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QUICK TAKE

EU-CHINA TRADE: DON'T EXPECT ANOTHER "LIBERATION DAY"



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PRESSURE IS BUILDING

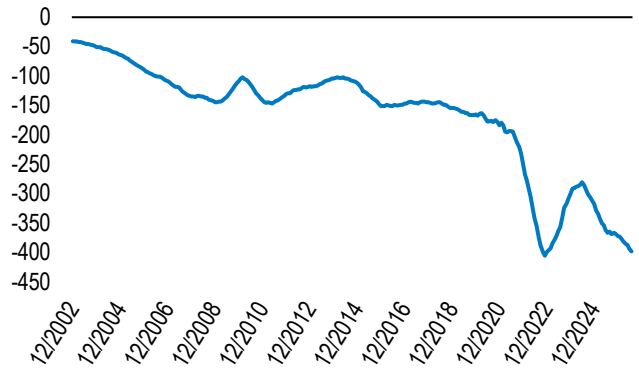
- Broad EU–China rupture remains unlikely
- Targeted trade action is becoming more probable
- Sector exposure matters more than headline tariffs

European Commission President Ursula Von der Leyen's State of the Union speech struck a more conciliatory note on China than expected, reinforcing the case for targeted pressure rather than rupture as the next trade talks approach.

Europe's trade relationship with China is approaching a more confrontational phase. But investors should not mistake tougher language for an imminent trade war. A 'Liberation Day' approach, characterised by broad and aggressive tariffs applied across large parts of the trading relationship, remains unlikely in the EU-China context.

Figure 1: EU-China Trade Balance

Bn Euro, 12-month trailing sum



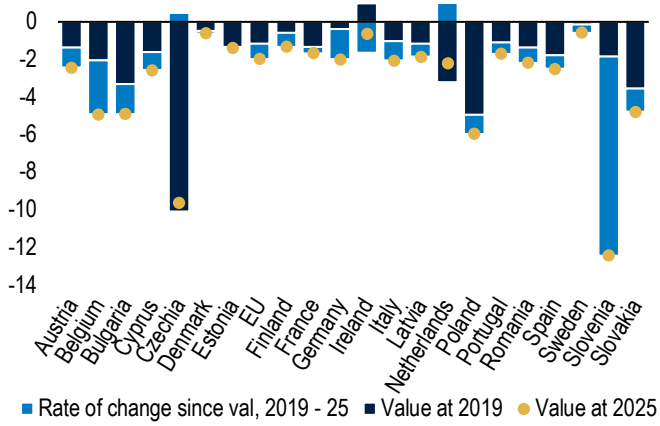
Source: Eurostat, as of 8 August 2026

Brussels has good reason to act. The EU-China trade deficit has widened sharply since the pandemic and every member state now runs a deficit with China. It's trade surplus with the EU reached €360.6 billion in 2025, according to figures cited by the European Commission, then widened by a further 9% during the first half of 2026.[1]

Rising Chinese imports have combined with falling EU exports, and the effect is most acute in Germany, where imports from China have surged across electrical equipment, computers, electronics and optical goods, while exports of machinery and autos have declined. In effect, German industrial production in sectors most exposed to Chinese competition has fallen markedly relative to less exposed sectors.

Figure 2: EU MS Trade Balance with China

Percent of National GDP

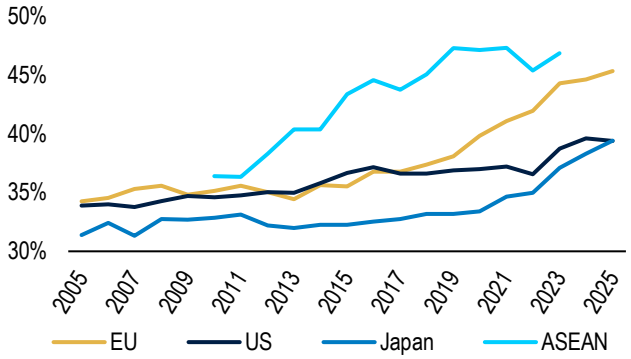


Source: Eurostat, as of 8 August 2026

[1] Thomson Reuters, EU wants initial Chinese action on trade gap by early October, as of 22 September.

The deeper issue is structural as China's export basket has become steadily more similar to Europe's, and the export similarity index between the two has climbed for two decades, meaning EU exporters increasingly compete head to head with Chinese firms in third markets rather than simply importing from them. Sectors such as machinery and equipment, metals, chemicals and motor vehicles now see the largest overlap and the largest price pressure.

Figure 3: China's export similarity index with advanced economies has risen...



Source: UN Comtrade, as of 8 August 2026

That shift defines the contours of the problem. A widening deficit driven by cheaper imports can be managed with tariffs at the border. However, a bigger gap driven by China displacing European firms in global markets cannot, and this is driving regulators in Brussels to consider broader industrial strategy solutions.

