China's Persistent Industrial Overcapacity Challenge[1]

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I. The Institutional Origins of China's Recurring Industrial Overcapacity Challenge

The Chinese economy today faces no less challenging an environment than in 2023 when the government suddenly ended its "Zero Covid" policy. While the Chinese government can abruptly unlock the Chinese people from their homes, it cannot command the economy to bounce back swiftly. As China struggles to reignite its growth engine, diagnoses from the United States and the European Union have painted a troubling picture of industrial overcapacity. Despite Beijing's vehement rebuttals, the Chinese economy has found itself mired in recurring cycles of overcapacity challenges that drag it into deeper debt addiction and have more than once stoked trade tensions.

Industrial planning in China is meticulous in setting production targets but notably lax in fostering consumption, prioritizing government-dictated industrial aims over individual preferences. China's five-year plans consistently articulate clear goals for industrial production and infrastructure development yet remain vague about bolstering household consumption. This oversight is not from ignorance; rather, it stems from the view that sees consumption in service to fuel state-prioritized industrial sectors.

The 110-page long 6th Five-Year Plan (1981-1985), the first five-year plan under China's Reform and Opening, dedicates merely one page each to income and consumption, while the remainder focuses on industrial sector development, international trade, and technology advancement. Similarly, the current five-year plan, the14th Five-Year Plan (2021-2025), sets numeric targets for economic growth, R&D investment, patent achievement, and food and energy production, but relegates household consumption to a single paragraph. Even here, it steers consumption towards areas like automobiles, electronics, digital products, and smart appliances, aligning closely with China's industrial priorities.

By defining preferred consumption areas, the Chinese government shapes domestic demand rather than allowing the market and individual preferences to determine it. China's vibrant e-commerce and platform economy might suggest a plethora of consumer choices. In reality, platforms like Alibaba, Pinduoduo, and Shein are microcosms of fierce competition for homogeneous goods. The illusion of diversity masks a market steered by industrial priorities rather than individual preferences. As policymakers vow to boost household consumption, they have taken the approach of encouraging people to consume durable goods and manufactured

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products in sectors prioritized by the state. To this end, the government has introduced administrative guidance, such as the Action Plan to Promote Trade-in of Consumer Goods jointly issued by fourteen government agencies. While the government can influence supply-demand dynamics in China's consumer markets, it cannot compel people to spend or criminally punish them if they are unmoved by the state's consumption promotion plan. When income growth slows, people naturally tighten their purses and only spend on what brings them the most satisfaction – an area beyond the reach of government control or regulation.

Top-down plans spur campaigns in targeted sectors led by local government officials whose promotions hinge on their ability to deliver GDP growth. As Mary Gallagher argued, the use of campaigns for governance tends to produce overcapacity because it provides clear priorities and goals that cascade through the system. This system fosters excessive use of leverage for investment in selected sectors, inevitably leading to ballooning debt and industrial overcapacity.

Since the 1994 fiscal reform, local governments have been under chronic financial strain to meet their dual mandate of promoting local GDP growth and providing public services with limited fiscal resources. As Chinese scholars described, Beijing's centralization of financial power while offloading obligations to lower-level governments exacerbates the "natural fiscal deficit" at the local level. Furthermore, the GDP-based promotion mechanism distorts incentives, pushing local officials to favor projects that can quickly boost local GDP, exacerbating local fiscal burdens by adding a "competitive fiscal deficit." To promote local growth and advance their careers, local officials hate to miss opportunities in pillar industries chosen by Beijing. Industrial policies outlined by the National Development and Reform Commission make it easier for local governments to secure approvals for new investments, lock in bank loans, and obtain fiscal support for new projects, despite their limited capacity.

The problem is that almost all local governments, with little coordination among them, are thinking the same at the same time and concentrating investment into the same sectors outlined by Beijing. As a result of concentrated, collective, but uncoordinated local investments nationwide, regional industrial structures are strikingly similar, almost guaranteeing overcapacity. Using data covering 27 industries and 31 provinces, Chinese researchers found that thanks to local government interventions, industrial structure similarity among provinces exceeded 95 percent once natural resource extraction industries were excluded. This means that from Xinjiang in the west to Shanghai in the east, from Heilongjiang in the north to Hainan in the south, localities across China established factories in almost identical industries, driven by local officials' desire to outperform their peers in the national promotion tournament.

As Beijing's priorities shift, specific sectors experiencing cycles of overcapacity change accordingly, but the underlying causal mechanisms and incentive structures persist. As local governments go through the cycles of plowing resources into Beijing's chosen industries and competing with each other to attract investors by offering explicit and implicit subsidies, they

directly contribute to overcapacity. This description is not invented out of thin air in the West. Rather, it has been the diagnosis written in China's policy documents, whose qualitative descriptions of industrial overcapacity capture the causal mechanism: overcapacity is "production capacity far exceeding market demand," which is caused by "blind investment and low-level, repetitive construction."

Duplicative investment by local governments inadvertently fuels intense domestic competition among firms and factories that barely make any profit producing homogenous products, a phenomenon dubbed by Chinese people as "*nei juan*" (involution). Due to close-to-no product differentiation, firms have commonly adopted a competition strategy of expanding production capacity fast and engaging in fierce price wars, rather than attempting to gain a competitive edge by improving corporate management or investing in R&D. After all, levering up and investing to expand is easier and faster, for as long as firms can keep their cashflow and survive. Finite domestic demand forces firms to export overseas, subjecting them to fluctuations in global markets and geopolitics. Economic downturns in export destinations and rising trade tensions can stymie export growth and worsen overcapacity at home.

