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Highlights

- » China Escalates Drone Operations against Taiwan, Tests Deception Capabilities
- » China Expands Crypto Ban to Emerging Products
- » Continuing Rise in Unprofitable Zombie Companies in China Underscores Economic Troubles
- » Even the IMF Warns China's Market Distortions Causing China Shock 2.0
- » U.S. and Taiwan Reach Trade Agreement
- » Alibaba's Latest Qwen3.5 Model Signals Continued AI Momentum in China

China Escalates Drone Operations against Taiwan, Tests Deception Capabilities

China has intensified its use of military drones against Taiwan in recent weeks, with recent airspace violations and a sophisticated transponder-spoofing operation in what analysts describe as rehearsals for a potential conflict scenario.

- On January 17, a People's Liberation Army (PLA) WZ-7 "Soaring Dragon" surveillance drone entered

the airspace over Taiwan-controlled Pratas Island (Dongsha) in the South China Sea for four minutes—"possibly the first confirmed PLA violation of Taiwan's territorial airspace in decades."¹ The drone flew at an altitude beyond the range of the island's air defense systems and departed only after Taiwan broadcast warnings over international radio channels.² Analysts characterized the incursion as a deliberate probe of Taiwan's rules of engagement, exploiting Pratas' light defenses and remote location more than 250 miles from Taiwan's main island.³ The Atlantic Council's Kitsch Liao noted Beijing can now repeat such flights to demonstrate it can enter this portion of Taiwan's airspace with impunity, incrementally raising the stakes for any response.⁴

- Separately, a Reuters investigation published February 26 revealed that a Chinese Wing Loong 2 military drone has conducted at least 23 flights over the South China Sea since August while transmitting false transponder signals.⁵ The drone spoofed the identities of multiple unrelated aircraft, including a sanctioned Belarusian cargo plane and a British Royal Air Force Typhoon.⁶ Operating out of a dual-use airport on Hainan, the Wing Loong 2 flew routes near Chinese submarine bases and toward the Bashi Channel between Taiwan and the Philippines.⁷ Flightradar24 confirmed the spoofing pattern was unprecedented.⁸
- Taken together, these developments mark a qualitative shift in PLA air operations—moving beyond gray zone patrols and harassment toward direct airspace violations and electronic deception designed to degrade adversary situational awareness. Experts cited in the Reuters article noted the transponder-spoofing campaign is particularly significant: in the opening phase of a conflict, even brief confusion over aircraft identification could disrupt allied response timelines.⁹
- regulators appeared to allude to such circumvention, stating that “speculative activities related to virtual currency and [RWA] tokenization have occurred from time to time.”^{† 13}
- In addition to reasserting the prohibition on trade in virtual currency, the notice banned the issuance of RMB-backed stablecoins without approval.¹⁴ Beijing fears stablecoins would permit unregulated financial flows that circumvent its capital controls. China is piloting its own version of a digital currency, the e-CNY, but its useability is limited to a handful of permitted applications.¹⁵
- The notice also established a channel—albeit a narrow one—permitting Chinese firms to issue financial RWA tokens on overseas platforms with strict oversight.¹⁶ RWA tokens are blockchain-based digital representations of assets like bonds or stocks, which in theory offer lower transaction costs, broadened investor access, and other efficiencies relative to assets traded through centralized exchanges. The regulations follow several RWA token issuances by Chinese entities in 2025, including projects ranging from a tokenized RMB 500 million (\$70 million) bond issued overseas by state-owned Futian Investment to a domestic blockchain platform for owning cakes of pu’er tea.¹⁷

China Expands Crypto Ban to Emerging Products

In a February 6 regulatory notice, China tightened its near-total ban on cryptocurrency activity by banning the private issuance of renminbi (RMB)-backed stablecoins.¹⁰ At the same time, it established a narrow pathway for overseas tokenized real-world assets (RWA).