Brussels has concluded, in effect, that its existing toolkit is inadequate to address the scale of the problem. Anti-dumping measures are slow and are frequently circumvented while safeguard measures, which can be applied quickly across whole product categories, have historically lacked unity across European industry,

From a Chinese perspective, Europe is too important a market for Beijing to provoke carelessly, particularly as the U.S. export share continues to decline, so China's own tools are likely to be reactive rather than escalatory in the first instance. Beijing's toolkit has moved from an ad hoc, case-by-case playbook towards a codified set of instruments including the Anti-Foreign Sanctions Law and rules on outbound investment among other regulations.

ESCALATION DOMINANCE

This dispute sits within a wider fragmentation of global trade. There is little international consensus on how to respond to China's industrial model, with governments differing on the approach. For instance, while the EU and International Monetary Fund have favoured a shift in China's subsidy and consumption mix, the U.S. has placed greater emphasis on currency adjustment. While concerns over Chinese overcapacity are increasingly shared, broad tariff walls remain an unattractive option given continued supply chain dependencies and the risk of broader economic disruption.

Facing a less predictable trading relationship with the United States while managing growing economic dependence on China, Brussels is increasingly seeking to balance risks from both east and west rather than align itself fully with either side. Indeed, the main constraint on more aggressive action is the realities of economic interdependence. China retains significant escalation leverage through its role in critical supply chains and strategic inputs, limiting Europe's ability to impose broad-based trade restrictions.

The trade relationship has also transformed: access to the Chinese consumer mattered less than it once did, while supply-chain resilience matters more. Europe will bolster its bargaining position without triggering disruptions that could damage its own manufacturers.

We believe the result is likely to be deterrence backed by selective action.

Safeguards, which restrict sudden import surges across wider product categories, can be deployed more quickly. The appeal of safeguards reflects the perception that they have helped stabilise the EU steel sector, where protection arrived only after a prolonged decline in output. Policymakers are increasingly focused on applying such measures earlier and more selectively with a proposed safeguard covering PET resin emerging as an important test case, with support reportedly building across several major member states. If successful, it could provide a template for extending similar protections to other sectors.

THREE PATHS

The EU is also considering a new "overcapacity" instrument that could act more like the U.S. Section 301 framework. Crucially, it could be deployed both sectorally and horizontally, for example, targeting an industry such as steel across all member states at once.

Three design features make it markedly sharper than existing tools. A mutualisation fund would provide EU fiscal support to industries harmed by the action or by any retaliation; a reverse qualified majority would mean measures proceed unless a majority of member states actively block them; and the instrument would be anticipatory, allowing Brussels to act without first assembling a full evidence base.

Combined with the EU's Anti-Coercion Instrument, a more powerful but politically difficult tool covering goods, services, investment and procurement, these new tools are expected to strengthen the EU's trade defenses with some implications:

Managed competition: We believe this is the most likely outcome. China could offer limited confidence-building measures, including wider market access, dialogue on an investment framework, price undertakings and an expansion of its list of entities excluded from subsidies. The EU could respond with a small number of anti-dumping investigations rather than broad tariffs. Both sides would claim progress while stalling while the trade imbalance continues to widen.

Targeted dispute: This is the principal downside scenario. If the EU proceeds with sectoral restrictions, China will probably answer with measures it regards as commensurate. Its response could include tighter market access, technology-transfer constraints or pressure at strategic supply-chain chokepoints. Beijing has developed a broader legal toolkit covering foreign sanctions, trade, supply-chain security and outbound investment. Retaliation could be fast, but recent signals suggest it would be reactive rather than designed to start a wider conflict.

A broad rupture: This remains a tail risk event. It could become more plausible if negotiations fail, Europe acts across several industries at once or critical-input restrictions cause a politically visible production shock. Neither side appears to want this outcome. Their economic interdependence and Europe's lack of unity on aggressive trade measures remain powerful constraints.

INVESTMENT IMPLICATIONS

The aggregate economic effect may remain modest but the granular impact on sectors may be more keenly felt. Investors should focus less on headline tariff rates and more on individual supply chains. Chemical producers facing import competition could benefit from safeguards, while manufacturers dependent on Chinese intermediates may face higher costs or disrupted production. Autos, machinery, steel, pharmaceuticals and clean-energy equipment deserve scrutiny. Company-level exposure to Chinese inputs, pricing power, inventory buffers and alternative suppliers could matter more than broad country allocation.

The next few weeks bring a dense run of EU–China decision points. For one, the next round of trade talks are scheduled on Oct 8-9th in Beijing. EU trade officials are seeking initial Chinese action before further ministerial consultations and discussion among EU leaders. A process-led outcome would support the managed-competition scenario.

Measures aimed at several strategic sectors would signal that the dispute is moving from deterrence to deployment. But for now, the central message is not that Europe and China are decoupling. It is that the cost of their interdependence is rising, unevenly and one sector at a time.

PGIM CONTRIBUTORS

KATHARINE NEISS
Chief European Economist

SHIKEB FAROOQUI
Lead Economist, Asia

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