This feeds a vicious cycle: firms backed by bank loans and local government support must produce non-stop to maintain cashflows. A production halt means no cashflow, prompting creditors to demand their money back. The more firms produce, the greater overcapacity, the lower prices drop, the greater losses they incur, the more financial support they need from local governments and banks, the deeper indebted they become, the less repayment capability they have, the more likely they become zombie companies, and the more fearful of stop producing they become. As economic growth slows and policies to reduce taxes and fees for firms are implemented to spur growth, local government revenue has declined while expenditures rise. This exacerbates fiscal deficits and compels more borrowing. This cycle involving a distorted relationship between local governments and the firms they support puts local GDP growth on debt steroids, ensnares the Chinese economy to debt addiction, and traps it in hard-to-reverse overcapacity.

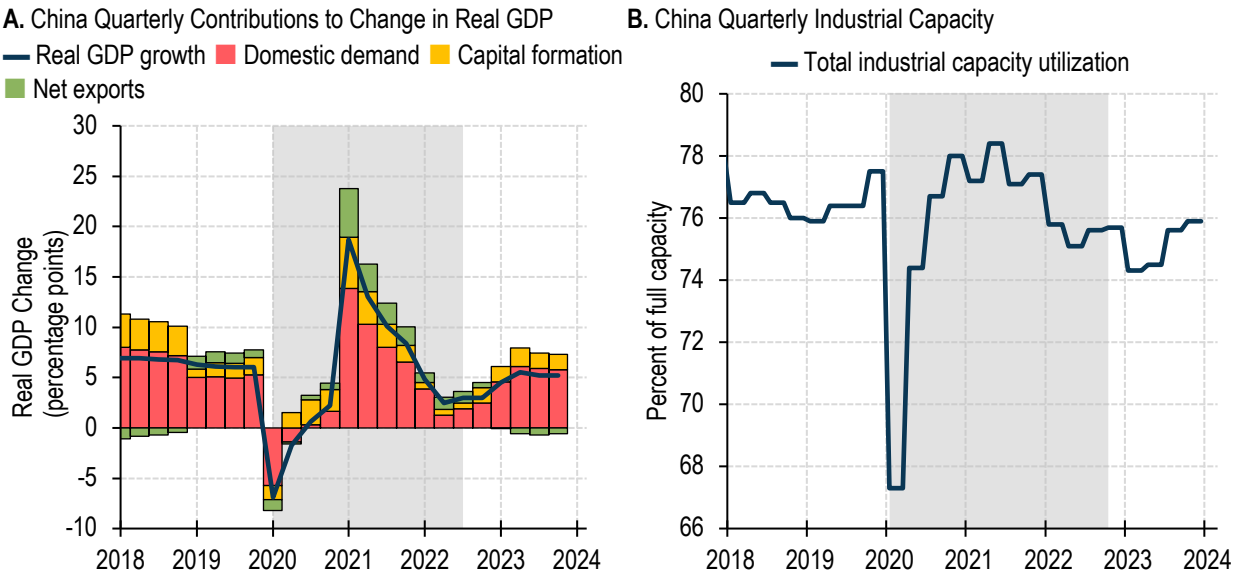
II. China's Sprawling Industrial Overcapacity Amid Weak Domestic Consumption

After a strong start in 2023, boosted by government assistance, Chinese domestic demand failed to expand and actually decelerated throughout the rest of the year. The exceptionally weak economy was hindered by subdued growth in domestic demand (see Figure 1. A). China faces structural obstacles to expanding demand through increased domestic consumption. Household incomes are growing slower than before the COVID-19 pandemic, and the struggling housing market has made Chinese people less certain about their financial health and more risk-averse, which translates into subdued consumer confidence and spending.

In years past, when domestic demand was flagging, China could rely upon robust net exports to soak up excess production capacity. However, that was no longer the case in 2023; net export growth was negative every quarter in 2023, dragging down fourth-quarter GDP by 0.6

percentage points (see Figure 1.A). Falling exports are another signal that the move by Western governments, led by the United States, to shift their manufacturing supply chains away from China is starting to have a real bite on the Chinese economy. Western economies are now completely past the widespread supply chain disruptions of 2022 that forced them to ramp up exports from China. Under less logistical pressure, these country's governments have moved to "de-risk" their exposure to China by decreasing imports of Chinese goods. For decades, Chinese enterprises have assumed robust growth in foreign demand for Chinese goods when making investment decisions about expanding production. Simply put, China's economy was built for much more demand than it receives today.

Figure 1 *Soft domestic demand and falling exports have worsened China's overcapacity problem.*



