QUARTERLY ANALYSIS OF ECONOMIC TRENDS IN CHINA

MERICS Economic Indicators

Solid GDP growth in Q2 masks China's challenges

Q2/2025

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MERICS
Mercator Institute for China Studies

MERICS Q2 ANALYSIS

China’s government steps up policy support as economic pressures mount

China’ GDP growth held steady over the second quarter of 2025, despite a minor slowdown. The economy expanded by 5.2 percent year on year, down from 5.4 percent in the previous quarter. For the first half of the year, China’s GDP also expanded by 5.2 percent, above the government’s annual growth target of around 5 percent. But headline GDP growth may look stronger than it is, lifted by deflation and base effects of low growth in the reference period last year. On top of that are persistent structural problems. The government responded by introducing further support measures to boost consumption and has initiated potentially significant reforms aimed at addressing overcapacity in key sectors.

Support measures introduced since mid-2024 helped lift consumption in Q2, notably trade-in programs on costlier household purchases like washing machines and fridges. Similarly, labor market measures, including tax relief and employment subsidies, have helped to ease some employment pressures. However, the severity of China’s structural problems has not meaningfully abated. High youth unemployment, weak income growth outlook and the struggling real estate sector continue to weigh down sentiment. Measures introduced by the government so far have helped stabilize the situation but are largely temporary and fail to address the underlying structural challenges.

The most comprehensive policy support to counter struggling consumer demand was introduced by the Peoples’ Bank of China jointly with six other government departments on June 24. The policy marks one of the most coordinated efforts by the government to improve the consumer and service sectors, as well as employment and income. It is also a recognition that its past stimulus policies were not sufficient to lift sentiment. Although many of the specific policies are not wholly new, their political prominence means that boosting consumption in earnest is now a higher policy priority.

However, it is government’s criticism of overcapacity and fierce price competition in the industrial sector that may signal the beginning of a more substantial course correction in China’s economic policy priorities. China’s strong manufacturing and technology sector growth has come with downside effects, including deteriorating profitability and deflation. This has effectively been reducing the tax base and suppressing consumption in the post-Covid period.

If implemented meaningfully, economic policy priorities in the industrial sector could begin to rebalance towards consumption. Doing so would require relaxing the current focus on geopolitically driven global tech competition in favor of strengthening domestic demand. China’s industrial policy has unleashed a rapid capacity build-up. Given the economic side effects, the central government will need to put the genie back into the bottle.

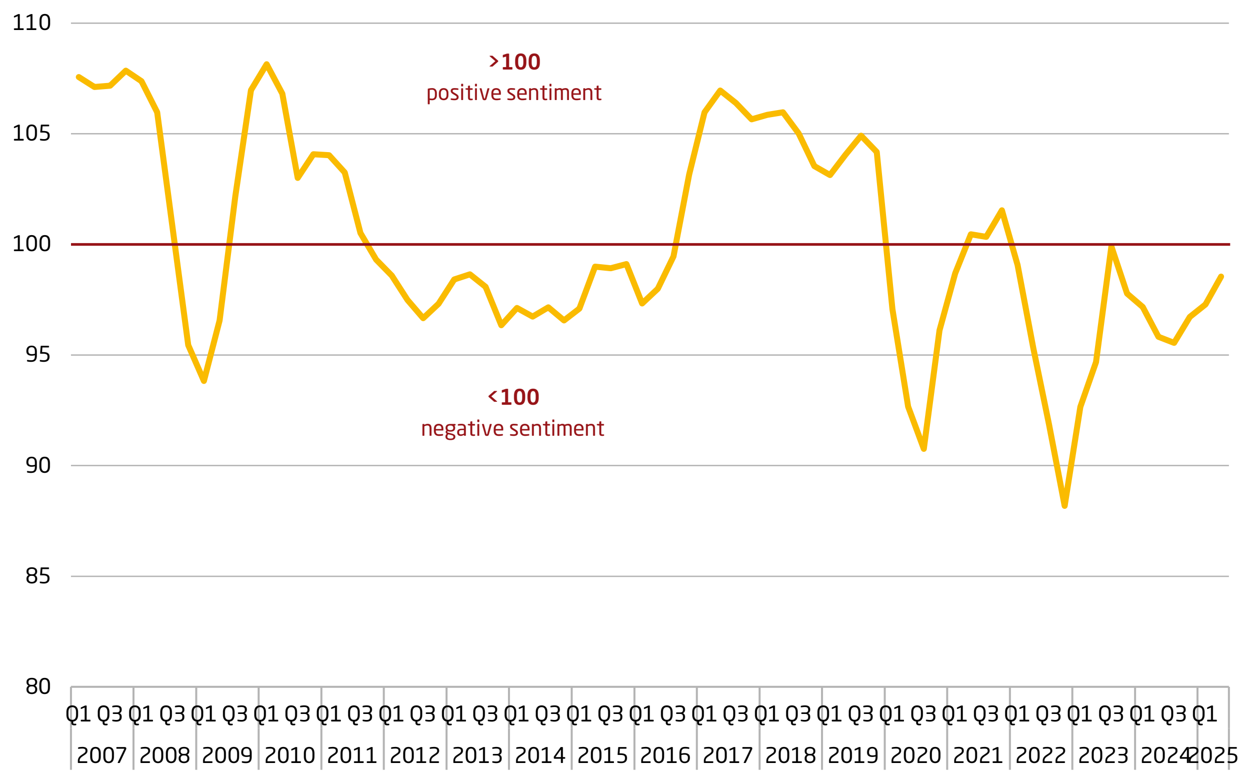
The government’s push for market consolidation in sectors such as electric vehicles and solar panels highlights how market exits in strategic industries must often be orchestrated from the top. The central authorities picking winners is an approach that is likely to meet resistance from local governments. Nevertheless, the recent policy adjustments introduced over Q2 suggest that efforts to address these underlying challenges are finally gaining momentum.