- China has banned most cryptocurrency activity on the Mainland since 2021.^{*}¹¹ However, trading has continued to flourish through unofficial gray markets, with tens of billions of dollars in activity taking place inside China.¹² In the February notice, Chinese
- Rather than endorsing such issuance of overseas RWA tokens, however, Chinese regulators indicated close scrutiny. Chinese regulators will screen asset-based securities token issuances based on the regulations for the traditional assets they mirror—for instance, tokens that resemble a stock paying dividends from Chinese operations would be regulated as an offshore equity.¹⁸ Trading in financial RWA tokens inside China remains prohibited.¹⁹ Adopting a restrictive approach to RWA tokens while the market is still in its infancy—with a market size of just \$25 billion in February 2026[‡]—reflects Chinese policymakers’ heightened sensitivity to financial and political risks from digital financial assets.²⁰ Though

^{*} Unlike the Mainland, China has allowed Hong Kong to emerge as a trading hub for cryptocurrencies and digital assets.

[†] For more, see U.S.-China Economic and Security Review Commission, Chapter 1, “U.S.-China Economic and Trade Relations (Year in Review),” in *2025 Annual Report to Congress*, November 2025, 71–72. <https://www.uscc.gov/annual-report/2025-annual-report-congress>.

[‡] By comparison, the transaction volume of stablecoins was just under \$300 billion. “Global Market Overview,” *RWA.xyz*, February 25, 2026.

Beijing has identified blockchain as a potentially transformative technology and seeks to be an early adopter, it views broad access to crypto markets as competing with traditional financing channels and threatening its tools of financial repression.²¹

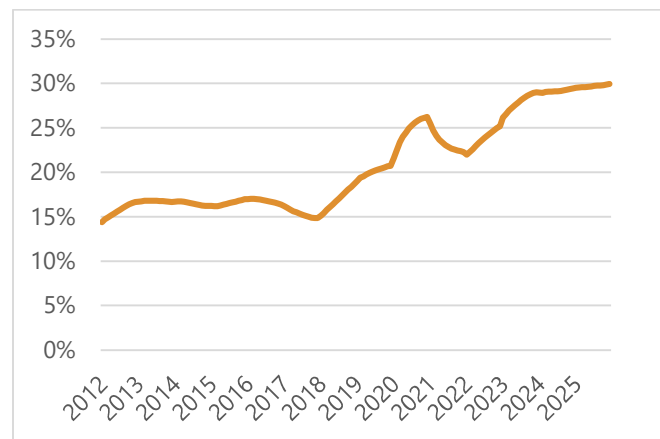
Continuing Rise in Unprofitable Zombie Companies in China Underscores Economic Troubles

China's share of industrial entities operating at a loss reached 30 percent in 2025, continuing an eight-year overall upward trend (see Figure 1).²² In an effort to meet its GDP growth target, China props up failing firms, creating zombie companies that continue to operate at a loss and exacerbating the oversupply of manufactured goods. The resulting intense price competition continues to generate deflationary pressure and erodes profit margins.*²³ China's overcapacity problem is driving a wave of exports as firms seek less saturated markets abroad.²⁴

- China's share of unprofitable enterprises rises to 35 percent once private companies are excluded from the calculation, highlighting how the state-owned sector continues to be a major drag on the economy.²⁵ Total profits at state-owned enterprises (SOEs) fell 3.9 percent year-over-year in 2025.²⁶
- While hypercompetition in a market economy would otherwise result in bankruptcies or industry consolidation, many of China's unprofitable zombie SOEs are kept alive by bank loans, local government subsidies, and other support via political connections.²⁷ The rising proportion of bank credit directed to SOEs crowds out potentially more productive private-sector investment, helping perpetuate China's overcapacity problem.²⁸ As long

as Beijing prioritizes GDP targets over market discipline, the overcapacity problem will continue.

Figure 1: Share of Chinese Entities Operating at a Loss, 2012–2025, Rolling 12-Month Average



Note: January share is approximated from February due to data gaps.

Source: China's National Bureau of Statistics, via Haver Analytics.

