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Economic Research

Economic Insight

China – Why do we think growth will slow in H2?

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We think the recent rise in retail sales growth, thanks to the stimulus measures, is just temporary. The policy impact is unlikely to be long-lasting. The sharp rise in loss-making enterprises points to a rather bleak picture for business confidence and employment, which in turn affect consumer confidence. Therefore, Beijing has a lot more work to do if the policymakers want to prioritize lifting consumption as one of the key policy goals.

Robust industrial production and better-than-expected retail sales growth point to a resilient first half of 2025. In real terms, they both grew around 6% yoy in April-May. These figures suggest GDP could again grow beyond 5% yoy in Q2, beating our expectation, after a 5.4% growth in Q1. We have summarized the latest development in our latest Economic Briefing on "**China – May retail sales surprise**".

That said, we continue to take a cautious view, especially for the second half of this year and next year.

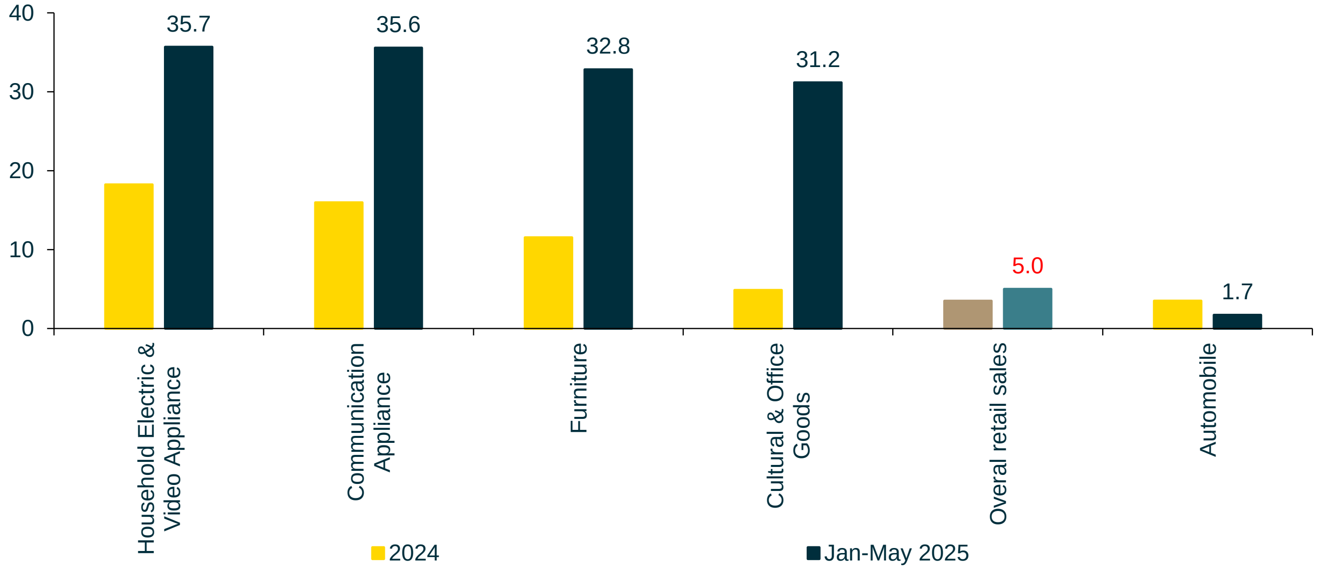
Consumption stimulus program does not produce long lasting effect

First of all, retail sales have been supported by the government's trade-in program for big-ticket consumer items such as home appliances and cars, as well as consumer electronics (Chart 1). However, there have been issues with the program itself. Over half of the CNY300 billion earmarked for the trade-in program by Beijing for this year has already been distributed by early June. Consumer participation has seen local governments quickly running out of funds for these subsidies.

The central government may soon distribute the remaining funds to local governments to fund the program. However, in our view, it is unclear whether consumer confidence has actually improved, given that the outlook for jobs and incomes has remained uncertain.