The MERICS China Confidence Index (MCCI)

The MERICS China Confidence Index measures household and business confidence in future income and revenues. The index is weighted between household and business indicators. It includes the following indicators: stock market turnover, future income confidence, international air travel, new manufacturing orders, new business in the service sector, urban households' house purchase plans, venture capital investments, private fixed asset investments and disposable income as a share of household consumption. All components have been tested for trends and seasonality.

The MCCI was first developed in Q1 2017.

MCCI has biggest improvement in nearly 2 years
MERICS China Confidence Index



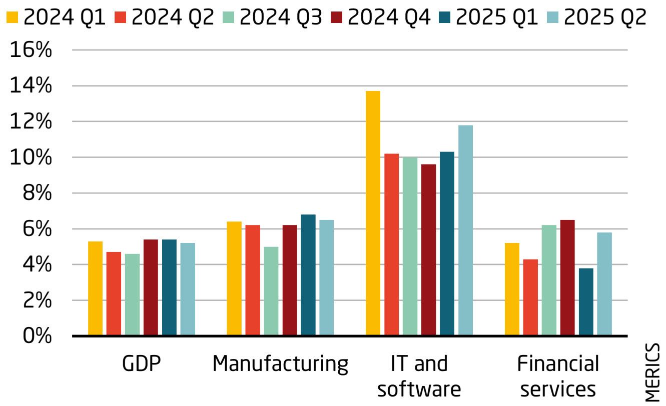
Note: The variable international air travel has been removed from the MCCI on Q3 2021.

Source: MERICS

MACROECONOMICS

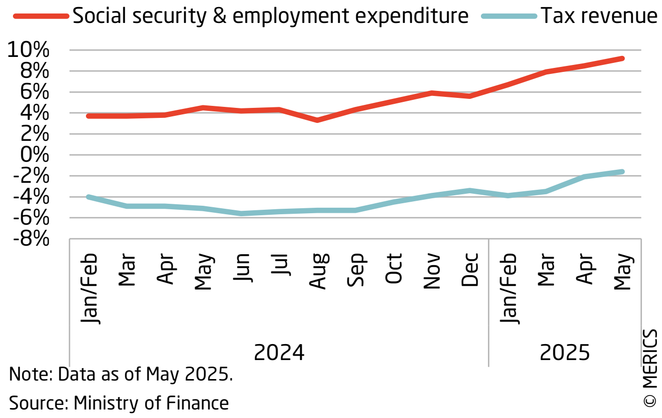
Strong GDP expansion masks underlying challenges

Base effects help lift GDP growth in Q2
Quaterly GDP growth by sector, yoy



Source: National Bureau of Statistics (NBS)

Labor market pressure increases social security expenditure
Government budget by type, ytd yoy



