China

Malign Indifference: China's Currency and the Threat to Europe

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The Chinese yuan's depreciation against the euro has been driven by deflationary pressures in China and the PBOC's passive approach to managing the currency against the US dollar. The yuan's weakness has helped drive up Chinese exports to Europe and depress European exports to China this year.

China's real exchange rate is likely to continue falling over the next two to three years given Beijing's limited policy capacity to combat domestic deflation. Falling Chinese export prices will compound competitive pressure on EU industry, erode the effectiveness of the EU's trade defense and economic security toolbox, and increasingly force policymakers to look beyond standard remedies.

A real depreciation linked to deflation pressure

Over the past year, the RMB has weakened significantly against the euro, falling by 8.2% in nominal terms. This continued a steep decline against the common currency since 2022 (Figure 1).

FIGURE 1

EUR-CNY exchange rate (scale inverted)

CNY per euro

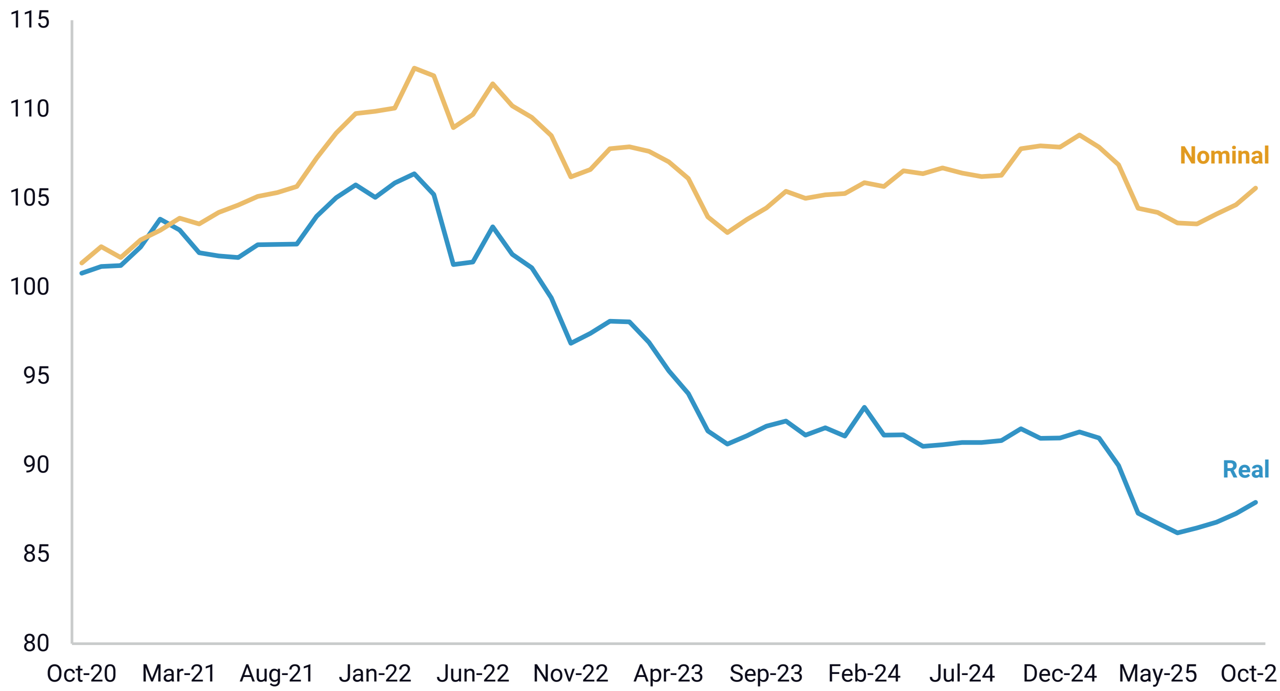
Source: Bloomberg, Rhodium Group calculations

In real terms (adjusting for inflation differences), the depreciation is even sharper, because China experienced much weaker inflation than the EU (Figure 2). Most of this real depreciation against the euro is the result of China's domestic deflationary pressures. These in turn are a byproduct of China's growth strategy, the rise in excess industrial capacity, and the corresponding imbalances between industrial output and domestic demand. The depreciation of the real exchange rate corresponds with the weakness in China's domestic investment activity following the collapse of the property sector in late 2021 and 2022.

FIGURE 2

China BIS Real and Nominal Exchange Rate Index, Oct 2020 – Oct 2025

2020 average = 100, Broad basket of currencies.



Source: Bank for International Settlements.