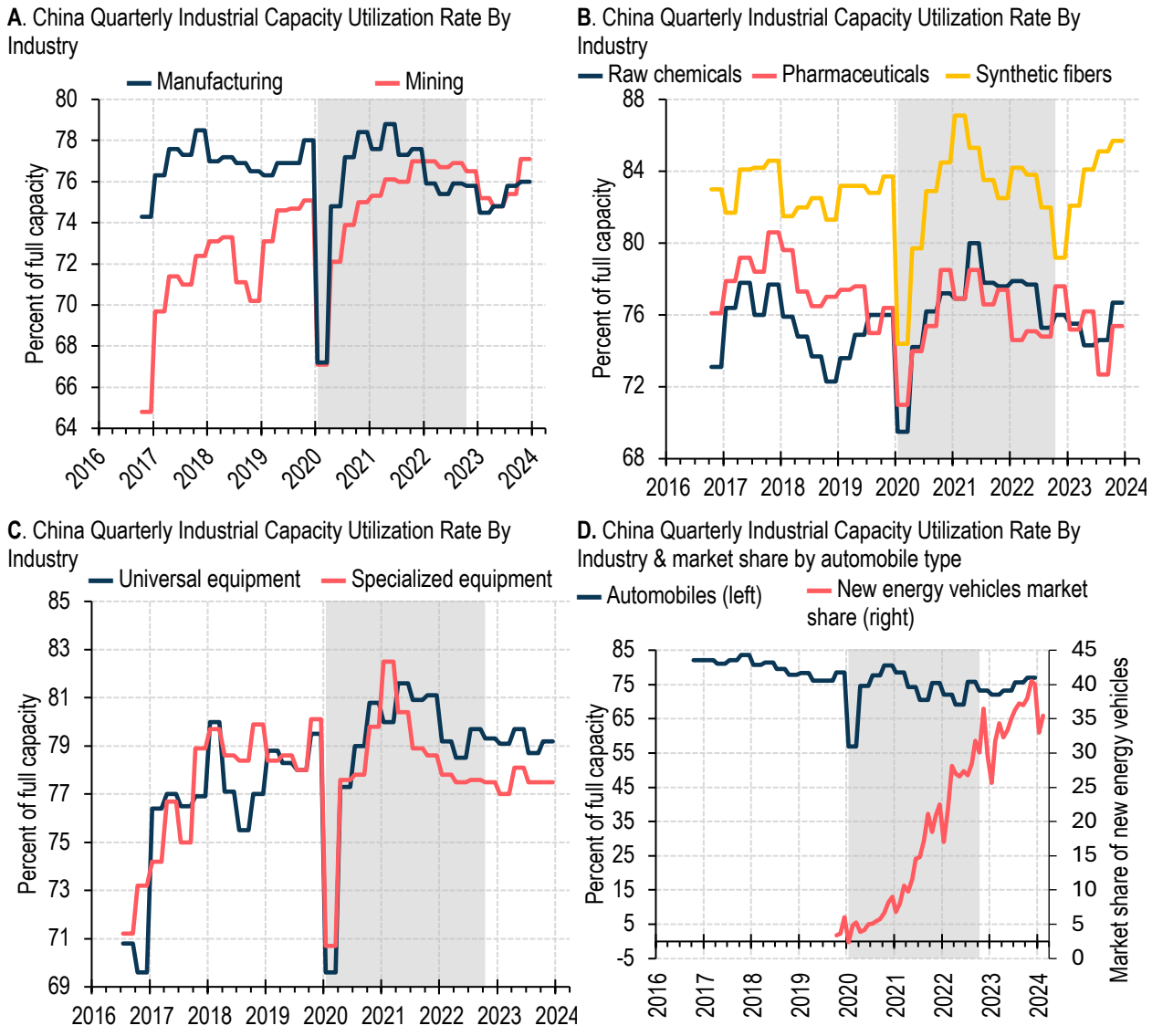
Notes: Shading indicates COVID-19 lockdown period.

Sources: China National Bureau of Statistics, Haver

Gross capital formation, or investment, remained steady, contributing 1.5 percentage points to GDP. Although steady investment has helped stabilize the overall economy in the short term, it does not necessarily benefit China's economy over the medium term. The additional investment serves to expand China's industrial capacity further, which is already overextended. Total Industrial capacity utilization in China peaked at 78.4% in the middle of 2021, when the rest of the world was emerging from the depths of the COVID-19 pandemic and hungry for Chinese goods. Since then, it has drifted lower to a nadir of 74.3% in early 2023 before rebounding slightly to 75.9% (see Figure 1. B). Generally, an industrial utilization rate below 80 percent is considered an indication of an overcapacity problem—China's economy has climbed above 78% for only three quarters over the last decade.

Unsurprisingly, the manufacturing sector has one of the greatest overcapacity problems in China's economy. It comprises a large component of the overall economy and is subject to export demand vicissitudes. Manufacturing sector capacity utilization has mostly tracked the overall economy, which stood at 76% at the end of 2023. The Mining sector is one of the few areas where considerable consolidation has eliminated some excess capacity over the last decade. Its capacity utilization rate stood at a multiyear high of 77.1% at the end of 2023 (see Figure 2. A).

Figure 2 *Many of China's industries fall below the 80% capacity utilization threshold, indicating widespread overcapacity problems.*



Notes: Shading indicates the COVID-19 lockdown period.

Sources China General Administration of Customs, Haver

Some industrial sectors in which China is now a global leader have also shown signs of overcapacity, and the government's policies to encourage consolidation have not been hugely successful. For example, China is the world's largest producer of active pharmaceutical ingredients and raw chemicals. Beginning in the 1990s, the government implemented policies to encourage the development of an indigenous industrial chemicals industry and a related, low-value-add basic pharmaceutical industry. This policy led to thousands of small chemical producers spread throughout China that engaged in a relatively low profit and environmentally degrading chemicals manufacturing industry. In recent years, the government has sought to encourage consolidation in the industry and move up in the value chain to higher-grade pharmaceuticals and chemicals made in laboratory environments in industrial parks with managed environmental standards. This government initiative has been only moderately successful, as forcing consolidation is unpopular at the local government level. The capacity utilization rate for both the raw chemicals industry and pharmaceuticals drifted down in 2023, settling below their 2018 peaks, reflecting that consolidation remains a distant goal (see Figure 2. B).

