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GLOBAL & REGIONAL FOCUS NOTES

China: "At the Crossroads"

An assessment of the current economic situation and the challenges lying ahead

- Over the past 75 years, China's economy has undergone a profound transformation, often hailed as an economic miracle
- This remarkable growth has slowed over the past decade, raising concerns about whether the economy is struggling or transitioning to a new phase in its development
- In 2024, the economy's performance was mixed: private consumption and the real estate sector undermined growth; external trade, mainly exports, was supportive
- One key to converting high savings into spending and boosting consumption lies in repairing damaged consumer confidence, which could take time
- Policy makers face a tough balancing act as they have to navigate a trade war that is likely imminent, heightened geopolitical uncertainty and an economy in transition

Introduction

This focus note, written at the close of 2024, carries dual significance. The year marked the 75th anniversary of the founding of the People's Republic of China (PRC) by Mao Zedong, while 2025 looms as a milestone for the "Made in China 2025" national strategy. Launched in 2015, this initiative aims to advance China's manufacturing sector, address growing international competition, and enhance economic security. Over the past 40 years, China's economy has undergone a profound transformation, often hailed as an economic miracle. However, this remarkable growth has begun to slow in recent years. Despite this, the size of China's economy, its leadership in cutting-edge technological industries, and its growing influence in the rapidly evolving global geopolitical landscape warrant close attention. This note provides an assessment of China's current economic situation and outlines the key challenges it faces. It serves as the starting point for a series of reports that will explore critical "Made in China" economic themes in greater detail.

In retrospect

Since China began its economic reform and opening-up in 1978, GDP growth has averaged 10% annually. This period of nearly five decades of unprecedented growth catapulted China to become the world's second-largest economy. However, since 2012, the economy has entered a phase of slower growth, with the average annual growth rate decelerating to 6.3% from circa 10% between 1978 and 2011. Excluding 2020,

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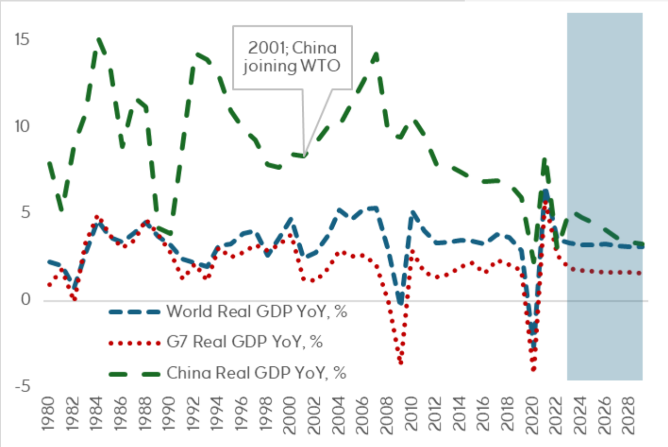
the year the COVID-19 pandemic disrupted global economies but was largely contained in China, the growth rate climbs to 6.7%.

As previously cited in analyst reports, the key drivers of China's rapid growth can be summarized as follows[1]:

- Economic reforms, spanning from the agricultural sector to the development of nonstate-owned economic entities and resulting to a more open, market-driven economy from a closed, state-planned one
- Industrialization, transforming China into the world's manufacturing hub
- Rapid urbanization, the fastest in human history, boosting productivity and demand
- Globalization, making China the largest exporter and a major recipient of foreign investment and technology
- The demographic dividend of a large, young workforce
- Increased use of leverage, which fuelled growth
- Also, the decision of western multinational corporates to redirect the production to China for cost efficiency reasons also held a key stake in the technological spillover that China was in need for

Figure 1: China's growth rate has diminished in the last decade. It remains double than the G7 average



Source: IMF, Eurobank Research

This period of rapid expansion has given way in the last decade to slower growth, driven by several factors:

- Declining productivity, largely due to diminishing returns from investment-led growth
- Demographic shifts, notably a shrinking workforce due to an aging population
- A shift in policy focus from "growth at all costs" to "high-quality growth"
- Recent demand-side imbalances, including high household savings driven by precautionary motives in the face of weak consumer confidence
- Ongoing trade and geopolitical tensions, adding uncertainty to global and domestic markets

Economy in transition: from complacency over sluggish growth to addressing the persistent challenges

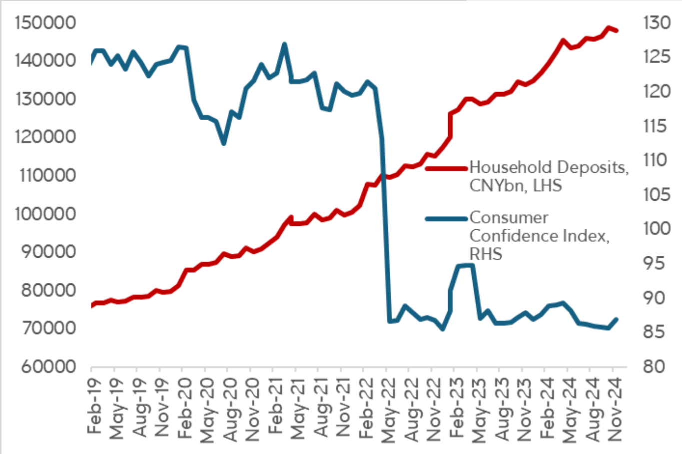
Amid increasing concerns expressed from various credible corners about the current state of the Chinese economy, the country is dealing with an economy undergoing a transition from an investment-led growth model to one also drawing contributions from consumption. Recent IMF forecasts extending to 2029 indicate that growth will continue to decelerate, though China's rate of expansion remains more than double the average of the G7 economies. China's GDP is projected to grow 4.8% in 2024, down from 5.3% in 2023, with further gradual cooling to 4.5% in 2025 and 3.3% by 2029. By contrast, G7 economies are expected to