Short of significant structural reform of its economic system, Beijing is running out of ways to escape producer price deflation. Its main tools—directed use of the domestic financial system and large-scale fiscal support—are now less effective than in the past and arguably close to exhausted. As a result, it seems unrealistic to assume that deflationary pressures will ease and China's real exchange rate will appreciate in the near term. The focus, therefore, should be on the People's Bank of China's (PBOC) management of the currency against the US dollar and a trade-weighted basket of currencies.

Malign indifference and structural weakness

For decades, China's central bank has intervened persistently in the foreign exchange market to manage the yuan's value. While the PBOC claims to manage the currency's movement against a trade-weighted basket of currencies, in reality it mostly prioritizes stability against the US dollar, using purchases and sales of US dollars in the spot and forward markets. There are several examples in recent history of the PBOC stabilizing the currency and allowing only very narrow movements against the US dollar for limited timeframes, and no clear examples of similar periods of stability against a currency basket. In 2023 and 2024, for example, that meant leaning against market pressure and actively propping up the RMB to keep it broadly aligned with the movements of the dollar, rather than systematically pushing it down.

Over the past year, as the US dollar has depreciated, this pattern has shifted from active resistance to a more passive "go with the dollar" stance: The PBOC has largely allowed the RMB to drift weaker in line with the dollar's movement without intervening to offset the resulting depreciation against the euro and other currencies. The most likely reason for the PBOC's restraint is that the central bank wants to avoid complicating sensitive US–China economic discussions. Essentially, the PBOC is in a no-win situation if it generates any international media headlines concerning movement of the currency. Should the PBOC appreciate the currency sharply against the dollar, this could be perceived as capitulating to US demands; should it depreciate, this could be seen as retaliation against the US. The obvious low-risk move for the central bank is to do nothing that would generate media attention and complicate leadership-level negotiations, which has produced a passive depreciation of the yuan in real and nominal terms as the US dollar has depreciated this year.

The net result of this policy stance is what can be described as malign indifference regarding the RMB's movement against the euro. The PBOC is not explicitly targeting a depreciation against the euro—it is just a byproduct of the dollar's global movements and the RMB's relative stability against the dollar. But the PBOC is not pushing back against this depreciation either, nor attempting to act in line with their stated policy stance of maintaining the stability of the RMB against a trade-weighted basket of currencies. This is not the first time that the PBOC's passive approach has produced these consequences. The central bank allowed a significant RMB depreciation against the euro while maintaining stability against the dollar in late 2009, under far different economic circumstances.

The larger concern is that while Beijing could allow some appreciation of the currency against the dollar in the short term, Chinese authorities may not be able to commit to a stable currency over the longer term. While the RMB is widely considered undervalued based on models of what levels might balance the current account, the current account is only one of several forces that influence exchange rates. The problem in China is that with the world's largest money supply ($47 trillion) and persistent capital controls, there are strong pressures for capital outflows that will continue to weaken the currency, even if the current account balance continues expanding.

This persistent weakness in the real exchange rate is likely to continue. Even if the PBOC wanted to manage the RMB more actively against a broader basket of currencies, its room to do so appears more constrained than in the past. Pan Gongsheng is a weaker central bank governor than his predecessors, particularly Zhou Xiaochuan, who was capable of influencing the official policy line in managing the currency. All financial regulatory bodies are now subject to Party supervision under the Central Finance Commission and the Central Financial Work Commission, which reduces the PBOC's scope for policy autonomy as well. This oversight (and an ongoing anti-corruption campaign within the financial industry) appears to have reduced the PBOC's policy initiative over the past few years.