Most distressingly, China's overcapacity problem has spread to those industries that are supposed to be leading the Chinese economy's charge up the global value chain. Universal and specialized equipment manufacturing, two industries that include high-end machinery and electronics, have shown weakness in the last two years as domestic demand and exports have both faltered. Both industries have falling capacity utilization and have crossed over the 80% threshold, indicating potential overcapacity problems (see Figure 2. C). The automobile industry as a whole is clearly in a state of overcapacity. Utilization rates have been drifting down for years, crossing the critical 80% threshold into overcapacity and finishing 2013 at just 76.9% (see Figure 2.D). The government has publicly pledged to lead consolidation in the industry, withdrawing subsidies, forcing weaker players out, and leaving the surviving large and more able to compete globally.

But it is worth noting that China's current industrial overcapacity challenge is not new. Thanks to the institutional design of campaign-style mobilization to develop state-picked strategic sectors, overcapacity has become a chronic reoccurring phenomenon in China's recent economic growth experience. It has challenged the coal, steel, and cement industries since the 1990s and emerging sectors since the global financial crisis. A recent paper published in March 2024 by Liang Yongmei of the Chinese Academy of Social Sciences analyzed four cycles of industrial overcapacity since China's reform and opening up. A classic example is the solar photovoltaic industry. In 2010, the State Council aimed to have strategic emerging industries account for 15 percent of GDY by 2020, with solar power as one of the chosen key sectors. Within two years, 31 of China's 34 provinces, municipalities, and autonomous regions listed the solar PV industry as a priority; 300 of 600 Chinese cities were developing the solar PV industry; and over 100 cities had built solar PV industrial bases.

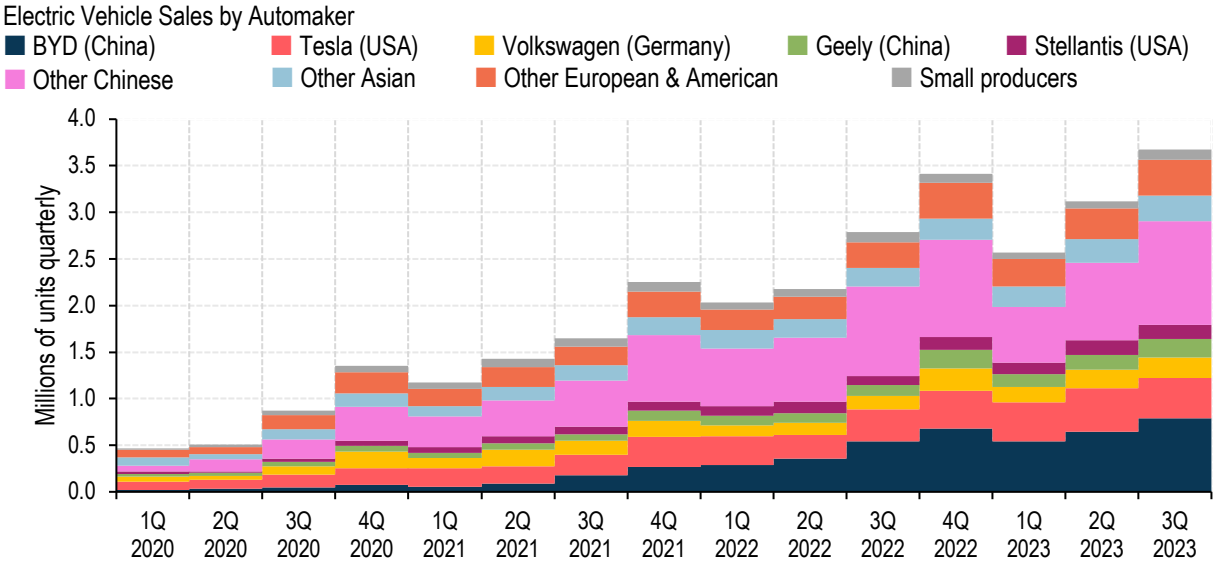
Another example is the industrial robotics industry, one of the prioritized industries in the "Made in China 2025" industrial strategy announced in May 2015. In 2013, China purchased about 20 percent of the world's industrial robots and surpassed Japan to become the world's largest industrial robot buyer. Hence, it made sense for China to improve domestic production. In less than two years following the launch of "Made in China 2025," over 20 provinces prioritized industrial robots and launched over 40 robot industrial parks, and the number of robotics companies exceeded 800, acknowledged by officials from the Ministry of Industry and Information Technology. The robotics industry now faces a structural overcapacity problem featuring excess capacity in low-end robotics due to massive duplicative investments but insufficient capacity in high-end robotics with indigenous intellectual property rights. This structural overcapacity problem challenges not just China's robotics but other high-tech sectors as well, such as the EV batteries sector with multi-billion investment. It is important to note that structural overcapacity in emerging sectors is not new in China. A 2013 study funded by the China Development Research Foundation, a foundation initiated by the Development Research Center of the State Council, found that a number of emerging strategic sectors, such as solar PV and batteries, were suffering from structural overcapacity problems featuring excess supplies at the low end and insufficient supplies at the high end.