Note: Data as of May 2025.
Source: Ministry of Finance

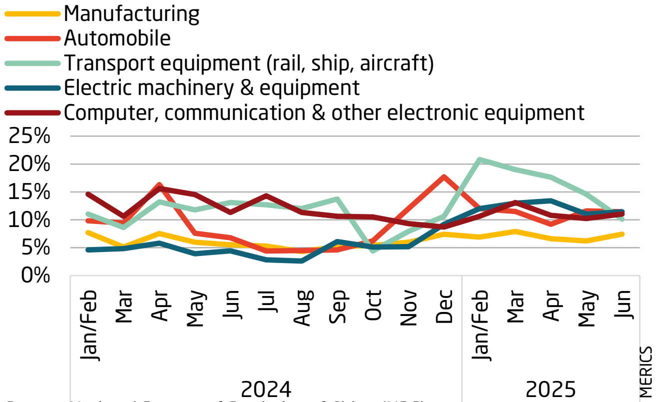
- Headline GDP growth beat expectations, expanding by 5.2 percent year-on-year in Q2. After 5.4 percent growth in Q1, the government's annual growth target of around 5 percent seems well within reach, even if GDP growth was to slow down in the second half of 2025. On the surface, China's economy appears to have been defying the growing uncertainty overshadowing many economies in the light of US tariffs.
- Stronger service sector growth in supported overall GDP growth in Q2 and helped to counter slowdowns in other areas. After a minor slowdown in Q1, growth in the tertiary sector accelerated to 5.7 percent in Q2. The improvement was the result of stronger expansion in the IT and financial services sector (see exhibit 1). This helped offset a slowdown in other areas of the service sector (including real estate and transportation), as well as in manufacturing and construction.
- Persisting deflation inflated real GDP growth, making growth appear stronger than it is. In addition, relatively strong growth figures in Q2 benefited from base effects. Weaker growth in the same period last year, when GDP expanded by only 4.7 percent, contributed to stronger growth data in Q2 this year (see exhibit 1). China's GDP growth hit its slowest pace since 2022 in Q3 last year, so base effects are likely to support GDP growth again in the coming quarter.
- The headwinds facing China's economy meant quarter-on-quarter economic growth cooled in Q2. Growth slowed from 1.2 percent in Q1 to 1.1 percent in Q2, indicating a loss of momentum.
- Some of the underlying challenges plaguing the economy are visible in the government budget breakdown. The real estate slump and lower profitability are impacting the government's tax base (see exhibit 2). At the same time, the weak labor market requires more expenditure on social security and employment.

What to watch: Quarter-on-quarter growth will provide a better picture of the momentum of the economy during the second half of this year.

BUSINESS

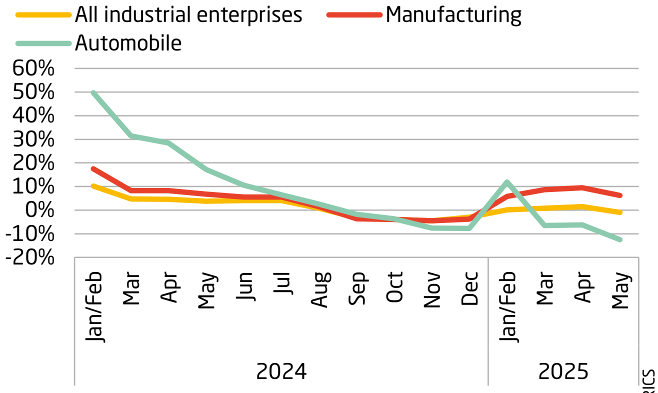
Manufacturing output remains robust amid tariff uncertainties

Transport and electronics sectors sustain high output in Q2
Industrial value added production, yoy



Source: National Bureau of Statistics of China (NBS)

Recovery in profit growth begins to falter
Operating profit, yoy ytd



Note: Data as of May 2025.
Source: National Bureau of Statistics of China (NBS)

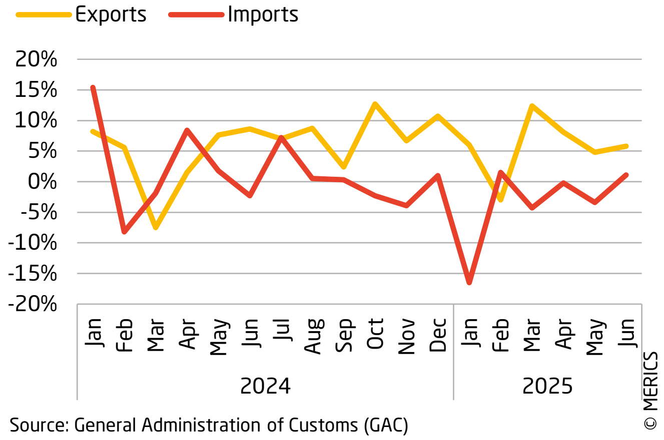
- China's industrial sector continued to grow strongly in Q2 amid ongoing trade tensions and rising tariff barriers to US markets. Industrial value-added output recovered in June, expanding by 6.8 percent year-on-year, after growth fell to 5.8 percent in May. Growth for the first half of 2025 overall was 6.4 percent, well above the 5.8 percent recorded for 2024 overall.
- Manufacturing was the strongest contributor with growth of 7.4 percent in June, led by high-tech manufacturing, which expanded by 9.7 percent (see exhibit 1). China's robotics and green tech sectors performed well, as production of industrial robots grew by 37.9 percent, service robots by 18.3 percent, NEVs by 18.8 percent and solar cells by 24.1 percent in June.
- Despite a modest recovery in Q1, industrial firms' profits fell by 0.9 percent in May (see exhibit 2). Profits in the automotive sector contracted by 12.5 percent in May, after BYD – the market leader in electric vehicles – slashed prices across a dozen models. State-owned enterprises and the mining sector also saw profits contract by 8.1 percent and 29.6 percent respectively in May.
- Low profitability and entrenched deflation prompted the government to criticize "disorderly" price competition especially in e-vehicles, solar panels and other emerging strategic industries. It called for consolidation and an end to price wars, though no specific regulatory measures were announced.
- China's real estate woes and reluctance to roll out large-scale investment in infrastructure have caused a decline in output of construction-related materials in recent months. In June, production of cement was down 5.3 percent, plate glass output fell by 4.5 percent and crude steel by 9.2 percent.
- Business sentiment in the manufacturing sector was subdued in Q2, as the purchasing managers' index (PMI) fell to 49.0 in April and recovered to just 49.7 in June (values below 50 indicate contraction). Weak domestic demand and uncertain foreign markets are dampening expectations. In June, the PMI for existing orders was just 45.2 and for new export orders, 47.7.

