Analyzing the Causes and Trends of China's Overcapacity

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The causes of China's recurring overcapacity problems are complex and cannot be attributed solely to production cycle failures. A historical review of the overcapacity issues from the 1990s reveals a connection to state-owned enterprise (SOE) reforms and financial regulations, while latest overcapacity since 2012 has been closely tied to government incentive policies and local governments' competition for investment expansions in strategic industries. Despite the differences in each phase, a common thread runs through all periods of overcapacity: SOEs have played a significant role in these industries, with government's administration also serving as a key factor. Therefore, the government-led capacity reduction process in the past, always accompanied by large-scale reform of SOEs and financial system reform, in essence.

The latest round of overcapacity issues in China, however, is more complicated due to domestic institutional reforms and shifts in the international landscape. First, the China's industrial structure has become more diversified, with each sector facing different challenges. For traditional industries such as cement and petrochemicals, overcapacity has been mainly driven by the recent decline in China's real estate sector and domestic demand. However, in advanced manufacturing, a new wave of overcapacity has been closely linked to substantial subsidies provided by local governments. In particular, under the pressure of the US-China trade war, China has prioritized to seek for technological autonomy, focusing on strategic emerging industries such as electronics, electrical machinery, and pharmaceutical manufacturing. As local governments compete to offer policy supports, this has exacerbated the overcapacity.

From an industrial perspective, China's manufacturing sector experienced widespread underutilization of capacity in 2024, with significant overcapacity in industries such as automobile manufacturing, food production, and non-metallic mineral products. This imbalance is evidenced by a sharp rise in inventory levels across related sectors—including metal ores, petrochemicals, and electronics—where inventory turnover rates have reached double digits. The accumulation of inventories in these key industries is driven not only by oversupply but also by other catalytic factors. In particular, increased investment in strategic manufacturing industries in recent years, exacerbated by the US-China trade war, has further exacerbated the issue.

On the international trade front, overcapacity in China has raised concerns among advanced economies such as the US and the EU. In February 2024, the *Financial Times* reported that China's overcapacity has led to lower export prices, effectively exporting deflation worldwide. The Economist also points out China has a "massive overcapacity" problem, affecting industries ranging from chemicals and metals to electric vehicles. *The Wall Street Journal* even referred to this phenomenon as "China Shock 2.0."

It is also worth noting that recent international concerns about China's overcapacity have shifted towards its cross-border e-commerce expansion. The rapid growth of Chinese cross-border e-commerce platforms like AliExpress, Shein, TikTok Shop, and Temu has facilitated the export of goods from small and medium-sized enterprises in China to international markets. By leveraging small-scale trade models to bypass potential tariffs, these platforms have emerged as a significant channel for exporting China's overcapacity.

With Trump returning to the White House, a new round of trade tensions between the US and China is already underway. China's overcapacity issues will undoubtedly remain a focal point of international attention, especially as the US uses tariffs to block Chinese goods. Other countries are likely to face increasing challenges in resisting the influx of low-priced Chinese products, and "China Shock 2.0" may emerge more rapidly and more intensely than before. Countries must brace themselves for the consequences of this shift in global trade.

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