The most recent example is the artificial intelligence industry, a prioritized industry in the 13th and 14th FY plans covering the decade from 2016 to 2025. In August 2019, the government set the goal of constructing about 20 AI pilot zones by 2023. In two years, 17 pilot zones were confirmed despite the description caused by the large-scale lockdowns during the COVID-19 pandemic. Cities hosting AI pilot zones have all introduced supporting industrial policies and action plans. China's post-COVID slow recovery, combined with President Xi Jinping's expressed strong desire to pursue technology self-sufficiency amid intense geopolitical competition with the United States, has tied Beijing's hands to concentrate resources to fund advanced manufacturing and strategic technology development and discourage distractive alternative investments, such as the property sector. Policymakers have turned to loan facilities to advance China's pursuit of science and technology leadership. They have mobilized the entire banking system and set up dedicated loan programs to support research and innovation in prioritized sectors. For example, in 2021, China Development Bank launched a special loan program for science and technological innovation and basic research. By May, CDB had distributed over RMB277 billion in loans to support critical sectors such as semiconductors, clean energy technology, biotech and pharmaceuticals, among other cutting-edge fields. In April 2024, the PBoC, along with the Ministry of Science and Technology and several other ministries, launched a RMB500 billion refinancing facility to support bank lending for technological innovation. By June, this strong credit support has resulted in the establishment of 421 national-level smart manufacturing demonstration factories, over 10,000 provincial-level digital workshops and smart factories, and more than 4,500 AI companies. Isn't this awfully familiar?

III. Cheap Chinese Exports and the Danger of Escalating Trade Tensions: Examples of EVs and Solar

The Chinese government has supported a boom in China's electric vehicle (EV) manufacturing industry for years, providing subsidies and access to cheap credit. This strategy initially showed great promise to vertically leverage China's dominant position in upstream industries like critical minerals processing and battery manufacturing. Beijing's support has successfully propelled domestic EV champions like BYD and Geely to the forefront of the global EV market. Altogether, Chinese EV manufacturers produce 40% of EVs, although a large portion of these are by the over 100 smaller companies that have few profits and likely would not exist without continued government for the industry (see Figure 3).

Figure 3 *About 40% of global Electric Vehicle (EV) production is by Chinese companies.*

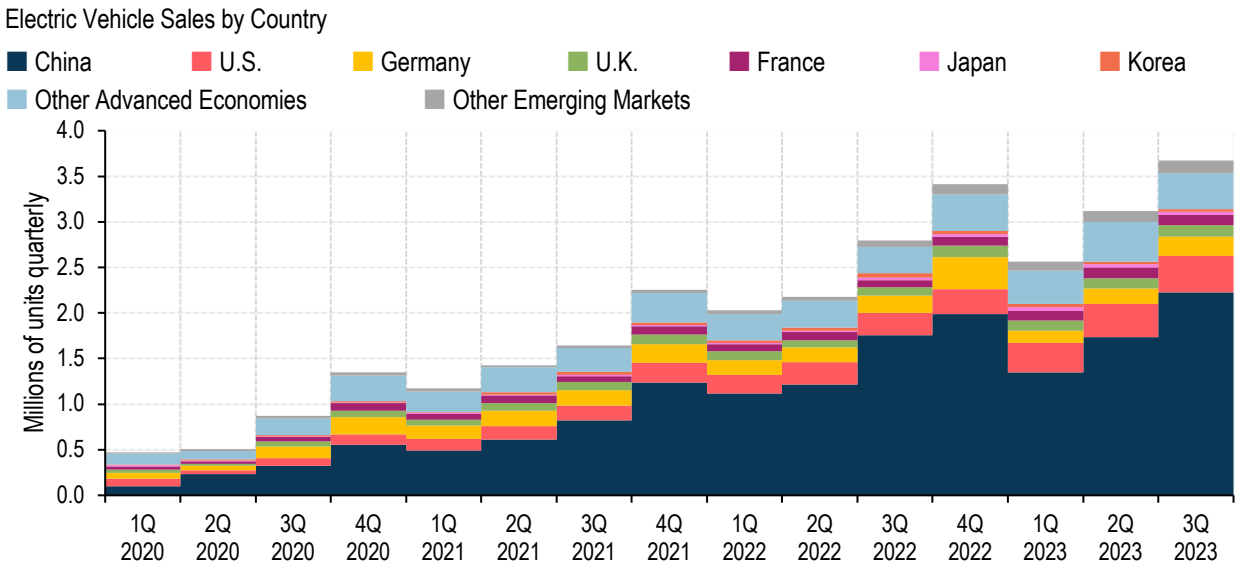


Notes: Joint ventures located in China assigned to Other Chinese. Renault-Nissan assigned to Other European/American. Does not include high-speed or commercial vehicles.