What to watch: Government criticism of cut-throat price wars could influence output in the second half of the year if it results in specific policies or guidelines.

INTERNATIONAL TRADE AND INVESTMENT

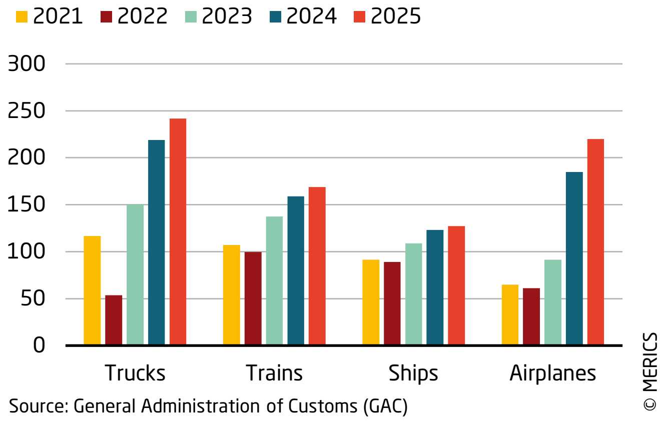
Rising geopolitical frictions have not dented China's exports

China's export machine powers on in Q2
Foreign trade USD basis, yoy



Source: General Administration of Customs (GAC)

Cross border movements continue to surge
Entries and exits by mode of transportation H1, 2020=100



Source: General Administration of Customs (GAC)

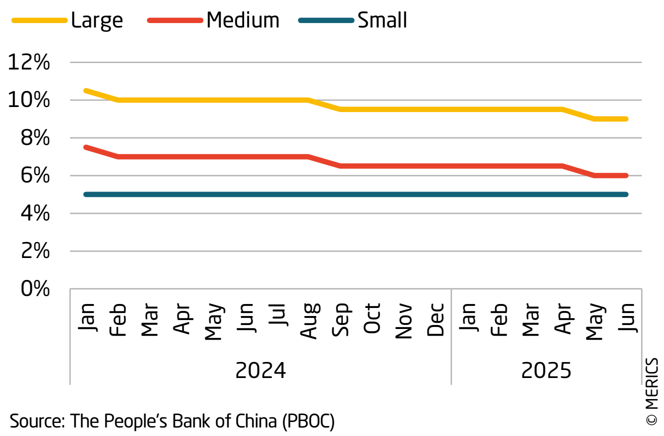
- Despite heated rhetoric and occasional tit-for-tat measures, China's exports have not suffered any significant negative impact. In Q2, export growth eased to 5.8 percent year-on-year in June, down from 12.4 percent at the end of March (see exhibit 1). In the first six months, exports grew by 5.9 percent. Imports shrank by 3.9 percent, due to weak domestic demand. As a result, the trade surplus surged by 34.6 percent to a new record high of USD 585.9 billion.
- Exports to the US were down by 9.9 percent year-on-year in CNY terms in the first half of 2025, though the decline eased off during Q2. Falling direct exports to the US were outweighed by stronger demand from ASEAN with exports up by 14.3 percent in the first six months, lifted by exports to Thailand (23.4 percent) and Vietnam (21 percent). The US is also targeting China's regional trade links: its trade agreement with Vietnam could put 40 percent tariffs on transshipments from China.
- New export orders remain weak, though they have not collapsed under higher tariffs. In April, the Purchasing Managers' Index sub-index fell to its lowest point since December 2022: it rebounded to 47.7 in June though still below 50 (indicating contraction). Similarly, transportation links by land, sea and air continue to expand (see exhibit 2).
- Uncertainty surrounding US trade measures continues to cloud prospects for Chinese exports in the second half of 2025. In this volatile environment, Chinese exports could face tariffs of up to 55 percent from August. But China has not stayed idle as geoeconomic shifts reshape global trade.
- Beijing intensified export restrictions including licenses requirements for rare earths in Q2 and adding US and Taiwanese companies to the Ministry of Commerce export control list. Frictions with the EU also escalated after it announced import restrictions and China retaliated. While the world is bracing for US tariffs, China is deepening engagement with key trading partners. It upgraded a free trade agreement with ASEAN in May, and is negotiating a trilateral agreement with Japan and South Korea.