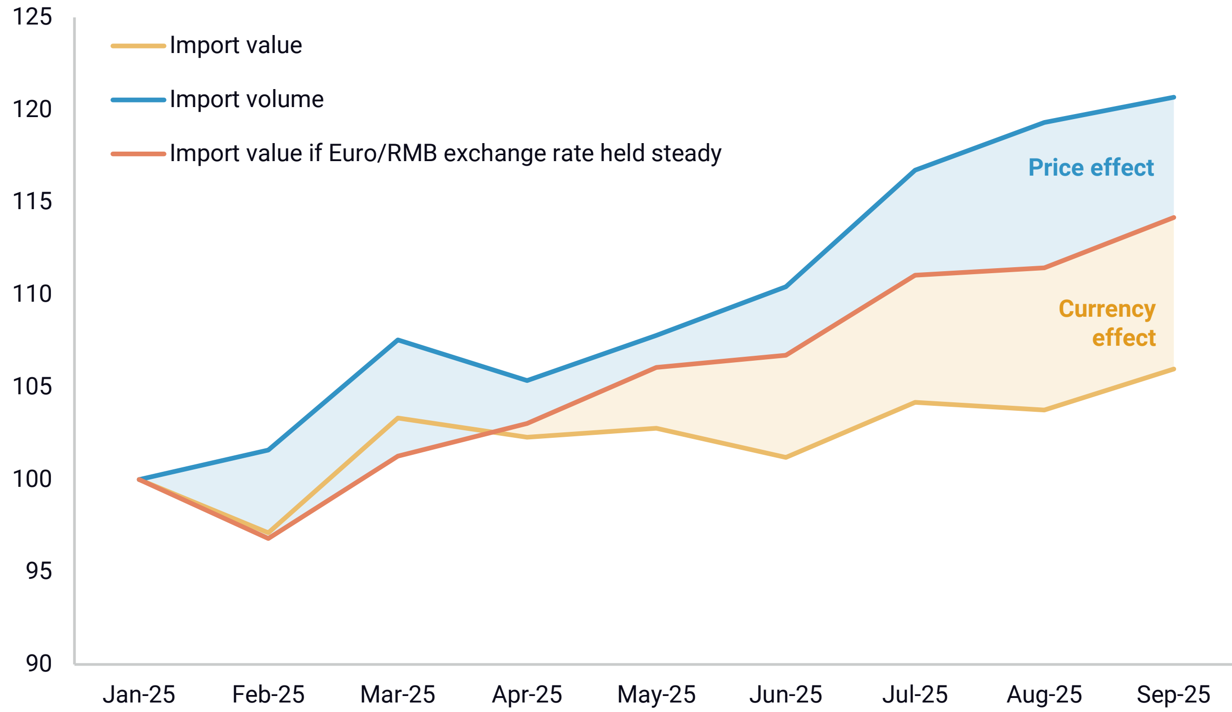
RMB depreciation weakens Europe's trade defense

The combined effect of weak Chinese export prices and a weak RMB compared to the euro has contributed to a fast increase in import volumes from China, at the expense of local producers that cannot compete on price. Since the beginning of 2025, currency effects account for roughly half of the widening discrepancy between EU import volumes from China and EU import values (Figure 3). In Q3 2025, EU import values from China rose only 0.2% year-on-year while import volumes rose 7%. Meanwhile, EU export values to China fell by 6% over the same period, due to weak Chinese demand and unfavorable relative prices for European exporters.

FIGURE 3

Index of EU import value, volume, and estimated import value from China if the euro/RMB exchange rate had held at Dec 2024 rate

Dec 2024 = 100, 3MMA



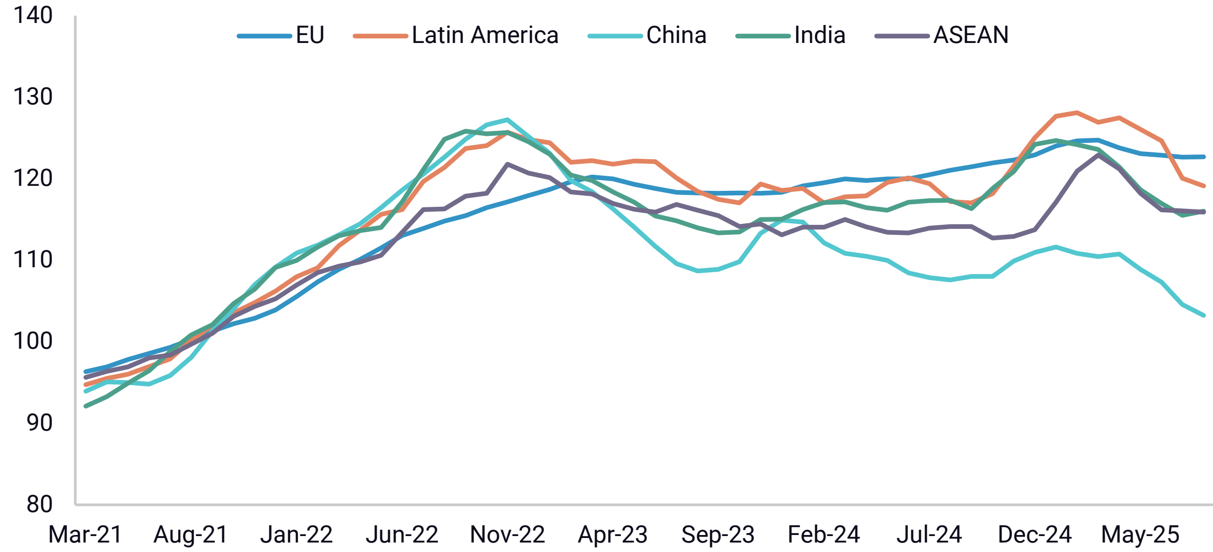
Source: Eurostat

Low prices of Chinese imports are not only hurting local producers but also complicating diversification efforts, because China's euro-denominated prices have fallen faster than those of alternative suppliers (Figure 4).