[1] https://think.ing.com/articles/china-economy-not-in-a-great-decline-but-in-a-great-transition/

see stable growth, ranging from 1.7% in 2024 to 1.6% in 2029, with global growth averaging 3.2%, largely supported by China and other emerging markets, mostly located in Asia.

In Q3 2024, real growth came in at 4.6% YoY, slightly lower than the 4.7% YoY in Q2, but still above the previous year's growth trend due to a stronger Q1 print (5.3% YoY). With the year-to-September growth averaging 4.8% YoY, a more robust performance is needed in Q4 to meet the official target of "around 5%" for FY2024. However, both our estimate and the broader market consensus expect a more conservative 4.8% YoY, keeping the annual growth rate in line with current levels. Regardless of whether the official target is met or slightly missed, the overall picture for 2024 has been mixed. Retail sales during the first 11 months of 2024 grew by 3.5% YoY, less than half the 7.2% YoY growth seen in the same period in 2023. On the other hand, industrial production between January and November rose 5.8% YoY, up from 4.3% YoY in 2023, reflecting the uneven recovery between supply and demand. Part of the excess production was directed towards international markets through strong exports that fared strongly in 2024. Still, the short circuit between excess production and weak domestic demand was mirrored in the deflationary landscape in the last couple of years. Not only CPI, but also PPI, a measure of factory gate prices, has been negative since October 2022, indicating that companies are forced to reduce prices due to gap between supply and demand. Consumption has been hindered by weak consumer confidence, which has remained depressed for the past two and a half years. The consumer confidence index, which dipped from 120 in early 2022 to 86.7 in April 2022 due to lockdowns, has only rarely and briefly surpassed 90 since. As Chinese consumers have grown more concerned about the economy's prospects, household savings have increased. Household deposits accumulated since the pandemic, swelling to CNY65trn[2] (USD$9trn) between January 2020 and August 2024. This has contrasted with what has been the case in other big economies, notably the US, where households quickly began spending the money they had accumulated.

Figure 2: Consumption trapped in the reverse relationship between consumer confidence and household savings



Source: Bloomberg, Eurobank Research

Several key factors have contributed to the weakened consumer confidence, out of which we pick out the following:

- Social anxiety following strict lockdowns during the pandemic's later stages.
- Labour market insecurity and wage concerns, as many businesses have implemented cost-cutting measures such as pay freezes, pay cuts, and layoffs to address squeezed corporate profits. This has led to a sharp rise in youth unemployment, peaking at a record high of 21.3% in June 2023, which prompted

[2] https://www.project-syndicate.org/commentary/china-growth-prospects-depend-on-government-meeting-three-key-challenges-by-huang-yiping-2024-12

China's statistical bureau to halt publication of this key figure. While youth unemployment has since decreased to 16.1% in November, it remains elevated, weighing on private consumption and the housing market.

- The ongoing real estate crisis, especially since Evergrande Group's 2021 default, which remains unresolved despite various support measures. Residential property sales have contracted more sharply in January-November, falling 20% YoY, compared with a decline of 3.7% YoY in the same period of 2023. On a similar footing went also prices that continued to drop. In November 2024, new home prices in 70 Chinese cities fell by 5.7%YoY, following a 5.9%YoY decline in the previous month - the steepest drop in over nine years. This marks the 17th consecutive month of price decreases, indicating that Beijing's ongoing efforts to address the prolonged downturn in the property sector, including lowering mortgage rates and reducing home buying costs, have not yet succeeded in reversing the negative trend. Yet, the economy also has its buffers that came in the shape of exports for 2024. As of November data, Chinese export volumes have increased by 13%YoY, with electric vehicles and semiconductors providing much of the impetus, while import volumes have risen by only 2%. Given that exports[3] account for approximately 20% of GDP, this 10ppts gap suggests a net export contribution to the headline GDP growth of nearly 2% despite the externally challenging environment. Part of this export momentum in the second half of 2025 is due to companies frontloading purchases due to concerns over future tariffs, making it questionable whether this performance will continue in 2025.

Policy Playbook: "fiscally proactive and monetarily looser"

After mixed economic data in the first half of 2024, the Politburo and economic policymakers, once hesitant, now appear fully convinced of the need for a substantial stimulus package to set the economy on a more sustainable growth trajectory. To achieve this, the disconnection between demand and supply must be addressed, which requires restoring consumer confidence to stimulate private consumption. Rebuilding consumer confidence is likely to be a gradual, multi-phase process, requiring clear communication and policy changes. It remains to be seen whether the measures introduced since September by Chinese policymakers incorporate these elements effectively.

