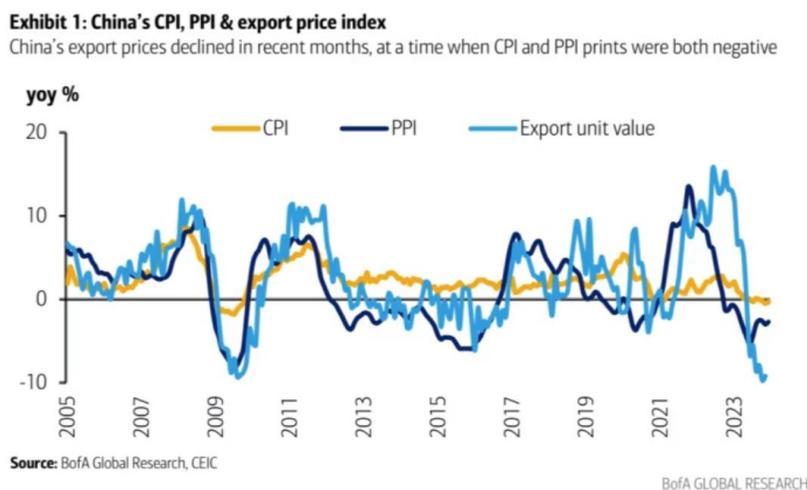
The core of China's deflationary impulse lies in its struggling household sector. Consumer spending is muted, hampered by stagnant income growth and consistently high youth unemployment. This demand shortfall is intrinsically linked to the unprecedented downturn in the property sector, which historically accounted for ~25% of GDP and was the primary store of wealth for Chinese households. As property prices have declined and pre-sales of new homes have stalled, the positive "wealth effect" that once powered Chinese consumption has reversed, creating a loop of increased precautionary saving and reduced spending. The property crisis also exposes deeper structural issues. Despite policy efforts like the 300 billion yuan relenting facility to clear unsold housing inventory, the challenge remains enormous. With an estimated 20 million pre-sold but unfinished homes, the crisis continues

to cripple developers, drag down the vast network of industries, from construction to steel, that rely on real estate activity, and depress local government revenues dependent on land sales.

Beijing's policy response to these powerful headwinds has been characterized by measured, targeted stimulus rather than the large-scale intervention markets called for. The People's Bank of China (PBOC) has eased monetary policy by increments, with a series of cuts to the Reserve Requirement Ratio (RRR) and the Loan Prime Rate (LPR). While these moves aimed to lower financing costs and boost credit, transmission has been weak due to the hesitancy to borrow from risk-averse banks and indebted corporates.

The focus has shifted toward directed credit for manufacturing and strategic sectors, a policy that supports the export engine but does not do much to address the core deficiency in household demand. This restrained stance, which prioritizes financial stability and avoids rampant speculation over aggressive growth, has allowed deflationary pressures to become entrenched within the domestic economy.

The chart below captures this dynamic. While consumer inflation (CPI) hovers near zero, indicating weak demand, producer prices (PPI) have been in deep deflationary territory for over a year, signaling severe industrial overcapacity. Critically, the Export Price Index has followed the PPI into negative territory, demonstrating that China's domestic deflation is now being exported globally as manufacturers cut prices to clear inventory.



Policy Mechanics: How Beijing Enables an Export Push

In the context of weak domestic demand and deflationary pressures, Beijing has turned to a familiar lever: boosting exports. This section examines the principal instruments through which the People's Republic of China has been supporting manufacturing and export activity as a standard recipe to redirect excess domestic output: currency, financial and fiscal support for manufacturing companies and, lastly, the implementation of "processing trade" regimes.

On to the first channel, the PRC has consistently maintained, at least in part, a managed exchange-rate regime, allowing political leaders to use monetary policy as a means towards the desired objective of supporting exports. Indeed, by preventing appreciations in the renminbi, the country was able to

keep their exports competitive, contrary to what happened recently to other currencies, including, for example, the Euro. While direct devaluation is used sparingly, the combination of modest reserves management, capital controls and selective “guidance” to exporters has consistently been an effective way of maintaining price advantages abroad.

In addition to the currency stance, Chinese state banks and policy banks continue to channel credit toward manufacturing firms, particularly in export-oriented provinces and sectors: think about electronics, automotive and machinery. Their willingness to provide these companies with low-cost financing and extended maturity heavily contributes to reducing firms’ cost of capital, allowing them to be competitive on the global landscape even amid broader headwinds in the markets.

