QUARTERLY ANALYSIS OF ECONOMIC TRENDS IN CHINA

MERICS China Economic Indicators

China's economy in Q2: Domestic woes dampen growth as imbalances intensify

Q2/2026

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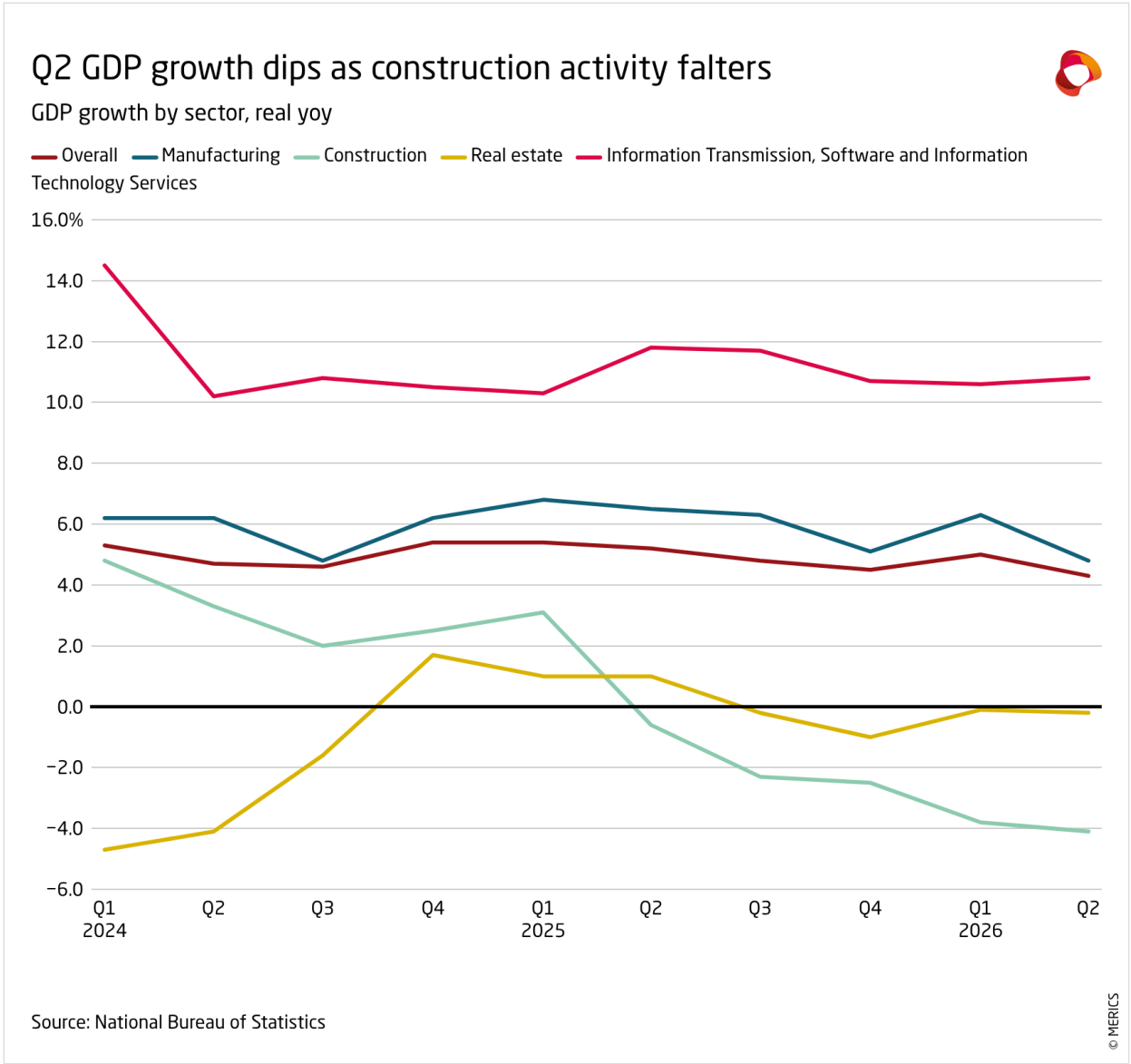
MERICS Q2 ANALYSIS