Source: Bloomberg Financial LP

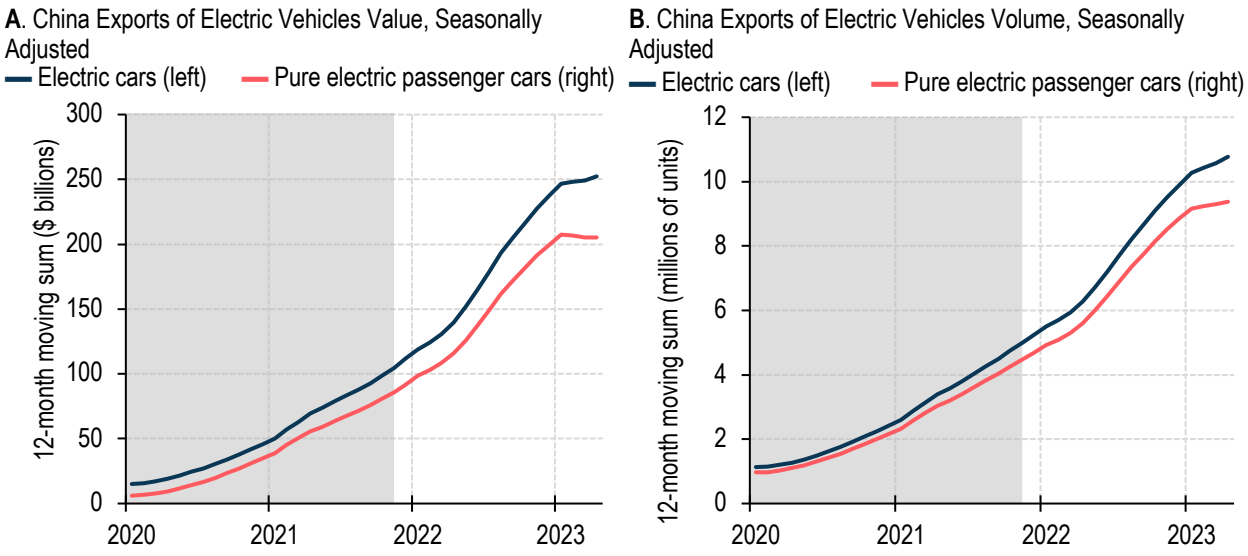
China's EV market is the largest and most price competitive in the world, more than 50% larger than the rest of the world combined in terms of the number of sales (see Figure 4). With a penetration rate in excess of 35%, EV adoption in China is well ahead of the United States—which was only 7.6% at the end of 2023— and other countries. This implies that China's domestic EV market expansion may have plateaued at least in the near term, and that in order for companies to survive, they may have no choice but to attempt to gain additional sales from abroad by dumping their EVs on the market. In fact, data published by the China General Administration of Customs showed that China's export of EVs has grown rapidly over the past two years in terms of value and volume (see Figure 5).

Figure 4 *The Chinese Electric Vehicle (EV) market is 1.5x larger than the rest of the world combined.*



Notes: Includes pure electric vehicles, hybrids, and plug-in hybrids. Does not include high-speed or commercial vehicles.
Source: Bloomberg Financial LP

Figure 5 *China's electric vehicle exports have grown rapidly in the last two years.*



Notes: Shading indicates the COVID-19 lockdown period.
Sources: Haver, China General Administration of Customs

The European Commission pointed out that EVs made in China are typically a fifth cheaper than EU-made models. In October 2023, the European Commission formally launched an anti-subsidy investigation into the imports of battery electric vehicles (BEV) from China.[2] The Commission has up to 13 months to assess whether to impose tariffs above the standard 10% EU rate for cars in its highest-profile case against China since an EU probe into Chinese solar panels narrowly avoided a trade war a decade ago. The anti-subsidy investigation covers battery-powered cars from China, including non-Chinese brands made there, such as Tesla, Renault, and BMW. It is also unusual in that it is brought by the European Commission itself rather than in response to an industry complaint.

The U.S. government has also taken action against China's EV industry but has cited national security concerns instead of explicitly expressing concerns about China's unfair trade practices. In February 2024, the Biden administration opened an investigation into whether Chinese vehicle imports pose national security risks and could impose restrictions due to concerns about connected car technology. According to the White House, the U.S. Commerce Department probe is needed because vehicles "collect large amounts of sensitive data on their drivers and passengers (and) regularly use their cameras and sensors to record detailed information on U.S. infrastructure."[3]

Similar to the EV sector, China's solar sector also faces an overcapacity problem that subjects the Chinese industry to rising trade tensions. Data from BloombergNEF shows that China accounts for more than 90% of global solar cell production and will doubtless remain the world's largest solar manufacturer in 2024.[4] Chinese solar industry's rapid expansion over the past few years has led to massive over-capacity as companies raced to build new state-of-the-art factories to meet growing demand and gain a technological edge over competitors with older equipment. At the end of 2022, China had 817 gigawatts of planned or operating module capacity — almost three times as much as the 310 gigawatts at the end of 2020.

Prices and profit margins plunged in response to investment expansion. The price of solar-grade silicon dropped by 80 percent in a little more than a year through August 2023, and the cost of modules has continued to fall, hitting a record 11.3 cents per watt on Jan. 10.[5] Lower

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[2] "Commission launches investigation on subsidized electric cars from China," European Commission, October 4, 2023. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_4752

