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Economic Research

Economic Briefing

China – Economy slows sharply

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Table of contents

We have been expecting growth weakness in H2 and July's data confirms this. Although this was partly due to extreme weather, it also reflects the weak underlying domestic demand. What's more, Beijing's "anti-involution" campaign to curb excessive and destructive competition is holding back investment across industries. This could potentially limit the extent to which Beijing implements the campaign if the sharp slowdown in growth persists. We expect the government to dial up stimulus efforts after July's and a couple of months of weak data.

Data shows domestic weakness despite robust exports

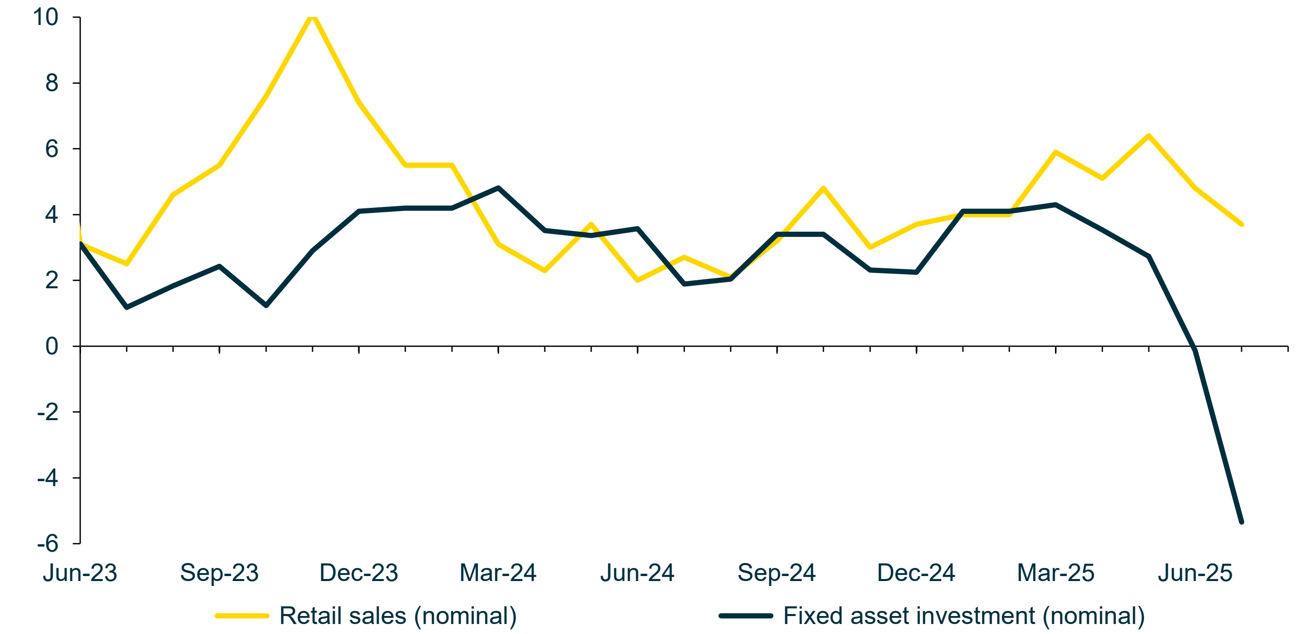
With the exception of exports, July's real activity, prices, and credit data all point to a visible slowdown in China's economy. We think there are three key takeaways. First, the difference between the still-decent growth in industrial production and the weakness in retail sales and investment suggests the extent of overcapacity in the economy. Second, the slowdown in retail sales suggests that consumption momentum has remained weak, with the exception of strong consumption seen for the big-ticket items and electronics that were incentivized by the government trade-in program. Third, the decline in investment is concerning.

Details suggest an alarming picture

On the positive side, industrial production grew 5.7% yoy, albeit this is a slowdown from 6.8% in June. But on the demand side things look a lot more concerning. First, nominal retail sales slowed to 3.7% yoy from 4.8% in June and 5.4% in Q2 (Chart 1). But this is not the worst.

Chart 1 - Sharp fall in investment and a slowdown in retail sales

Year-on-year %



Source: NBS, CEIC, Commerzbank Research

What's alarming is the two consecutive months of decline in fixed asset investment. It registered -5.3% yoy in July after -0.1% in June, based on our calculations using the headline year-to-date data. Manufacturing and infrastructure investment both contracted in July, the first time after the pandemic. Local governments and firms have been holding back investment amid the recent "anti-involution" campaign to curb excessive and destructive competition.

The renewed weakness in the property sector also contributed to the decline in investment. Indeed, real estate investment fell sharply by 17.2% yoy in July, down from -12.9% in June. Housing sales also fell by double-digit for the second month at -14% yoy in July after -13.6% in June.

The only bright spot from this month's data is exports. From the trade data released last week, exports in USD term grew by a faster-than-expected 7.2% yoy in July from 5.9% in June. The resilience in exports was supported by (i) the front-loading of shipments to the US via rerouting (or transshipments) of Chinese products through third countries and (ii) the price competitiveness of Chinese products for other final demand destinations.

Persistent deflationary pressures and weak credit demand also summarized how weak underlying domestic demand has been. CPI was unchanged from a year ago in July and in H1 it averaged a 0.1% yoy decline. PPI deflation extended for the 34th month, at -3.6% yoy in July.

Bank loans contracted in July, the first time in two decades. This was triggered by a net repayment of loans by households and corporates. While growth in outstanding total social financing (TSF), a measure of broad credit plus equity, rose to 9% yoy from 8.9% in June and as low as 7.8% in November 2024, this actually reflects strong issuance of government bonds to support fiscal stimulus, at a time when private sector credit demand was weak.

Anti-involution may only have limited success

To break the vicious cycle of deflation, the government has launched a campaign to fight **overcapacity and involution** (meaning ruinous competition). Beijing has asked local governments to "strictly control" new investment in industries suffering from intense competition or having overcapacity concerns.

We think there are two implications. First, in the short-term, the campaign is having an impact on investment. This means the government needs to balance between slowing investment growth too much versus its effort to fight overcapacity and reduce deflationary pressures.

Second, from the medium-term perspective, while it is likely easier to manage overcapacity and control prices in the commodity industries which are mainly dominated by state-owned enterprises, curbing excessive competition in most other industries where private enterprises play a much more significant role will be more challenging and will require time. In particular, driving unproductive or unprofitable firms out of business is not in local governments' favor as they rely heavily on local businesses for value-added tax revenues and employment. We take a cautious view about the success of the campaign.

July's data supports our view

As we discussed in our recent Economic Insight publications, we expect **H2 growth to slow** as tariff impact materializes globally and **domestic household sentiment turns gloomier**. We have been saying that our concern is that growth could decelerate sharper than what policymakers are currently expecting for H2. July's data seems to be supporting our view.

All of these means the government needs to do more to stimulate demand and to stabilize the housing market. For now, Beijing is just sticking to its spending plan for this year announced back in the National People's Congress annual meeting in March. This is because Beijing takes a less dovish view of the economy following the 5.3% growth seen in H1. But we expect the government to dial up stimulus efforts after July's and a couple months of weak data.

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