

IN CHINA, ECONOMIC GROWTH REMAINS RESILIENT BUT THE FIGHT AGAINST DEFLATION IS FAR FROM WON

Since the beginning of the year, China's economic growth has proved to be more robust than expected. Exports have withstood US tariff attacks and household consumption has recovered thanks to government stimulus programs. However, large clouds are casting a shadow over the picture and are likely to slow growth in the second half of the year. On the one hand, trade tensions with the United States remain high and the tech war continues, even though Beijing and Washington have agreed to extend their truce until November. On the other hand, internal structural problems remain (real estate crisis, labour market fragility, low confidence in the private sector, deflation). Despite this gloomy backdrop, economic policy easing remains cautious. In addition, the authorities have been reviewing their priorities in recent months, expanding their initiatives to combat deflationary pressures and to reduce excess production capacity. For China's foreign trade partners, a reduction in production capacity could ease competitive pressure from Chinese goods. However, these "anti-involution" efforts also risk penalising growth in the short term; they will need to be accompanied by increased support for private consumption in order to achieve objectives and reduce supply-demand imbalances.

ECONOMIC GROWTH IS EXPECTED TO SLOW...

After a better-than-expected first half of 2025, growth in the manufacturing sector will slow in the second half of the year, while activity in the services sector is struggling to recover strongly.

Chinese economic growth stood at +5.3% year-on-year (y/y) in H1 2025, a faster pace than expected at the beginning of the year. In the manufacturing sector, activity strengthened (+6.6% y/y in H1 after +6% in 2024), supported by the solid performance of merchandise exports. The decline in exports to the United States, caused by the tariff shock¹, was effectively offset by an increase in sales to the rest of the world². However, the momentum of the export sector could peter out in the coming quarters given the expected effects of the tariff shock on global trade and the risk of further US protectionist measures. The deterioration in the export outlook has caused (in part – see below) the recent slowdown in industrial production growth (+5.7% y/y in July) and manufacturing investment (down by 1.3% y/y in value terms in July, after a rise of +7.5% in H1).

In the services sector, growth also accelerated in H1 (+5.5% y/y after +5% in 2024). However, the recovery in domestic demand, which is supporting it, remains fragile and depends on policy stimulus measures. The recovery in household demand has been boosted by government subsidies from the consumer goods trade-in scheme but appears to have lost momentum in July (retail sales rose by 3.7% y/y in volume terms, vs. more than 5% in H1). In the real estate market, the few signs of stabilisation that appeared last winter were short-lived: home sales fell by 8.1% y/y in July (after 4.4% in H1), while property investment continues to contract and housing prices continue to decline. Household confidence is not improving, as it is still weakened by the real estate market crisis and by a job market and income trends that have deteriorated compared to the pre-COVID period. There are still major obstacles to a solid recovery in domestic demand.

... IS THIS WORRYING THE AUTHORITIES?

Fiscal and monetary policy support has remained moderate since the beginning of the year. This policy stance is likely to be maintained in the short term.

Monetary policy easing has remained gradual and moderate (such as interest rate cuts, liquidity injections, and easing of mortgage lending conditions). Moreover, it has faced reluctance from enterprises, households, and banks. Growth in outstanding bank loans has continued to slow, reaching a new historic low of +6.8% y/y in July (vs. +10.9% at the end of 2023). Yet, the easing of monetary conditions facilitated bond issues by local governments (whose average issuance rate has been below 2% since April, compared with 2.5% a year earlier) and supported fiscal stimulus. The fiscal strategy has mainly involved increasing investment in strategic sectors, infrastructure, and housing, providing support to exporters, and stimulating household demand.

Boosting private consumption is a priority in the economic strategy for 2025, and the authorities have introduced various support measures. The main announcements this summer include the continuation of the government subsidy programme for consumer goods and its extension to spending on services, new child allowances, and interest subsidies on consumer loans. The increase of initiatives is a positive development, but the measures taken remain modest in scope and more ambitious reforms of the social protection system are progressing slowly.

Despite persistently sluggish domestic demand and risks related to the international environment, the authorities do not currently seem to be considering any more significant easing of monetary and fiscal policy, or new measures to support the real estate sector. Meanwhile, since the beginning of the summer, they have been paying greater attention to the structural problem of deflation and "involution."

THE DILEMMA BETWEEN ANTI-INVOLUTION MEASURES AND EMPLOYMENT

The term "involution" refers to "disorderly" competitive practices in a large number of sectors in China, which lead to overcapacity, falling prices, and declining corporate profits. The problem stems in particular from the industrial policy pursued in recent years, aimed at supporting investment in strategic industries. It affects a wide range of sectors, from heavy industries (such as steel and coal) to pharmaceuticals and green technologies (electric vehicles, photovoltaics). Service sectors such as e-commerce and delivery platforms are also affected by involution.