FIGURE 4

EU import unit value index by exporting region and country, Mar 2021 – Aug 2025

2021 average=100



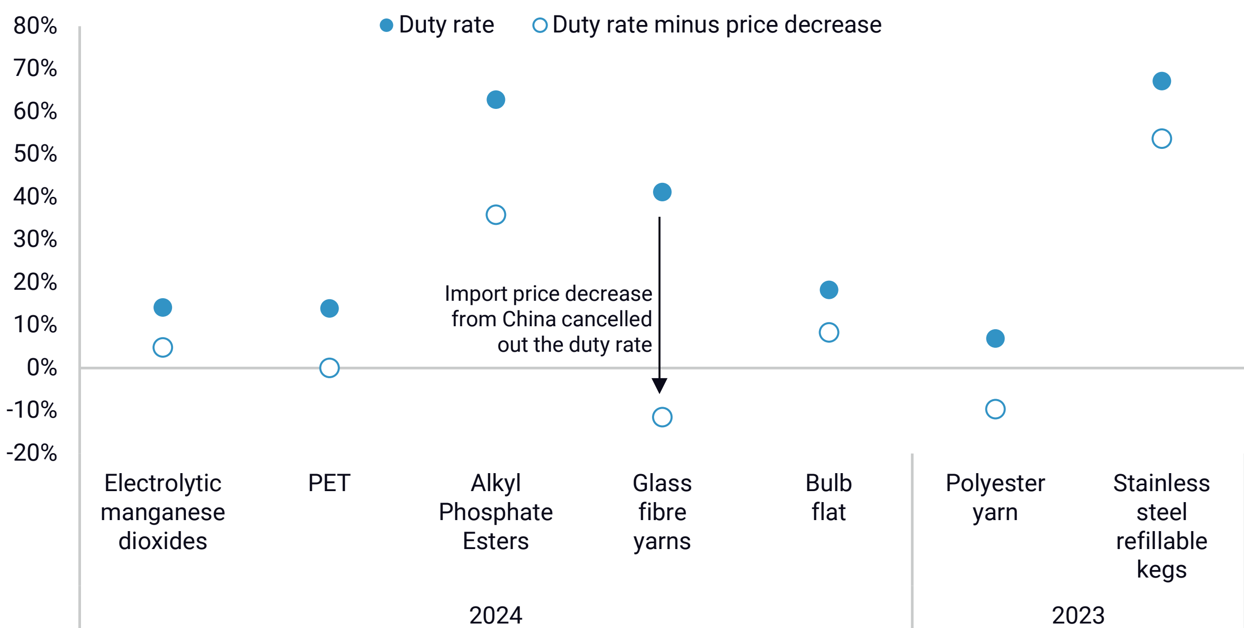
Source: Eurostat

Deflation in China and RMB depreciation also undermine the ability of EU trade defense instruments to effectively protect local industry. Even if a duty rate imposed following trade defense investigations was sufficient to offset non-market pricing when imposed, subsequent declines in euro-denominated import prices can negate the intended relief. That adjustment can occur much faster than trade defense procedures can be reviewed and adjusted (typically every few years). In practice, import price declines have already canceled out the duties for three out of seven of the cases enforced by the EU Commission on imports from China in 2023 and 2024, excluding electric vehicles, which are discussed below (Figure 5). In four of the seven cases, import volumes from China continued to grow in the past year. Bulb flats, a steel product used in shipbuilding, grew 68% year-on-year and polyethylene terephthalate, more commonly known as polyester, expanded by 210%.

FIGURE 5

Definitive duty rate and price decrease in products subject to AD and CVD duties enforced by the EU Commission in 2023 and 2024

Percent. Import price change (€/kg) as of Q3 2025 vs Q3 of the duty-implementation year; averaged across targeted HS codes where multiple apply. Duty rates shown are definitive and averaged across companies.