Even the IMF Warns China's Market Distortions Causing China Shock 2.0

Though it used more technical financial language to describe China Shock 2.0, an annual review by the International Monetary Fund (IMF) painted China's economic health in stark terms: China's trading partners are absorbing the cost of an unsustainable growth model, driven by weak demand and subsidy-fueled supply buildup.

- The world is absorbing the costs of China's weak demand and excess production, according to the latest Article IV consultation by the IMF, which concluded February 18. A prolonged property sector downturn and weak consumer confidence

* For more, see U.S.-China Economic and Security Review Commission, Chapter 8, "China Shock 2.0," in *2025 Annual Report to Congress*, November 2025, 429–471.

have dragged inflation down to 0 percent. Supply-side measures have compounded the problem, sustaining China's manufacturers beyond what domestic or global demand can absorb at profitable prices.²⁹ Deflationary pressure could also become self-reinforcing if falling prices raise the real burden of debt, further depressing spending and investment.

- The IMF concluded this pattern is bad for both China and the world, noting, "Higher net exports have also resulted in the emergence of external imbalances, with adverse spillovers to trading partners. China's large economic size and heightened global trade tensions make reliance on exports less viable for sustaining robust growth going forward."³⁰
- The fund's conclusions largely tracked findings by the Commission in its [2025 Annual Report regarding "China Shock 2.0"](#) and come after China's global goods trade surplus hit a record \$1.2 trillion last year.*³¹

IMF staff estimated that China spends about 4 percent of gross domestic product (GDP) on industrial subsidies as of 2023, versus an estimated 1.5 percent for EU countries.³² The scale of subsidies has led to "significant resource misallocation" in China and lowered GDP by as much as 2 percent while driving down export prices.³³

- IMF staff noted subsidy expenditures have been consistent in recent years and recommended China cut its industrial policy significantly—by about half.³⁴ It is worth noting that the IMF's analysis accounted for the fiscal cost of grants and tax breaks but not additional support for favored firms

like state equity investment or preferential regulation.³⁵

- The IMF welcomed China's "anti-involution campaign"—an attempt to counter deflationary pressures from excess competition on price—but warned measures thus far are likely insufficient. Foremost, the review called on China to "scal[e] back unwarranted industrial policy significantly" and let firms go bankrupt and exit the market to reduce overcapacity.³⁶

U.S. and Taiwan Reach Trade Agreement

The bilateral U.S.-Taiwan Agreement on Reciprocal Trade (ART) signed on February 12, 2026, aims to deepen economic and technological integration and enhance coordination on economic security.³⁷

- Under the proposal, Taiwan agreed to reduce or eliminate 99 percent of tariffs on U.S. imports, including on auto and most agricultural products; reduce non-tariff barriers; further align economic security measures; and make multi-billion-dollar purchases of liquefied natural gas (LNG), aviation equipment, and other U.S. products, among other provisions.³⁸ For its part, the United States agreed to reduce the reciprocal tariff rate on goods from Taiwan to 15 percent (down from 20 percent)[†] and provide Section 232 tariff exemptions in accordance with a companion memorandum of understanding (MOU) signed between the two sides in January.³⁹ The ART includes provisions that would allow the United States to nullify the deal if Taiwan enters into future trade agreements with China, including digital

* See U.S.-China Economic and Security Review Commission, Chapter 8, "China Shock 2.0," in *2025 Annual Report to Congress*, November 2025, 429–471; For more on China's goods trade surplus, see Graham Ayres et al., "China Bulletin," *U.S.-China Economic and Security Review Commission*, February 4, 2026. <https://www.uscc.gov/trade-bulletins/china-bulletin-february-4-2026>.