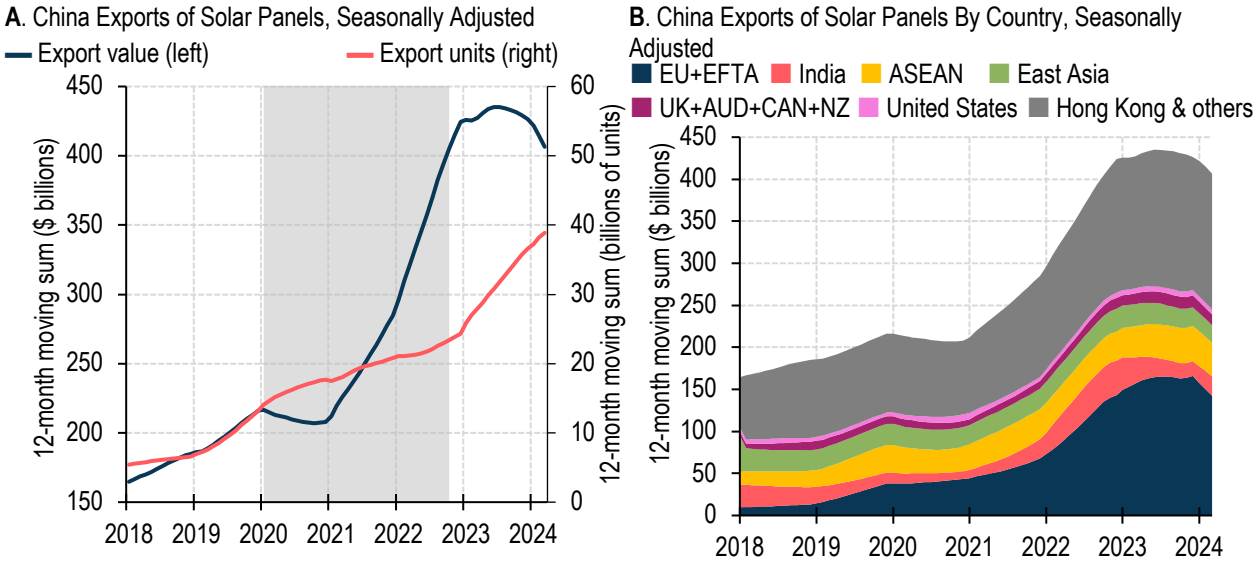
[3] "FACT SHEET: Biden-Harris Administration Takes Action to Address Risks of Autos from China and Other Countries of Concern," The White House Briefing Room Statements and Releases, February 29, 2024. https://www.whitehouse.gov/briefing-room/statements-releases/2024/02/29/fact-sheet-biden-harris-administration-takes-action-to-address-risks-of-autos-from-china-and-other-countries-of-concern/

[4] "China's Solar Manufacturers Face Fraught 2024 After Output Boom," Bloomberg News, January 17, 2024. https://www.bloomberg.com/news/articles/2024-01-18/china-s-solar-manufacturers-face-fraught-2024-after-output-boom?sref=51J26SiN

[5] "China's Solar Manufacturers Face Fraught 2024 After Output Boom," Bloomberg News, January 17, 2024. https://www.bloomberg.com/news/articles/2024-01-18/china-s-solar-manufacturers-face-fraught-2024-after-output-boom?sref=51J26SiN

prices have already started squeezing profits of some of the biggest solar makers including Longi Green Energy Technology Co. and Tongwei Co. Tumbling prices are hurting the value of solar products even as production and exports ramp up. Chinese companies shipped $46 billion of cells and modules abroad in 2022, a 63% jump from the previous year, according to BloombergNEF. However, last year, the volume of exports rose 14% through November, but the value fell 4.2%. This trend continued in the first quarter of 2024. Despite the continued increase in export units of solar panels, the value has declined even sharper. (Figure 6).

Figure 6 *Falling prices have caused China's exports of solar panels to fall in value while still gaining in volume.*



Notes: Shading indicates the COVID-19 lockdown period.

Sources: Haver, China General Administration of Customs

IV. China's Reaction to the Current Overcapacity Narrative

Chinese policymakers and domestic economic analyses are not oblivious to overcapacity problems plaguing their economy and trade relations. In December 2005, then NDRC Director Ma Kai, warned of severe overcapacity challenges in seven industrial sectors and attributed such overcapacity problem to "blind investment and low-level expansion." For almost two decades since then, Beijing has issued over a dozen administrative guidelines to tackle overcapacity across various sectors, but with limited success. This March, Lu Feng, an economics professor at Peking University, highlighted current overcapacity problems in several sectors, such as new energy vehicles, EV batteries, and mature chips. His observations are supported by data. For example, BloombergNEF estimates that China's battery production in 2023 alone was similar to

global demand. With the West adding production capacity and Chinese battery makers continuing to expand investment and production, the global overcapacity problem is likely to worsen before improving. Lu warned that China's current overcapacity will pressure Chinese firms to dump products in international markets and exacerbate China's already unbalanced trade relations, which easily sparks trade tensions.

Lu's warning resonates overseas. Paul Krugman has warned that a second China shock" is building as China seeks to solve its economic problems not by expanding consumer spending but "dumping the stuff it produces but can't or won't consume in other countries' markets." Lael Brainard, the Biden administration's National Economic Advisor, argued that China's "policy-driven industrial overcapacity" undermines market-based innovation and competition, American workers, and supply chain resilience and vowed "there can be no second China Shock here in America." Members of the G7 have also expressed their shared concerns over "China's non-market policies and practices" that "are leading to harmful overcapacity that undermines our workers, industries, and economic resilience." The massive inflow of cheap Chinese manufactured products has already raised trade tensions. Since 2023, a few governments have launched anti-dumping or anti-subsidy investigations on imports from China, such as Vietnam and Brazil. Mexico, the United States, Turkey, and the European Union have imposed tariffs on various imports from China, including but not limited to electric vehicles.

Faced with mounting international pressure, China has staunchly defended itself, citing its industrial efficiency and competitiveness. Much like the denial of an obvious problem in the story of Emperor's New Clothes, President Xi Jinping, leading Party journals, state media, and public policy discussions have consistently denied that China has an overcapacity problem. Chinese diplomats argue that the global market suffers from a significant capacity shortage problem rather than overcapacity. The *People's Daily* accused the United States of exaggerating China's overcapacity in the new energy sector with malicious protectionist intentions to contain China and suppress the development of China's strategic industries.