For now, the stimulus strategy consists of several key components, including:

- A more proactive fiscal policy, accompanied by a higher deficit-to-GDP ratio which is expected to be set at 4% in 2025 from 3% in 2024
- A shift in monetary policy from "prudent" to "moderately loose," aimed at improving liquidity conditions and boosting market confidence.
- Increased issuance of ultra-long special treasury bonds to fund large-scale equipment upgrades and consumer goods trade-ins.
- Renovation programs for shantytowns and dilapidated houses, along with efforts to control the supply of new real estate land, make better use of existing land resources, and optimize the development of commercial and office properties. These initiatives are designed to foster a new growth model for the real estate sector.

These measures were highlighted during two important political meetings in December, closely watched by market participants. On December 9, China's Politburo, led by President Xi Jinping, shifted its monetary

[3] https://www.cfr.org/blog/chinas-stunning-2024-export-growth

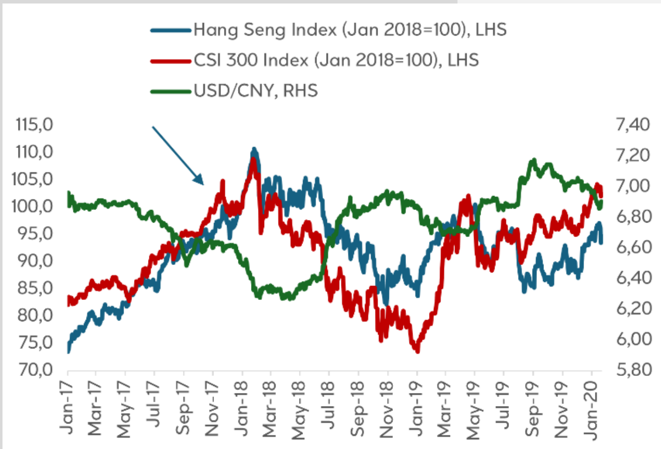
policy stance from "prudent" to "loose" for the first time since 2010, when a similar shift was made to support the post-global financial crisis recovery. This announcement improved confidence, driving 10-year bond yields to record lows below 1.9%, and pushing major stock indexes to monthly highs in the following session. The focus then shifted to the Central Economic Work Conference (CEWC) held on December 11-12, which, as expected, aligned with the Politburo's policy directives.

What does Trump 2.0 hold?

The two meetings came soon after the election of Donald Trump in the US, whose campaign prominently featured the imposition of heavy tariffs on all imports from China. While he promised during the election campaign to impose 60% tariff on Chinese goods, this might just be a negotiation tactic. An alternative scenario is a phased approach, such as a 10% tariff increase in the first half of 2025, followed by another 10% in the second half, which would be less disruptive to the US economy.

Overall, a second Trump presidency presents a complex and challenging outlook for China, marked by the risk of heightened trade tensions, economic disruption, and increased geopolitical uncertainty. China is expected to respond with a combination of retaliatory measures, diplomatic efforts, and initiatives to strengthen its domestic economy. The situation remains fluid, and the specific details of Trump's policies, as well as China's responses, will be crucial in shaping the eventual outcome.

Figure 3: The 2018 trade war roiled Chinese financial markets. Could be heading towards a repetition?



Source: Bloomberg, Eurobank Research

One lesson from the first Trump term and the 2018 trade war is the resilience of China's global export share. Despite tariffs, China did not experience a significant decline in overall export volumes, partly due to its increased openness to free trade and its ability to diversify export destinations. In fact, the trade war led to a shift in China's export focus, with exports to emerging and developing economies nearly doubling from 2018 to 2023. This diversification helped offset the decline in exports to the US. As a result, China's export exposure to the US, as a percentage of GDP, has decreased, with exports to the US now accounting for just 3% of GDP, down from pre-trade war levels. This suggests that the impact of potential US tariffs on China's economy may be less severe than in the past.

What's at stake? To fall or not to fall in the "middle-income trap"

The Chinese economy is facing several key challenges and potential shifts, both domestically and internationally, that could have significant implications:

- Economic Growth and Transition: slowing growth, a lingering real estate crisis, weak domestic demand, and the risks associated with economic rebalancing.

- Trade and Geopolitical Risks: potential for severe US tariffs that could disrupt vital trade prospects, as well as escalating tensions with Taiwan and/or in the South China Sea.
- Structural Issues: declining productivity as China approaches the status of an advanced economy, coupled with the challenges posed by an aging population.

Many of these factors are part of the broader "middle-income trap," and China faces a genuine risk of falling into it. To avoid this, China must implement significant structural reforms, shift its economic focus towards consumption and services, and further strengthen its technological capabilities. The success of China's economic transition will depend on the government's ability to address these challenges and implement the necessary reforms to create a more sustainable and balanced growth model. While these are the key tools from an academic and theoretical standpoint, the outcome will be much more complex and will require close monitoring.

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