[†] At time of publication, Taiwan's tariffs are 10 percent under the Section 122 proclamation following the Supreme Court's February 20, 2026, ruling that tariffs issued under the IEEPA are not legal. Though President Donald Trump announced plans to raise the Section 122 tariff to 15 percent for all trading partners, this has not yet been put into effect. Steve Kopack and Garrett Haake, "Trump's Global Tariff Takes Effect at 10%, despite Announcement of 15%," *NBC News*, February 24, 2024. <https://www.nbcnews.com/politics/trump-administration/trump-global-tariff-start-10-percent-despite-announcement-15-percent-rcna260369>; White House, "Proclamation 11012: Imposing a Temporary Import Surcharge to Address Fundamental International Payments Problems," 91 Fed. Reg. 9339 (February 20, 2026).

services agreements and preferential trade agreements.*⁴⁰

- The agreement advances U.S. efforts to deepen tech integration with Taiwan by tethering the expansion of production in the United States by Taiwan's high tech companies to tariff exemptions on semiconductors. Under the MOU agreed to in January, Taiwan committed to invest at least \$250 billion in the U.S. semiconductor, energy, and artificial intelligence (AI) sectors and to provide another \$250 billion in credit guarantees for further investment.⁴¹ The MOU includes a provision whereby chip imports to the United States from Taiwan's semiconductor companies will be exempt from Section 232 tariffs for volume up to 2.5 times their planned production capacity in the United States while facilities are being built and 1.5 times upon completion.⁴² As the Commission assessed in its [2025 Annual Report](#), Taiwan's central role in semiconductor manufacturing makes it a vital partner in countering China's AI and advanced computing ambitions.
- Taiwan's Legislative Yuan (LY) must review and ratify the agreement before it comes into effect, where it appears likely to face partisan challenges. Members of the opposition party Kuomintang (KMT) and Trans-Pacific Partnership (TPP) coalition—who together hold a majority in the LY—have called for Taiwan to renegotiate terms of the ART following the U.S. Supreme Court's decision that the International Emergency Economic Powers Act (IEEPA) does not authorize broad tariffs.⁴³ The KMT had previously criticized negotiations for lacking transparency and has consistently raised concerns about the "hollowing out" of Taiwan's domestic semiconductor industry that could weaken the so-called "Silicon Shield."⁴⁴ President Lai Ching-te's Administration and the DPP are making the case to adhere to the agreed-upon terms, citing that 76 percent of Taiwan's exports to the United States could be subject to Section 232 duties in the absence of an agreement.⁴⁵ Taiwan is now the United States' fourth-largest trade partner behind only Mexico, Canada,

and China, with exports surging 78 percent in 2025 to nearly \$200 billion.⁴⁶

Alibaba's Latest Qwen3.5 Model Signals Continued AI Momentum in China

Alibaba's latest release extends China's lead in open-weight AI models by achieving inference costs a fraction of comparable U.S. proprietary models and combining multimodal capability with algorithmic efficiency.