What to watch: Should US tariffs become a reality in August, their impact as well as China's response will alter trade flows even further.

FINANCIAL MARKETS

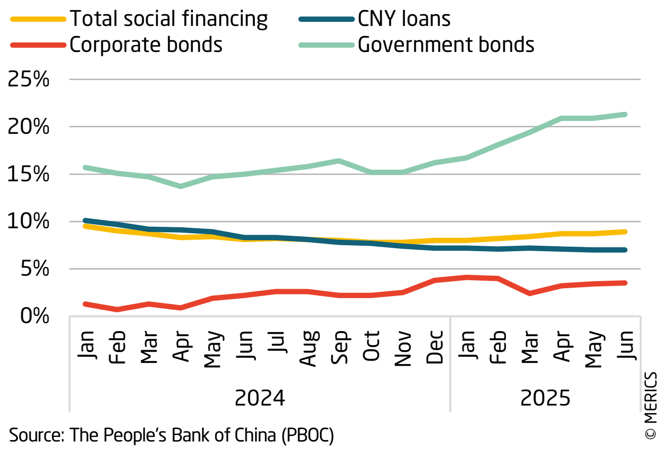
Central bank introduces more policy support for the economy

PBOC steps up monetary support in Q2
Required reserve ratio by type depository institution



Source: The People's Bank of China (PBOC)

Growth of government bonds accelerates in Q2
Aggregate financing by type, yoy



Source: The People's Bank of China (PBOC)

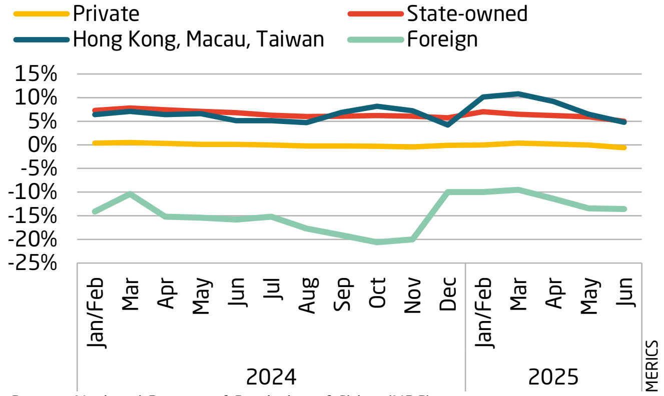
- After holding back earlier in the year, the People's Bank of China (PBOC) has implemented several policies to support the economy. The fresh support fits with the central bank's "moderately loose" stance on monetary policy in 2025. The decision to do more to stimulate the economy reflects growing concern about China's growth prospects in the second half of the year.
- Among the measures introduced, PBOC lowered the 7-day reverse repurchase rate, a benchmark for lending interest rates, from 1.5 percent to 1.4 percent. Further relaxation of the required reserve ratio (RRR) freed up an additional CNY 1 trillion in liquidity (see exhibit 1). Furthermore, mortgage rates for real estate were reduced, cutting rates for first time buyers to 2.6 percent, down from 2.85 percent.
- Previous interest rate adjustments have helped stabilize the economy but have failed to overcome weak sentiment, which continues to hold back credit demand. Uncertainty continues to haunt consumers and private companies, limiting their responsiveness to moderate monetary policy easing. Government and state-owned enterprise lending is likely to be more responsive to the latest changes.
- Total social financing, a measure of broad credit demand, has been improving steadily this year, reaching 8.9 percent in June compared to the same period last year, and up from 8.4 percent at the end of Q1 in March. Strong growth in government bond issuance was a key driver of this (see exhibit 2).
- The depreciation pressure on China's currency after Trump's "liberalization day" tariffs announcements on April 2 eased over Q2. The USD/CNY exchange rate recovered from a low point on April 9 of 7.35 to the USD 7.16 at the end of June.
- China's stock markets have also recovered from the initial shock in April, showing the underlying resilience in financial markets. The Shanghai Stock Exchange Composite Index was up by 11.2 percent at the end of Q2 after a low point on April 7, while Hong Kong's Hang Seng Index was up by 21.4 percent.

What to watch: Expect more fiscal and monetary support if credit demand from consumers and private corporates fails to pick up.