V. Implications for U.S. Policy under the Second Trump Administration

As U.S. President Donald Trump and Chinese President Xi Jinping prepare for their next engagement as leaders of the world's two great powers, both come armed with more leverage. Trump has threatened to slap at least 60 percent tariffs on Chinese goods, with additional tariffs punishing Beijing for not doing enough to curb the flow of chemicals used to produce fentanyl, a drug devastating American communities. Beijing has restricted exports of rare earth minerals critical for semiconductors and other advanced technologies. This move is not only a reaction to the Biden administration's export controls on sensitive technology; it sends a clear message: China is now more capable than ever of implementing countermeasures that target U.S. supply chain vulnerabilities.

Trump's pre-office threats of new tariffs on China should be viewed more as positioning for future trade negotiations than as a fait accompli. A tit-for-tat trade war with China would

dampen the stock market and U.S. GDP growth—two metrics Trump is particularly sensitive to and reluctant to admit performed relatively well under the Biden administration. For the Trump administration, sweeping tariffs risk stoking inflationary pressures and alienating American consumers.

The U.S. government should be extremely careful about what it wishes for. If Washington's goal is to mimic industrial policies like Beijing has pursued for decades, it should be aware that it runs the same risk that now slows down China's continued growth: debt addiction, overcapacity trap, distorted incentives, and hugely wasteful resource allocation. If Washington's goal is to outcompete China, it has a better chance of winning by playing its stronger hand and perfecting what the American system is better at, rather than willingly reducing itself to a copycat following China's lead. Fixating on keeping China down distracts the United States from becoming its better itself and optimizing its own strength. America thrives on innovation, competitiveness, and market-driven solutions—traits that should be emphasized rather than diminished. To strengthen America's innovation capability, the U.S. government should consider complementing tariffs and subsidies with talent attraction and invest-in-America programs to take advantage of the exodus of Chinese talents and Chinese companies with desired technologies in EVs and batteries to create jobs in U.S. communities.

U.S. policymakers should also resist the temptation of using the old Cold War framework to force a China strategy upon American businesses and the American people. It is intellectually comfortable to make analogies with the past, especially the wars we won. After all, generals are always fighting the last war. Identifying a near-peer competitor as if we were living through a new Cold War is a useful political force for the U.S. government to organize itself and its allies. It can even become the one thing capable of piecing through the incredible partisan divide in Washington that prevents all substantive policymaking. However, that does not mean this is the optimal policy. Viewing the world through a Cold War lens precludes all better outcomes.

The U.S. policymaking community needs to realize that China's pursuit of self-sufficiency, while creating overcapacity and raising trade tensions, also reflects President Xi's insecurity and his desire to reduce China's strategic vulnerabilities, especially in times of extreme geopolitical conditions, such as a militarized conflict over Taiwan or in the South China Sea. As President Xi attempts to mobilize Chinese people and domestic resources to build a self-sufficiency wall around China technologically and financially, Washington should know that an isolated China with 1.4 billion anxious people is too important and potentially too dangerous. An isolated and self-sufficient China will have nothing to lose and will be impossible to deter. That means the U.S. government will have no leverage against the Communist Party of China and the Chinese government.

Hence, the U.S. government should do all it can to disincentivize the Communist Party of China and the Chinese government from isolating itself and building a wall that can sanction-proof the Chinese economy. To this end, the next president should foster alliances, restore damaged multilateral institutions, and create new structures of interdependence that make isolation and self-sufficiency not only unattractive but also unattainable for China.

China may also be more flexible in its trade policies than it appears. Since the escalation of the U.S.-Chinese trade war, in 2018, Chinese scholars and officials have explored several policy options, including imposing voluntary export restrictions, revaluing the renminbi, promoting domestic consumption, expanding foreign direct investment, and investing in R&D. Chinese scholars have also examined Japan's trade relations with the United States in the 1980s, noting how trade tensions forced mature Japanese industries, such as automobile manufacturing, to upgrade and become more competitive with their Western rivals, an approach that could offer lessons for China's electric-vehicle industry.

In this context, President Trump may have an opportunity to redefine U.S. policy towards China and U.S.-China relations. The Trump administration has the opportunity to make a grand bargain with China rather than continue with the Biden administration's compartmentalized approach to dealing with China. Trump's consummate anti-China rhetoric may grant him the public credibility needed to broker a broad and enduring deal with China, much like President Reagan's arms control deals with the "evil" Soviet Union. His firm grip on the Republican Party makes him nearly impervious to criticism from the right, giving him flexibility in diplomacy where his predecessors would have been tangled in knots.

During his first term, Trump negotiated the 2020 Phase One trade agreement with China, which focused on increasing Chinese purchases of U.S. agricultural products. While the deal fell short of its goals and was largely abandoned amid the COVID-19 pandemic, Trump now has a second chance to reshape U.S.-China trade relations—and this time, he should think "bigly". To succeed where the Phase One agreement faltered, Trump must temper his instinct for high-stakes brinkmanship with a strategic, long-term vision for U.S.-China economic relations. As the adage goes, "sometimes it takes a warrior to make peace." Paradoxically, Trump's isolationist tendencies and combative rhetoric may afford him the political leverage needed to pursue negotiations free from the constraints that hampered his predecessors. Trump's unique political attributes may be exactly what's required to strike a broad, durable deal with China—one that includes not just trade, but also investment, intellectual property, and even the highly sensitive issue of Taiwan. Such an agreement would not only redefine U.S.-China relations but could also set the global economic order for a generation.