Chart 1 - Retail sales supported by stimulus program vs overall retail sales

Annual growth for 2024 and year-to-date annual growth for 2025

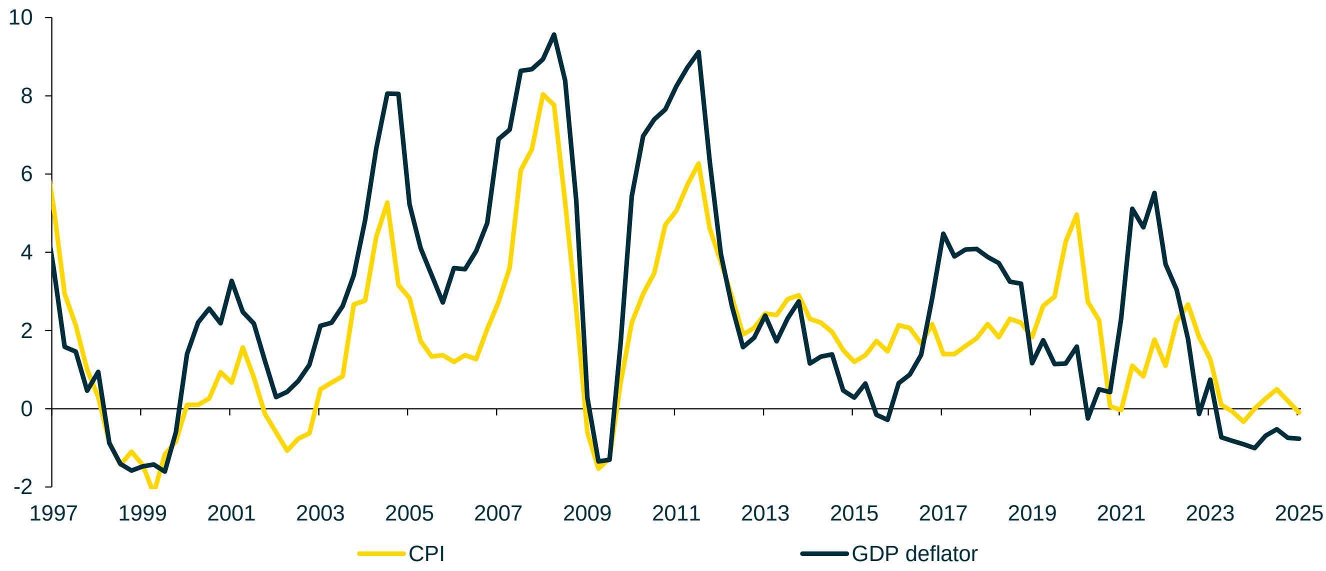


Source: NBS, CEIC, Commerzbank Research

The long deflationary cycle since 2023 suggests it will be hard to reverse the weak underlying demand. CPI inflation hovered around zero in recent months, while PPI deflation worsened to -3.3% in May. The GDP deflator as a broad measure of prices in the economy stayed in deflation territory since 2023 (Chart 2). Due to weakness in demand, firms have been cutting prices to survive. An example of this is the latest price war in China's auto market. It was reported that the prices of some electric car models have been reduced by over one-third. Firms have chosen to cut prices in order to attract demand, despite auto and other big-ticket consumer goods are being supported by the government stimulus program this year. This is a reflection of how weak the underlying consumer demand has been.

Chart 2 - China has entered a long deflationary cycle since Q2 2023

% yoy, quarterly



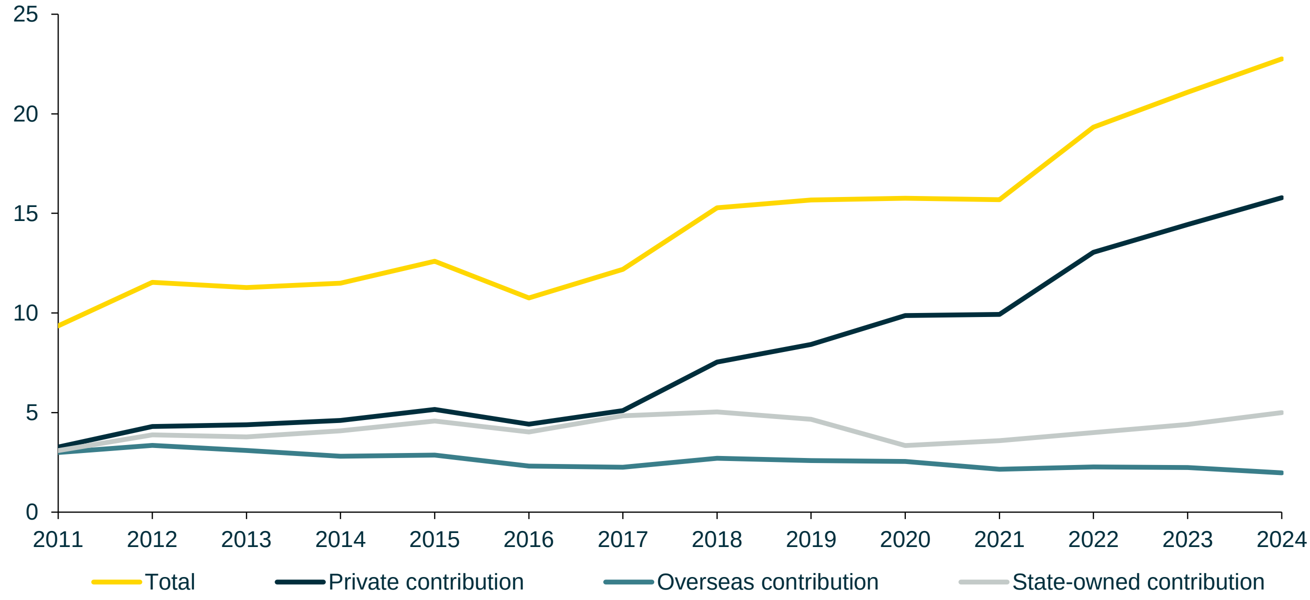
Source: NBS, CEIC, Commerzbank Research

Private sector weakness weighs on job creation

Deflation has squeezed the profitability of firms. In fact, the share of loss-making firms increased to 23% in 2024, up from just below 10% in 2011 (Chart 3). The increase was mostly driven by the private sector. While the rise in loss-making private companies since 2021 probably is in part due to the ongoing real estate downturn, the rising trend started way before that, since 2017. This suggests market competition has generally been fierce and over-capacity has been building up.