INVESTMENT

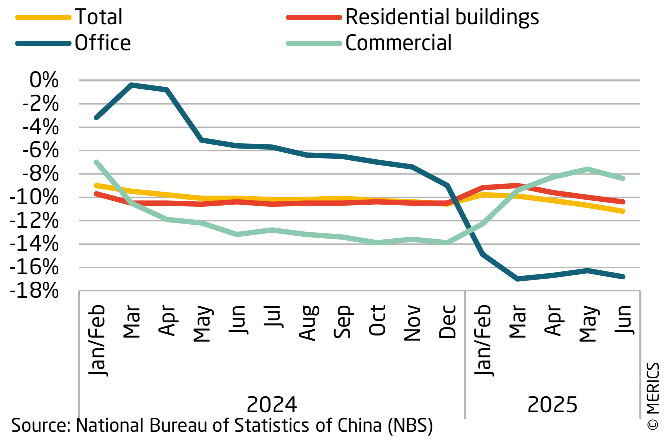
Real estate takes a turn for the worse as other sectors slow in Q2

Foreign investment slump worsens as the slowdown broadens
Fixed asset investment by ownership typ, ytd yoy



Source: National Bureau of Statistics of China (NBS)

No recovery in sight for real estate investments
Fixed asset investment in real estate by type, ytd yoy



Source: National Bureau of Statistics of China (NBS)

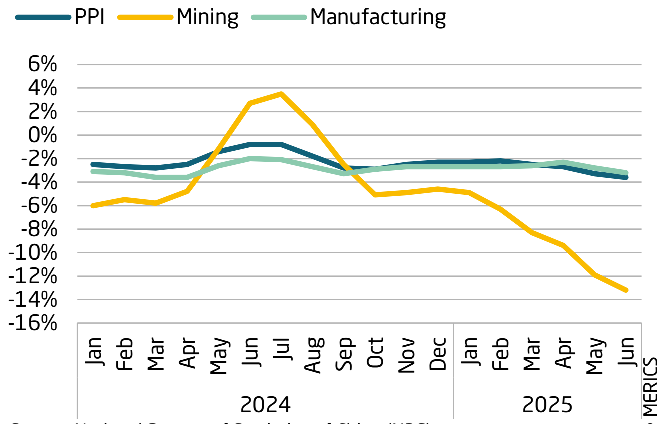
- The Q1 uptick in fixed asset investment quickly stalled in Q2. Growth slowed from 4.2 percent year-on-year at the end of March to 2.8 percent by June, its weakest pace since November 2021. Investment is losing momentum, which risks becoming a drag on the economy.
- Investment activity slowed across state, private and foreign-owned firms. Investments by foreign companies dived again, wiping out minor improvements seen since December 2024 (see exhibit 1). Private sector investment had not shrunk in past five months, but fell by 0.6 percent in the period until June compared to the same period of 2024.
- The key factor behind weaker investment is the deteriorating real estate market. Despite government efforts to stabilize the sector since 2020 (when it cracked down on bad debt and bloat), conditions worsened in Q2. Real estate investment fell over Q2, contracting by 11.2 percent year-on-year in June. It was the biggest decline since February 2020, highlighting how entrenched the malaise is.
- The slowdown is becoming more pronounced as other areas that helped counter the real estate sector are beginning to lose steam. Importantly, investment in manufacturing, while still strong, slowed to 7.5 percent year to date in June, down from 9 percent at the start of the year.
- Automotive and other transportation equipment (rail, ships, aerospace) continues to pull in investment, with automotive expanding by 22.2 percent and other transportation by 27.3 percent year-on-year in the first six months. But both sectors have had double-digit expansion for more than two years so slower growth is inevitable at some point.
- A sharp slowdown in infrastructure investment further contributed to the overall slowdown. Growth fell from 5.9 percent in Q1 compared to year-earlier to 2 percent for the first six months. While more support measures can be expected, stronger infrastructure investment will not be able to support growth to the same degree as it has in past crises.

What to watch: Manufacturing investment is likely to slow at a faster pace if the government follows through on its desire to curb overcapacities.

PRICES

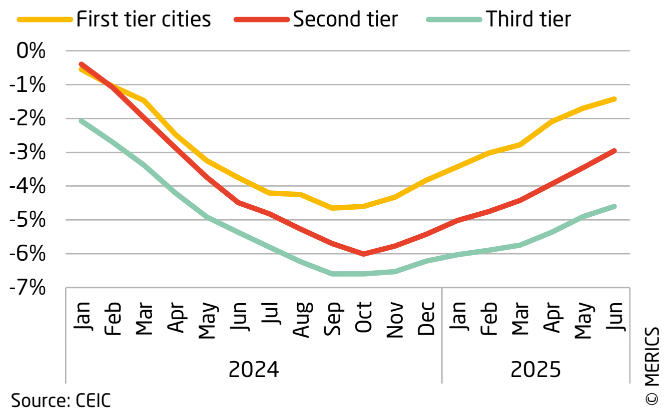
Government seeks to dampen price competition to battle deflation

PPI can't escape deflation as mining prices collapse
Producer price index by type, yoy



Source: National Bureau of Statistics of China (NBS)

Prices in first tier cities lead the way in the recovery
Average price increases for newly constructed residential units by city type, yoy