Furthermore, a major instrument employed as a tax incentive is the export tax-rebate system, which allows exporters to recover the value-added tax (VAT) and consumption taxes paid on inputs. For example, China’s Ministry of Finance and State Taxation Administration announced that, effective 1 December 2024, export tax rebates for aluminum and copper products were eliminated, and for certain finished oils, photovoltaic products, batteries and non-metallic mineral products the rebate rate was reduced from 13 % to 9 %. On this matter, empirical evidence shows that VAT rates significantly boost export volumes.

Lastly, China allows “processing trade” in which imported inputs are used to manufacture goods for export with favorable tax treatment and quota access. Certain clean products exported under the processing-trade route continue to enjoy zero tax under new rebate rules, e.g., clean products in oil-refining, even while the general trade route faces tighter rebate rates.

These combined policy levers reduce marginal costs for Chinese export firms, maintain capacity, even during phases of the business cycle when domestic demand might be weaker, and help suppress export prices, supporting the competitiveness of Chinese exports abroad.

The Friction: US & EU Trade Opposition

China’s export-led recovery has been stifled by trade conflicts with its two largest external markets, the United States and the European Union. In 2025, a combination of tariffs, anti-subsidy probes, and other types of non-tariff barriers has shaped the global trade landscape, challenging Beijing’s ability to rely on exports as a deflationary buffer. The previous trend of cyclical trade tensions has evolved into a system of global trade protectionism, which these major economies claim to have adopted for reasons such as “economic security” and “de-risking”.

The United States of America re-escalated its trade conflict with China in April 2025, following the “Liberation Day”, issuing a new wave of executive orders that mandated tariffs on a wide range of Chinese goods, including electric vehicles, semiconductors, and green-energy components, with most tariffs reaching as high as 145 percent. China retaliated by raising duties on US-imported goods from 84 to 125 percent. In May 2025, a truce was agreed upon, where the US reduced its tariffs from 145 to 30 percent, while China lowered theirs from 125 to 10 percent, with Washington imposing the extra 20 percent to put pressure on Beijing to curb the illegal trade in fentanyl, a powerful opioid drug. Still, trade tensions ensue between the US and China as the current administration’s “America First” policy is characterized by a shift in protectionism and unpredictability.

The European Union, a long-time proponent of open trade, recently took a sharp defensive turn. Unlike their US partners, they did not use drastic tariff measures and first pursued investigations into specific sectors. Notably, in 2023, the European Commission launched an anti-subsidy investigation into Chinese battery-electric vehicles (BEVs), concluding in late 2024 that the industry benefited from extensive state support. By early 2025, the EU imposed countervailing duties of 20-35 percent, with provisional rates reaching higher for specific producers, such as BYD. Furthermore, the EU has expanded its Foreign Subsidies Regulation (FSR), giving Brussels the authority to block Chinese firms from public mergers and acquisitions if they are deemed beneficiaries of non-EU state aid. Already, we have seen several Chinese solar and rail companies excluded from European procurement bids under this rule. Customs reforms announced in November 2025 aim to end tax exemptions for low-value e-commerce parcels from China by 2026, which will negatively impact companies such as Shein and Temu.

Beyond tariffs and subsidies, both Washington and Brussels have widened their use of non-tariff barriers. The U.S. Inflation Reduction Act (IRA) restricts tax credits for electric vehicles and batteries to supply chains free of “foreign entities of concern”, which, in effect, barred Chinese firms from taking advantage of these. The EU is following suit, intensifying export-control reviews on critical raw materials, renewable energy, and digital infrastructure.

China’s policy response has sought to mitigate the external shock without fully abandoning engagement in trade with these external markets. The Ministry of Commerce has extended its own anti-subsidy investigation into European dairy products. Simultaneously, Beijing has accelerated trade diversification towards Southeast Asia, the Middle East, and Africa through expanded Belt and Road financing and localized production hubs, to offset Western demand losses.

Date	US/EU Action	Chinese Response
Oct 2023	Eu opens anti-subsidy investigation into Chinese BEVs.	China denounces “protectionism under the green banner.”
Apr 2025	U.S. introduces 145 % tariffs on Chinese imports under new executive order.	China imposes retaliatory tariffs up to 125 %
May 2025	Ninety-day tariff pause: U.S. and China reduce duties.	China signals conditional participation, maintains restrictions on U.S. agriculture.
Jun 2025	EU-China trade meeting addresses BEV prove and export-control disputes.	Ministry of Commerce threatens reciprocal investigations in strategic goods.
Nov 2025	EU announces end of parcel tax exemption for Chinese e-commerce goods (effective 2026).	Beijing urges WTO consultation, accelerating outreach to ASEAN partners.