Chart 3 - Rising share of loss-making firms was driven by the private sector

Share of loss-making firms in all enterprises (%, yellow line); percentage-point contributions of private companies, overseas companies, and state-owned enterprises to the share of loss-making firms

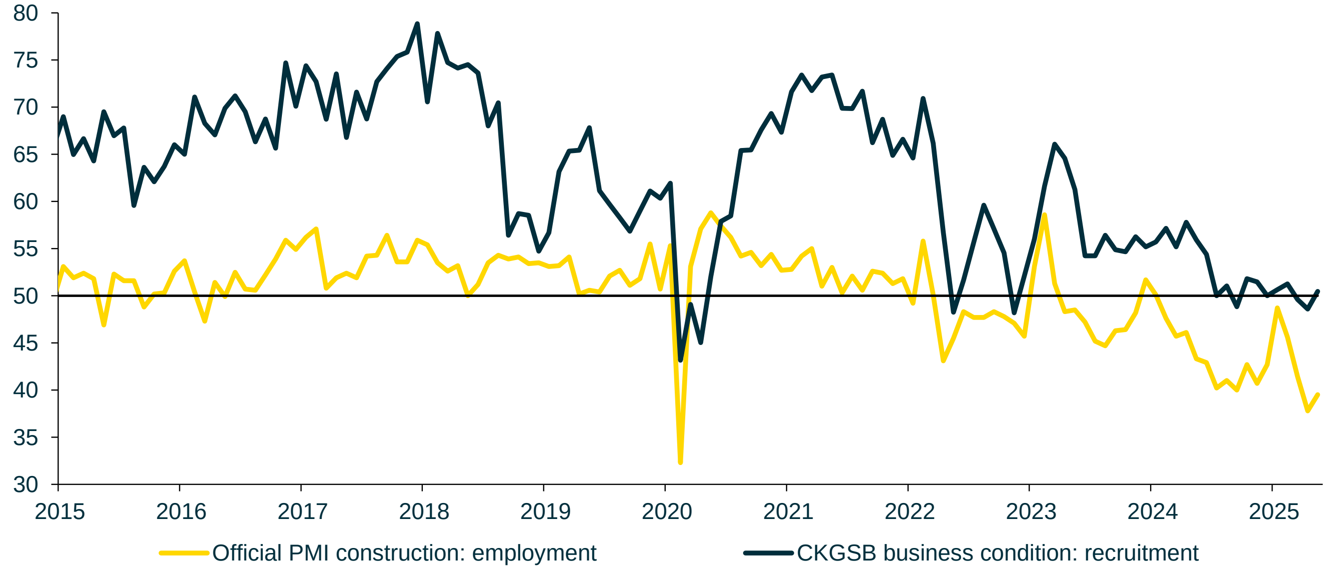


Source: NBS, CEIC, Commerzbank Research

If businesses are not profitable and confidence is weak, they will not be hiring. As the problems of overcapacity and employment are structural, Beijing needs to allow and initiate meaningful reforms and consolidation in various industries to resolve these problems (Chart 4).

Chart 4 - Worsening of employment conditions

50 being neutral for both series from the official PMI and Cheung Kong Graduate School of Business (CKGSB) business condition index which covers different manufacturing and services sectors.



Source: NBS, Cheung Kong Graduate School of Business, CEIC, Commerbank Research

Housing downturn and trade tensions weigh on sentiment

Last but not least, the ongoing housing downturn is affecting employment directly. It is also dampening consumer sentiment via the wealth effect, given that over 60% of Chinese household wealth is stored in housing, according to the official household balance sheet data.

And of course, the US-China trade tensions have challenged the outlook for exports, and hence employment too.

Limitations to government stimulus

Given the slow economy and the ongoing housing downturn, the government sector has no choice but to raise its borrowing due to the lack of tax and land sales revenues. Although the central government debt is projected at below 30% of GDP in 2025, which is low by international comparison, local government debt (official plus local government financing vehicle debt) is projected to rise to as much as over 100% of GDP based on our measure. Many have argued that the central government could carry on more debt on behalf of the local governments. While this is true to some extent, we believe there is a limit as to how much more debt the government can carry.

As such, there is a good chance that the policy stimulus will eventually slow due to fiscal constraints. Our concern is that, once the stimulus slows or even stops, the macro picture will worsen again.

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