Source: EU Commission, Eurostat

In major cases like EVs, this can be extremely harmful. In 2024, the European Commission spent significant political capital advancing countervailing duties on Chinese EVs after a lengthy anti-subsidy investigation. Even then, it was clear that several Chinese automakers could absorb the duties and remain highly profitable, given the sizeable spread between domestic and European pricing.

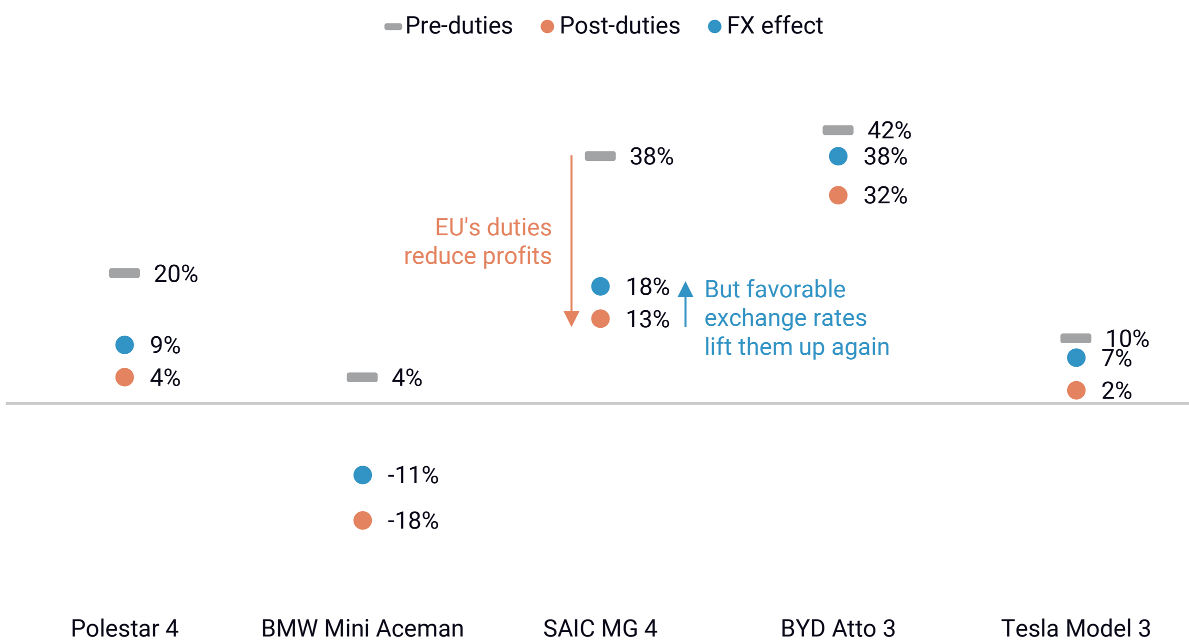
The duties curbed exports from some producers—most notably SAIC, which faced one of the highest tariff rates—but did little to constrain China's broader EV export momentum. Aggregate volumes have returned to pre-duty levels, supported in part by the depreciation of the RMB against the euro. Sales into Europe have helped prop up profits for Chinese automakers now in their third year of price wars and acute overcapacity—conditions Beijing warned in July were compressing margins to levels that risk undermining R&D and longer-term innovation.

For highly cost-competitive manufacturers with relatively low duty rates, such as BYD at 17%, the European market remains especially profitable (Figure 6). BYD continues to earn margins in Europe above those in China's domestic market. Based on our estimates, the favorable exchange rate alone added roughly €1,669 in profit for each Atto 3 sold in the EU in 2025 compared to 2024. As the RMB weakens further, the incentive for China-based OEMs to export to Europe only increases.

FIGURE 6

Estimated gross profit margins for China-made BEVs sold in the EU

Gross profit margin in percent



Source: Rhodium Group. Note the estimate is derived by using an adaptation of the methodology outlined in Ain't No Duty High Enough. Pre-Duties means the estimated gross profit margin before the additional EV duties and with the 2024 RMB-EUR exchange rate, Post-Duties assumes after EV duties and with the 2024 RMB-EUR exchange rate, FX effect means post duties and with the current (i.e. trailing six month average) exchange rate.

Currency dynamics also undermine the EU's strategy of encouraging Chinese firms to localize production in Europe: Exporting from China becomes more attractive, and firms have lower incentives to convert RMB earnings into euros for European investments. Rhodium Group's China Cross-Border Monitor shows subdued Chinese investment in Europe in Q2 and Q3 2025. Auto and EV investment has not increased following the imposition of EV duties. Instead, newly announced auto investment in the EU has fallen sharply—from a $15 billion peak in 2023 to $4.5 billion in 2024, and just $2 billion in Q1–Q3 2025.