Channels & Transmission

We now turn to the mechanisms through which China's export push spreads across global markets. The first step is China's domestic slowdown: weak spending at home and falling manufacturing products prices prompted firms to sell more goods abroad at lower prices. This strategy is useful in absorbing unused industrial capacity inside China, but once these cheaper goods enter global markets, the effects no longer remain between China and its direct trading partners and affect the global trade equilibria in general.

The United States plays a central role here. In case Washington raises tariffs on Chinese products, and assuming China doesn't reduce its industrial output, the impacted goods are redirected to other destinations. As a result, a shock to China's export routes could spread across multiple regions rather than staying within the bilateral U.S.–China trade relationship.

Trade diversion is the first mechanism through which this happens. In case U.S. tariffs make Chinese goods more expensive in America, Chinese exporters could reroute shipments to markets where entry barriers are lower. ECB analysis shows some predictions of what the outcome could be: in product categories affected by U.S. tariffs from 2017 to 2023, Chinese exports to the U.S. declined by around ten percent, while China's share of euro-area imports in those same goods rose by roughly two to three percentage points. However, the effects of tariffs levied might even extend beyond Europe. Southeast Asian (ASEAN) economies have been progressively absorbing more Chinese intermediate goods for their own manufacturing hubs. At the same time, Mexico and Türkiye benefit because they can re-export into the U.S. and EU, while, on the other side, several emerging markets in Latin America and Africa face stronger competition in consumer goods and light industry. What emerges is a global reshuffling of supply rather than a simple shift of exports from one major market to another.

As diversion widens, the second transmission mechanism becomes increasingly important. China's export prices have been falling in line with domestic producer prices, which have been negative for extended periods. When these lower-priced goods arrive abroad, the drop in import prices is immediate. ECB modelling suggests that increased shipments of discounted Chinese goods could trim about 0.15 percentage points from euro-area inflation in 2026, while CEPR scenario analysis shows that in more open advanced economies the effect could be closer to two to four tenths of a percentage point. The process unfolds in several steps: cheaper imports lower the cost of goods; domestic firms must reduce their prices to stay competitive; profit margins narrow; wage growth slows in exposed industries; and inflation expectations move lower as a result. In Japan and Korea, where Chinese inputs are deeply embedded in supply chains, the combination of cheaper components and tougher export competition makes the pass-through even more powerful.

The United States is partly insulated from this channel because tariffs block much of the discounted supply. This keeps U.S. goods-price inflation higher than in Europe or parts of Asia and reinforces differences in how central banks, particularly the ECB and Federal Reserve, interpret incoming inflation data. Emerging markets experience more mixed effects: countries that depend on Chinese

intermediate goods benefit from lower costs, while those competing with China, such as India in consumer goods or Brazil in machinery face margin pressure and weaker investment.

Diversion and pass-through together set the stage for the third mechanism: the retaliation and policy-uncertainty loop. As redirected Chinese goods accumulate in Europe, Brussels launches anti-subsidy probes, tightens procurement standards, and considers safeguard measures to prevent the bloc from absorbing tariff-displaced Chinese supply. A 2025 HKTDC report details these steps, emphasizing Europe's concern that state support in China keeps export prices artificially low. The United States simultaneously broadens its tariff network to include electric vehicles, batteries, solar products, and machinery. China must then choose between further credit easing to sustain manufacturing capacity or allowing production to scale back a decision with global repercussions for supply, trade flows, and pricing.

Uncertainty rises because firms in Europe, North America, and Asia cannot predict the regulatory conditions governing their supply chains. As a response, multinational companies delay capital spending, diversify production toward Vietnam, Mexico, Eastern Europe, and Indonesia, and increase hedging in currency and commodity markets. This uncertainty affects terms of trade: countries importing more discounted goods enjoy short-term real-income gains but risk long-term erosion of domestic industry, while countries facing higher barriers grapple with rising input costs and declining export orders. The combination of immediate disinflation and the possibility of deeper fragmentation lead to more volatile inflation paths in the medium term.