Source: CEIC

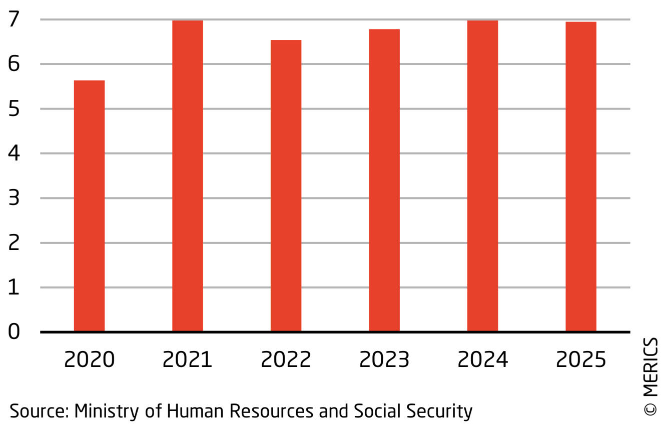
- China's economy remained under deflationary pressure in Q2 as falling prices continued to generate adverse effects. Price falls eroded corporate profitability and dampened consumption as households delayed making large purchases. In Q2, the government intensified policy measures to counteract deflation as its previous half-hearted measures have failed to reverse the situation.
- Deflation remains most entrenched in the industrial sector, with no improvement in sight. The Producer Price Index (PPI) has now been contracting continuously since October 2022 and the situation deteriorated further in Q2. Prices slipped during all three months of the quarter, recording a year-on-year drop in June of 3.6 percent, the steepest since July 2023.
- The fall in PPI was exacerbated by declining prices in mining. Price contraction in mining worsened over the quarter, falling by 13.2 percent in June year-on-year, deepening the 8.3 percent contraction at the end of Q1 in March. But prices in the industrial sector dropped across the board (see exhibit 1).
- Greater manufacturing capacity has been a central objective of industrial policy, to enhance national competitiveness. However, this expansion has triggered intense price competition. In response, the government introduced a series of policies in Q2 to curb "destructive price wars" and promote industry consolidation. The measures targeted a wide range of industries from e-vehicles to solar panels.
- Deflationary pressure is less pronounced on the consumer price index (CPI), but there was little improvement. In June, the CPI rose by 0.1 percent year-on-year, the first expansion since January. Over the first half of 2025, the CPI declined by 0.1 percent. Core inflation, which excludes volatile food and energy prices, performed slightly better, rising by 0.7 percent in June and 0.4 percent year-to-date.
- By end of Q2, housing prices had fallen in 67 of the 70 cities tracked by the National Bureau of Statistics, slightly better than the 68 cities reported at the end of Q1. But prices are falling at a slower pace (see exhibit 2). If the trend continues then house price growth could return to tier one cities by Q3.

What to watch: A turnaround in PPI in response to government intervention would be a considerable shift in the fight against deflation.

LABOR MARKET

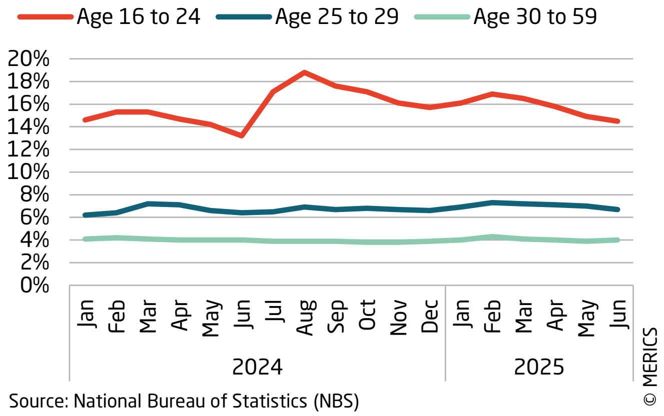
Government steps up efforts to support the labor market

Job creation falls below 2024 levels in H1
New increased urban employment H1, in million



Source: Ministry of Human Resources and Social Security

Youth unemployment remains a challenge despite improvement in Q2
Surveyed urban unemployment by age group



Source: National Bureau of Statistics (NBS)