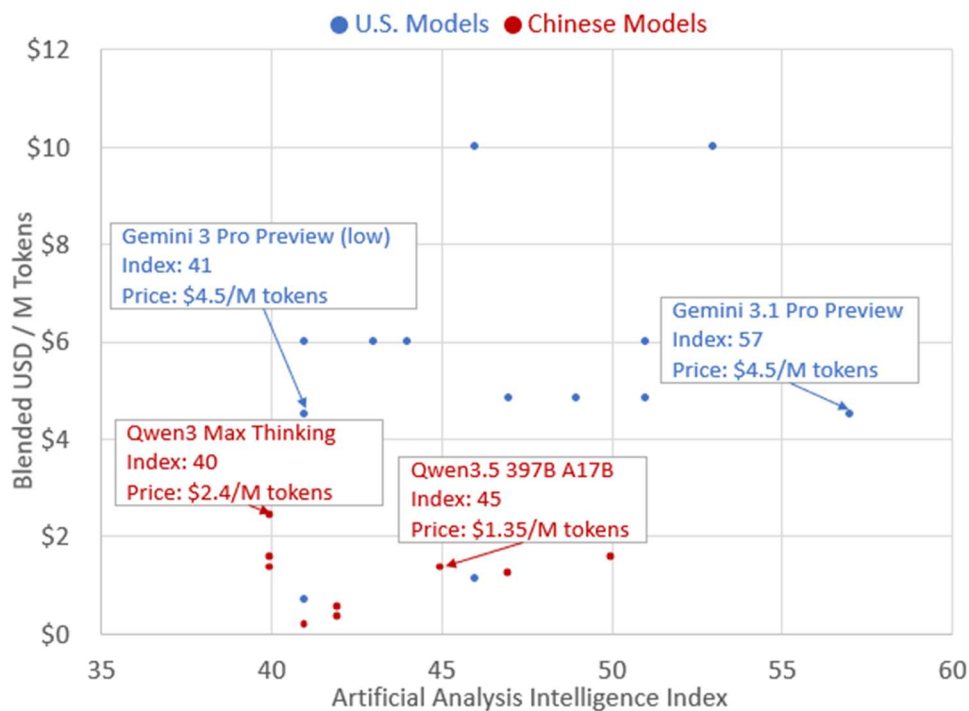
- On February 16, Alibaba released Qwen3.5-397B-A17B, the first open-weight model in the Qwen3.5 series, making its learned parameters—the values that determine how the model processes and responds to inputs—publicly available for download and reuse.⁴⁷ This release reinforces Alibaba's position as China's leader in open AI model development. Its Qwen model family already surpassed Meta's Llama as the world's most downloaded open model family in September 2025 and accounted for half of all fine-tuned models uploaded to Hugging Face—a global open model collaboration platform—by the end of 2025.⁴⁸
- In many ways, the model delivers competitive performance at lower cost than comparable U.S. models. It contains 397 billion total parameters but activates only 17 billion during inference (i.e., generating outputs from trained models from new inputs), reducing computational requirements while maintaining performance.⁴⁹ Alibaba claims the model is more efficient to run, requiring 60 percent less memory usage than its previous Qwen3 Max Thinking, and is priced at one-eighteenth the cost of Google's Gemini 3 Pro.⁵⁰ Artificial Analysis, an independent U.S.-based benchmark aggregator, confirmed improved performance relative to Alibaba's

* Though there are not signs that either will join soon, both Taiwan and China's applications to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) have been pending since 2021.

prior models at a fraction of comparable U.S. model prices (see Figure 2).

- Qwen3.5-397B-A17B is multimodal and marks Alibaba's first vision-language model (VLM)—an AI model that can learn from text, images, and videos, unlike large language models (LLMs) that are restricted to text.⁵¹ Alibaba claims the model surpassed Gemini 3 in spatial intelligence (i.e., the ability to interpret three-dimensional environments), a key capability for physical AI applications such as robotics and autonomous vehicles.⁵² Three days after the Qwen release, however, Google released Gemini 3.1, which scores higher on the Artificial Analysis Intelligence Index (see Figure 2).⁵³
- Architecturally, the Qwen model advances China's open model ecosystem by scaling the so-called Mixture-of-Experts (MoE) design—an approach that improves efficiency by activating only the most relevant parameters to a given input or task, rather than the full model.* The model scaled from 128 experts in its predecessor to 512, exceeding DeepSeek V3's 256 experts.⁵⁴ This allows the model to draw on broader specialized capabilities without activating all parameters simultaneously, delivering stronger performance without proportional increases in compute cost.

Figure 2: Top U.S. versus Chinese Inference Costs Relative to Capability



Note: The figure displays the top 22 models as of February 25, 2026. Blended price on Artificial Analysis is a combination of output and input price token prices at a 3:1 ratio. Source: Artificial Analysis.⁵⁵

* Mixture-of-Experts (MoE) is a machine learning technique that divides an AI model into separate sub-networks (referred to as "experts")—each of which specializes in a subset of the input data—to jointly perform a given task. Dave Bergmann, "What Is Mixture of Experts?" IBM, accessed March 2, 2026. <https://www.ibm.com/think/topics/mixture-of-experts>.

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