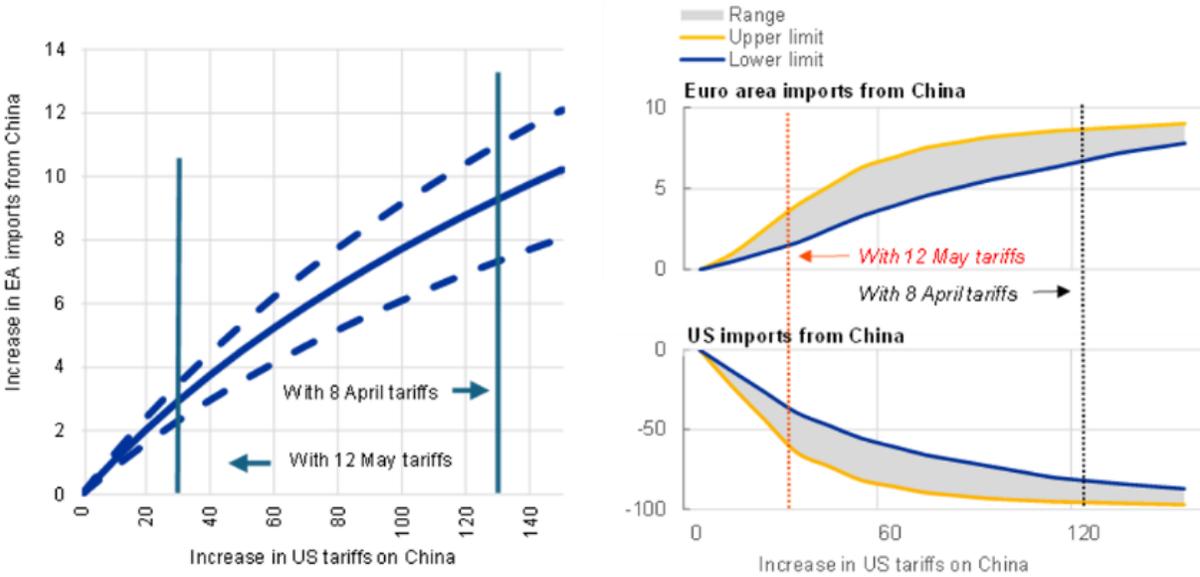
Financial markets reflect these shifts quickly. In Europe, falling goods-price inflation pulls down short-term yields even as longer maturities retain a risk premium tied to potential trade conflict. The euro tends to strengthen as cheaper imports improve purchasing power. China's renminbi remains under tight management but faces depreciation pressures if retaliation intensifies. Equity markets diverge by sector: retailers and consumer-goods producers benefit from cheaper Chinese inputs, while European and U.S. capital-goods exporters face margin compression when competing with rerouted Chinese supply. In credit markets, emerging Asia attracts capital linked to supply-chain relocation, while global high-yield issuers remain vulnerable to tariff-related news flow.

Together, these mechanisms show how China's export-led deflation spills into global markets through redirected supply, lower import prices, and reactive trade policy. The near-term effect is widespread disinflation in open economies, while the medium-term effect is greater uncertainty, higher fragmentation risk, and rising volatility in both macroeconomic outcomes and financial pricing.

Scenario Evaluation: The Impact of China’s Export Shift on Europe’s Inflation Perspective

Recent analysis by the ECB highlights how China's export-led approach to domestic deflation could directly influence price dynamics in Europe. The research explores a situation where the United States significantly increases tariffs on Chinese imports, compelling Chinese manufacturers to redirect their products to less restricted markets, primarily Europe. Given that the euro area has a similar import structure to that of the US, these redirected goods are likely to be concentrated in the manufacturing and consumer sectors, where price competition is already fierce.