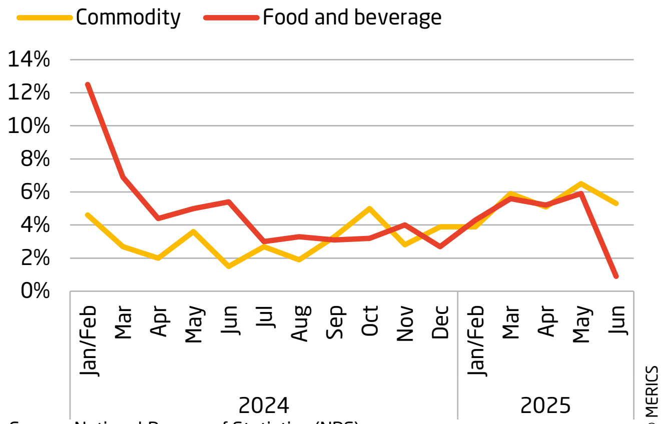
- Government measures taken since late 2024 helped to stabilize the labor market in Q2. However, despite modest improvements in headline employment figures, China's persistent structural and economic problems continue to cause concern. The authorities have responded with a new round of policies in Q2 in the hope of supporting employment and incomes to stimulate consumer confidence.
- Targeted labor market measures were issued during Q2 by the central bank and ministries (including the Ministry of Finance and the Ministry of Human Resources and Social Security) that included more job subsidies, further support for graduate and rural employment and vocational training programs. To stimulate job creation in consumption-related sectors like eldercare and education, the measures included expanded financial tools such as relending facilities and tax incentives.
- On the surface, job creation seems to be gradually improving. A total of 6.95 million new urban jobs were created in the first six months of 2025, slightly down from 6.98 million during the same period last year (see exhibit 1). While the slowdown reflects ongoing challenges, employment is broadly on track to meet the annual target of 12 million new urban jobs in 2025.
- Urban unemployment continued to decline throughout Q2, down to 5 percent in June from a peak of 5.4 percent in February. However, as the hiring season for new university graduates intensifies, youth unemployment remains high. Despite some improvement over the three months to end-June, youth jobless rates remain higher than during the same period last year.
- Amid economic uncertainty, companies remain cautious about expanding their workforce. The employment sub-index of the Purchasing Managers' Index (PMI) for the service sector remained flat at 45.5 in Q2, indicating an ongoing contraction (values below 50 signal a decline) in service jobs. The manufacturing sector fared slightly better, but after a modest uptick to 48.1 in May, the index slipped to 47.9 in June.

What to watch: Employment sentiment will need to improve for the new round of government support to be effective.

RETAIL

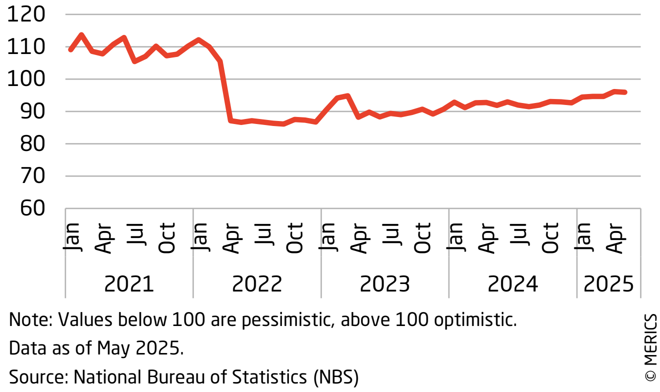
Household demand remains hooked on government support

Consumers begin to tighten their belts in June
Retail by type, yoy



Source: National Bureau of Statistics (NBS)

The rebound in household sentiment is progressing slowly
Consumption Willingness, sub-index of Consumer Confidence Index



Note: Values below 100 are pessimistic, above 100 optimistic.
Data as of May 2025.
Source: National Bureau of Statistics (NBS)

- Retail sales improved through much of Q2, with growth in May reaching 6.5 percent year-on-year, the fastest pace since November 2023. Solid sales in April and May lifted growth for the first half of the year to 5.1 percent. However, a slowdown in both commodity retail and spending on food and beverages in June highlights the ongoing challenges for retail to get on a more stable footing (see exhibit 1).
- Online retail sales cooled to 6 percent in June year on year after a peak in 2025 of 6.3 percent in May. Alternative data points from online retail platforms underlined consumption is losing steam. Sales at Tmall, Taobao and Jingdong accelerated a slowdown over Q2 and were down by 7.8 percent in June.
- The government's trade-in programs have been a key policy tool to support demand. Backed by this stimulus program, there was strong sales growth in household appliances (30.7 percent), furniture (22.9 per-cent), and mobile devices (24.1 percent) in the first half of 2025. These programs are expected to continue to support demand, with more central government funding scheduled for allocation to local governments in July and October as part of a CNY 300 billion package announced at the start of the year.
- Persistent weak consumer sentiment remains the biggest challenge to a more sustainable recovery in demand. Uncertainty is fueled by a mix of factors, from a weak labor and real estate markets to concerns about trade frictions. In this environment, consumer sentiment is improving at only a sluggish pace (see exhibit 2).
- The government stepped up its support in a bid to boost consumer sentiment and household spending. A comprehensive package announced by the People's Bank of China (PBOC) and six ministries includes a list of 19 targeted measures – they include ensuring financial support towards households and developing "new types" of consumption (e.g. green, digital, and health).

What to watch: The new, expanded support needs to improve household sentiment to establish consumption as a key growth driver.

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