Absent stronger trade protection measures, this trend complicates any discussion about conditioning FDI on job creation, IP sharing, or use of local supply chains, simply because there may be fewer investment projects to condition in the first place.

Europe's options

The RMB is unlikely to strengthen considerably against the euro in the coming months, absent a series of hawkish signals from the US Federal Reserve that would suggest interest rate cuts are on hold. China has no interest in a brokered "Plaza Accord"-style exchange rate adjustment that would appreciate the currency, particularly when trying to combat domestic deflationary pressures. Persistent capital outflows from China would similarly undermine the sustainability of any negotiated currency adjustment. Even if Beijing wanted to hold the RMB "up" or reduce intervention in the foreign exchange market temporarily, the real exchange rate is likely to remain under pressure from weak consumer demand and overcapacity in China.

This leaves European policymakers in a difficult position, as there are no easy asks from Beijing. Continued RMB depreciation will undermine the effects of EU tariffs and trade defense measures. Non-tariff barriers and other technical controls, safeguards, and requirements become more attractive to limit the flood of Chinese exports. The EU may need to adapt its trade defense regime accordingly. After all, even without the PBOC intervening in the foreign exchange market to keep the currency weak, overcapacity and domestic deflationary pressures are inherently tied to China's zombifying financial system and pervasive state intervention that has been at the heart of China's political economy.

One option would be to incorporate a measure of China's currency undervaluation into existing EU trade defense instruments. Anti-dumping investigations are already "currency proof," as they rely on "out-of-market" benchmarks (i.e., non-Chinese prices) to address domestic distortions. But the EU could, in principle, use the currency argument in future countervailing duties. The United States has already created a legal pathway to treat currency undervaluation as a countervailable subsidy in CVD cases via Commerce Department regulations that took effect in 2020. The EU could choose to pursue a similar approach. Even then, however, weaving currency dynamics into existing trade defense instruments would not solve a core limitation: They are not agile enough to adjust as exchange rates and domestic price levels move.

A more structural, though more controversial, approach would be to impose an across-the-board, unilateral tariff mechanism that adjusts with trends in China's domestic prices (and potentially currency moves), effectively compensating for persistent RMB weakness. Although non-WTO compliant in itself, such action could be justified using GATT Article XV, which holds that members should not "frustrate" the intent of the agreement through exchange rate actions (and vice versa). That could be framed either as a basis for legal challenge or as part of the justification for measures taken outside the normal WTO trade-remedy toolbox, ideally in coordination with other major economies.

Both routes face serious technical and political hurdles. On the technical side, assessing currency undervaluation is inherently model-driven and sensitive to current account data and assumptions. Countries rely on the IMF's assessment framework, and that framework itself relies on China's official current account data from the State Administration of Foreign Exchange. That data appears understated in China based on improbable adjustments in interest income and less transparent methodologies of measuring goods trade relative to official Customs data. On the political side, the EU and the IMF have previously expressed concern about the US approach of using foreign currency undervaluation as a basis for CVD actions. The EU may also be cautious about elevating currency issues given its own trade surplus and the risk of drawing additional unwanted scrutiny from Washington.

A more realistic route would be to lean more heavily on instruments that are less sensitive to price and exchange rate swings, such as non-price criteria and resilience criteria in procurement—safeguards triggered by import volumes rather than values—and other technical or regulatory controls that limit import surges without relying primarily on price-based trade remedies. These instruments are already increasingly used by the EU Commission and will likely feature in the upcoming Industrial Accelerator Act. Local content requirements—planned for the auto sector and potentially others—could also be relatively immune to exchange rate fluctuations, depending on how they are designed (see our note: Made in Europe 2025). To constrain China's EV exports, the EU could mandate or tie fiscal incentives for corporate fleet purchases to local content thresholds. This would effectively shut China-based EV makers out of 60% of new car sales in the EU unless they produce and source locally. BYD, for example, sells roughly 89% of its vehicles in Germany into corporate fleets.

Barring an unlikely shift in China's growth model, Europe should assume that Chinese goods will become even cheaper in euro terms over the next few years. A weak RMB, persistent deflation and excess capacity in China will keep undercutting EU producers and steadily erode the bite of conventional trade defense tools. That leaves European policymakers with hard choices: Either accept ever-growing exports from China and weaker incentives for localization, or move toward structural action that restricts trade.

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