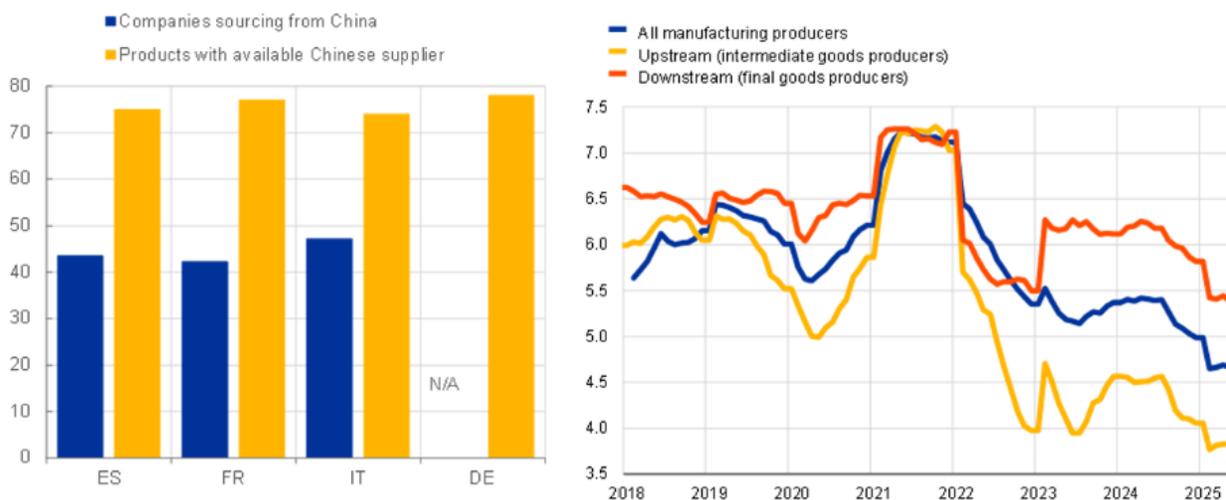
The model simulations indicate a distinct and accelerating trend of trade diversion from the United States to Europe as tariff rates on Chinese products increase. When US tariffs rise, euro-area imports from China grow almost proportionally, with the strength of this effect intensifying at higher tariff levels. In the moderate scenario related to the April tariff round, euro-area imports rise by approximately 6 to 7 percent. Under the more stringent May tariff configuration, import growth escalates to about 10 to 12 percent, indicating that each additional increment in US protectionism enhances Europe’s exposure to redirected Chinese goods.



Estimated increase in euro area imports from China

Simultaneously, US imports from China sharply decline along the same tariff gradient, with reductions nearing complete displacement under the highest rates. This resulting pattern underscores a nearly one-to-one substitution effect: what the United States excludes, Europe increasingly takes in. This transition suggests a significant rebalancing of global trade flows and pricing power. As European markets emerge as the primary destination for China’s surplus exports, competitive pressure on import prices heightens, contributing to lower traded-goods inflation. The overall result aligns with the ECB’s modeling, which associates severe tariff escalation in the United States with a measurable, albeit temporary, disinflationary effect on the euro area.

The rise in trade tensions has not been abrupt or isolated. It has developed through a series of reciprocal actions between Beijing and Western economies, each aiming to safeguard domestic industries while retaining strategic advantages. Chart 2 depicts this timeline of trade actions taken by the US and EU against Chinese exports, which includes rounds of tariffs, anti-subsidy investigations, and shifts in policy, alongside China's corresponding industrial responses. This sequence clearly indicates that these pressures are not fleeting distortions but rather structural forces that are reshaping global trade.



Current sourcing from China and profit margins of Chinese producers since 2018

These trade tensions provide the context for the ECB's modeling of global spillovers. According to its projections, the redirection of Chinese exports could lead to a seven to ten percent increase in euro-area imports from China under a severe US tariff scenario. This influx of lower-cost goods would have a measurable disinflationary impact, potentially reducing headline inflation by approximately 0.15 percentage points in 2026, with effects gradually diminishing in 2027. While the scale of this impact may seem modest, it holds considerable significance within the framework of Europe's stringent inflation-management cycle.

Europe's vulnerability to this channel is now greater than it was during the 2018–2019 trade conflict, when imports from China to the euro area increased by only two to three percent. Since that time, Chinese companies have strengthened their distribution networks in Europe, supply-chain connections have become more intricate, and the renminbi has depreciated, all of which enhance the price-transmission mechanism. Coupled with domestic policy support and substantial exporter margins, China currently has greater flexibility to reduce export prices without jeopardizing profitability.

This situation places Europe in a dual role as both a beneficiary and a captive of China's deflationary approach. Lower-priced imports provide temporary relief to real incomes and corporate margins, yet they also undermine local pricing power and intensify political pressure to implement its own protectionist measures. For China, the capacity to export deflation aids in maintaining output but does little to address the underlying weakness in domestic demand.

The ECB's assessment thus reveals a broader reality of the present global cycle: China's efforts to combat deflation through external demand directly clash with a Western pivot towards protective trade policies. The ensuing redistribution of price pressures may momentarily reduce inflation in Europe, but it also underscores the fragility of the global system as a means of achieving balanced growth across regions.