¹ With the additional 30% US tariffs on Chinese goods and sectoral taxes implemented since early 2025, the effective rate of tariffs applied by the US to China rose from 10.7% at the end of 2024 to 34.2% at the end of May and 41.4% at the end of August (source: Fitch).

² BNP Paribas – EcoPerspectives: China – First effects of the trade war, June 2025.



EDITORIAL

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INDUSTRIAL CAPACITY UTILIZATION RATES

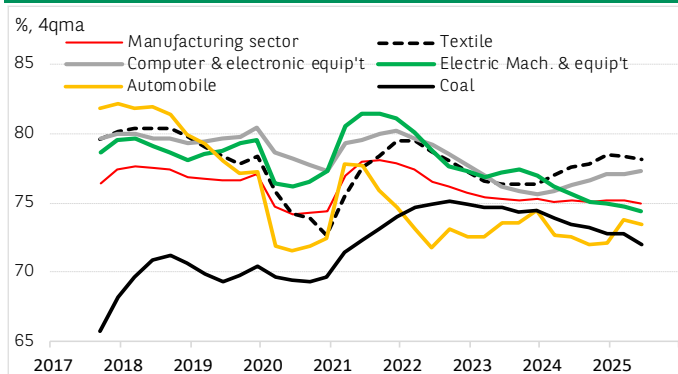


CHART 1

SOURCE: NBS, BNP PARIBAS

PRICE DYNAMICS

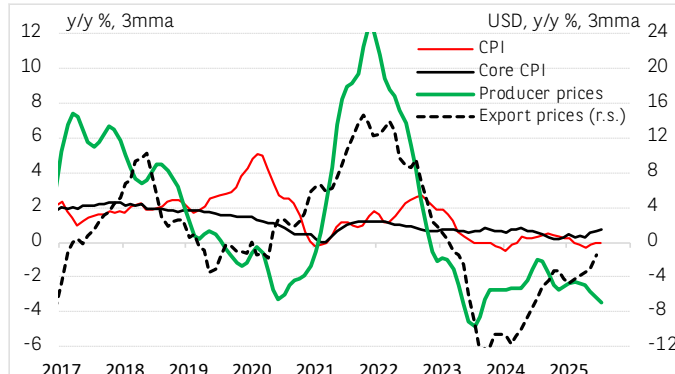


CHART 2

SOURCE: NBS, BNP PARIBAS

For several months, the authorities have been trying to clean up practices and rationalize supply in these sectors. The central government and local governments are encouraging companies to work together to raise prices and curb production overcapacity. They are also beginning to introduce production guidelines and rules aimed at eliminating the weakest producers – in particular by encouraging consolidation that strengthens the position of the largest and most robust players that remain capable of innovation.

These measures could lessen deflationary pressures and improve corporate earnings in some sectors over the coming months. For the time being, they have probably contributed to the rebound in stock markets (the CSI300 index has gained 13% since the end of June). However, while some companies are reporting signs of stabilisation in their selling prices and profits, macroeconomic indicators are not yet showing any improvement. Capacity utilisation rates were low in Q2 (74% on average in industry, vs. 75% in 2024 and 76.5% before COVID in 2018-2019). On the price side, CPI inflation was zero in July (vs. -0.1% y/y in H1); core inflation has accelerated very slightly since April (+0.8% y/y in July), but producer prices show no signs of rebounding (-3.6% y/y after -2.8% in H1).

However, anti-involution measures appear to have already contributed to the recent weakening of manufacturing investment and industrial production, and a downward correction on the supply side could weigh on employment in the short term. The authorities could therefore soon be faced with a dilemma between anti-involution and employment. Thus, in order to achieve their objectives without constraining economic growth, anti-involution measures will have to be accompanied by a recovery in domestic demand. Once again, strengthening household consumption appears to be the key to resolving the structural imbalances in the Chinese economy. Given the modest measures to support households announced in recent months, the success of the anti-involution campaign seems highly uncertain.

WHAT ARE THE CONSEQUENCES FOR CHINA'S FOREIGN TRADE PARTNERS?

In external markets, reduced production capacity and “disorderly” competition in China could ease the competitive pressure stemming from Chinese goods. This could reduce downward pressure on export prices – which have recently stabilized after falling sharply in 2023-2024.

In the short term, however, this is unlikely to undermine the strong competitiveness (price and non-price) of Chinese products, which is notably boosted by the weakness of the yuan (especially in real effective terms). Nor should it call into question the strategy of Chinese companies aimed at selling on foreign markets their production that is unsold on the local market as well as offsetting the contraction of their exports in the US by increasing their market share in the rest of the world.

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