Market Implications

Global investors face a complicated set of repercussions due to the opposition between China's export-driven deflation struggle and growing Western trade barriers. For Western economies, imported disinflation is the predominant near-term concern, but medium-term risks of supply chain disruption and policy-induced volatility are beginning to offset this trend.

Rates & Inflation Markets

Lower-priced Chinese exports, especially in consumer products, are likely to hold down both headline and core inflation in the Eurozone, enabling the European Central Bank (ECB) to maintain an accommodative stance relative to domestic conditions.

Foreign Exchange (FX)

The euro is expected to hold up quite well compared to cyclical, trade-sensitive currencies such as the AUD and KRW. Lower imported inflation supports household purchasing power in the Eurozone. However, the euro's appreciation against the US dollar is constrained by the ECB's comparatively soft policy stance. The renminbi (CNY) outlook depends heavily on China's policy mix. The PBoC is expected to limit excessive depreciation to avoid destabilizing capital flows. Still, structural pressures, slowed domestic growth and the need to maintain export competitiveness indicate controlled depreciation with episodes of volatility around major trade policy announcements.

Equities

European consumer goods and retail companies stand to benefit in the near term as lower input costs from China support margins in sectors such as apparel, electronics, and household goods. European and US capital goods manufacturers face increased uncertainty: Industrial machinery, robotics, and green-technology firms are more exposed to trade investigations, tax, and potential tariffs. Chinese equities are likely to show instability, as while the broad market faces pressure from weak domestic fundamentals, export-oriented firms, particularly those capable of adjusting supply chains or operating in less targeted industries, may perform more resiliently. Shipping and logistics companies connected to rerouted trade flows could also benefit.

Credit & Emerging Markets (EM)

EM Asia ex-China may gain from supply-chain diversification. Vietnam, India, Mexico, and others are receiving increased FDI and export activity as firms adopt "China+1" manufacturing strategies. This supports local-currency debt and select equity markets. High-yield (HY) credit remains sensitive to trade-related shocks. While direct exposure in the US HY market is limited, a deterioration in global trade conditions could trigger broader risk aversion. Industries with complex cross-border supply chains would be particularly vulnerable to spread widening.

Tactical Plays

China's deflationary export push, countered by the intensifying U.S. and EU trade opposition, has brought about significant changes to investment and funding strategy. With industrial, protectionist policy overtaking the old free-trade model, investors must balance exposure across regions, asset classes, and event-driven catalysts, more so than previously. The following tactical approaches translate the earlier scenarios into positioning ideas.

Base Case – Europe's Slow Disinflation

The base scenario, characterized by European disinflation, contained spreads and moderate primary-market demand, favors longer-duration, high-quality issuance. Sovereigns and multinationals continue to anchor funding curves, while investment-grade companies benefit from a supportive bid for duration. For issuers, this means a preference for euro-denominated quasi-sovereign and high-grade corporate paper, which emphasizes green and transition-linked bonds that remain shielded from anti-subsidy investigations.

Barbell Strategy in U.S. Credit Markets

In the United States, the capital markets landscape is characterized by fiscal expansion and volatility induced by an unpredictable tariff policy. A barbell structure in issuance and credit selection offers resilience. At one end, large, defensive corporates in staples, utilities, and healthcare sustain stable issuance conditions and investor appetite. On the other end, some riskier, economically sensitive companies in logistics or U.S. manufacturing could tap opportunistic windows for new debt and equity financing, leveraging market rallies around tariff pauses. Primary issuance is likely to skew shorter in tenor amid elevated rate uncertainty, while secondary spreads remain anchored by strong retail and fund inflows.

Asia and China: Optionality in Primary Markets

Asia, excluding China, remains a relative winner in the redirection of global capital. ASEAN sovereigns and state-linked corporates are drawing steady inflows as global investors diversify supply-chain exposure. For China, issuance activity will remain event-driven. The PBOC's incremental easing supports selective refinancing in high-grade corporates and policy-bank bonds, but external issuance is constrained by trade frictions. Offshore markets could see tactical openings during tariff truces or liquidity injections.

Cross-Asset Hedge – Gold and Commodity Duration

Persistent deflation exports from China and trade fragmentation favors real-asset hedges. Maintaining exposure to gold, industrial metals, and long-volatility structures provides a good balance against funding-spread shocks or issuance delays. In cross-currency funding, USD liquidity premiums justify partial EUR- or CNH-hedged issuance to stabilize cost of capital.

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