China's economy in Q2: Domestic woes dampen growth as imbalances intensify

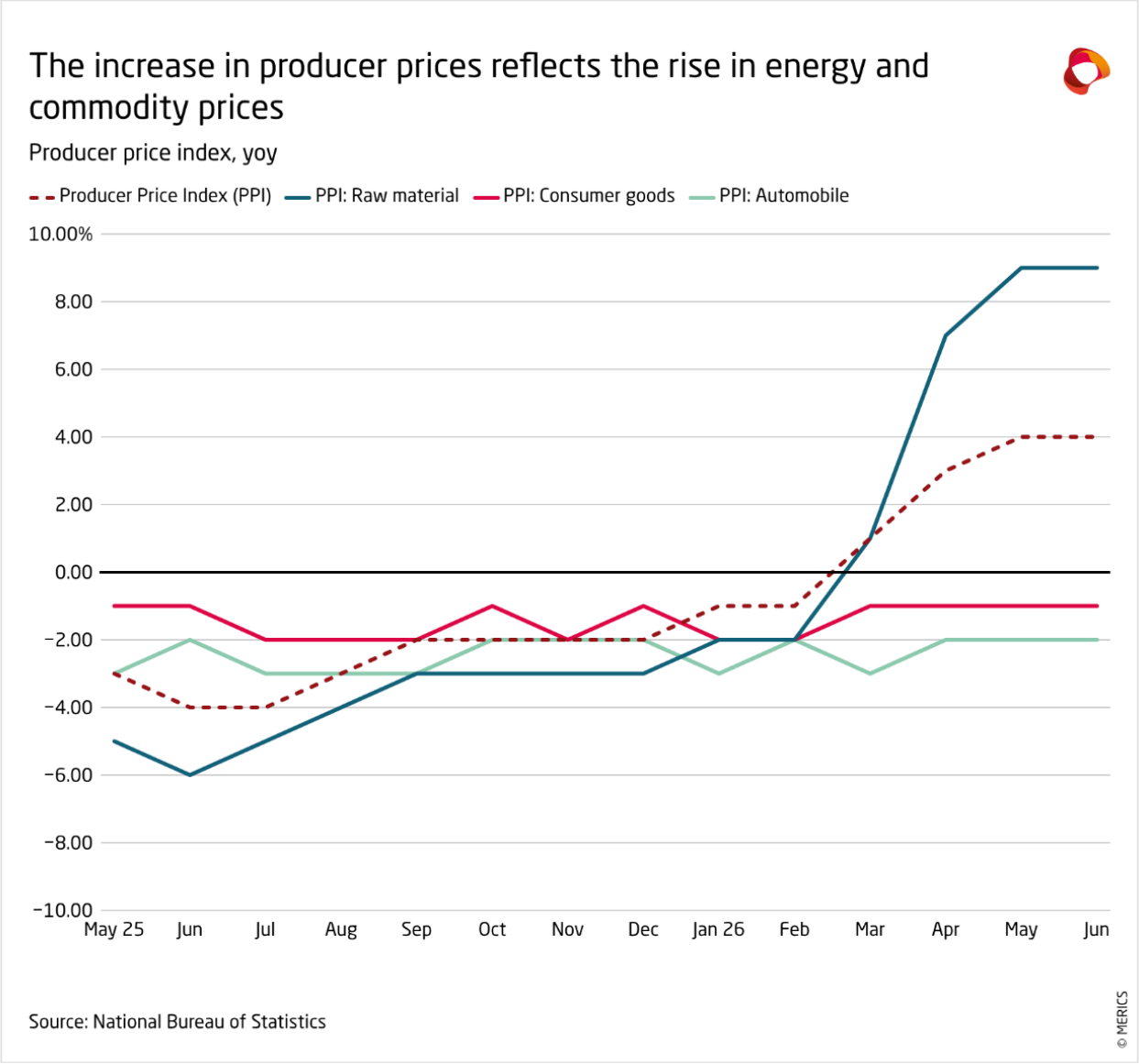
By **Alexander Brown, Andreas Mischer**

China's economy cooled considerably in the second quarter of this year. GDP growth slowed to just 4.3 percent, dropping from 5.0 percent in Q1, on a sharp fall in investment and sluggish consumption. China's exports continued to grow, delivering crucial momentum for an otherwise flagging economy. As China's structural imbalances intensify, China's leadership will need to act if it wants to keep its annual growth target of 4.5-5.0 percent in sight. Overall growth in the first six months was 4.7 percent and is trending downwards, so some form of additional fiscal support is almost guaranteed. But so is continued growth in exports, implying EU-China trade tensions will remain high.



Cash-strapped local authorities and households spend less

The main factor dragging down GDP growth was nosediving fixed-asset investment (FAI). It dried up as the state-led push in Q1 to promote spending on infrastructure, and by state-owned enterprises, fizzled out. Overall FAI declined by 5.7 percent in H1, with impacts across many sectors. Real estate investment dropped by 18.0 percent, the largest contraction for a half-year on record. But FAI also fell in road building, education, healthcare, and construction. This suggests the funds of already cash-strapped local governments, which would normally shoulder a hefty share of infrastructure spending, have dried up.



Ominously, China's multi-faceted economic imbalances are becoming more entrenched. Domestic car sales collapsed by 16.1 percent in June year on year, reflecting weak consumer confidence and suppressing headline growth. Excluding car sales, consumption grew by 3 percent, nothing to cheer about, but better than June's aggregate increase in retail sales of 1.0 percent. The 4.1 percent increase in producer prices recorded in June does not signal improving domestic demand, but rather higher global prices linked to the AI boom and upheaval in the

Middle East. Energy-intensive sectors, suffering from higher input prices due to the war in Iran, showed significant price hikes, while prices in other areas kept declining.

Though manufacturing output is holding up overall, regional disparity is increasing. Some provinces like Jiangsu and Zhejiang – hotspots for flourishing sectors such as semiconductors, biotech and robotics – have recorded substantial growth in manufacturing value-added. By contrast, China's northeast saw manufacturing decline. Growth is thus becoming narrower in terms of sectors and regions and entrenching inequality, something policymakers know but have not yet addressed.

Foreign demand for Chinese goods shows no limits

Although China's domestic economy is in the doldrums, its international trade remains strong. Exports increased by 27.0 percent in June and imports by 36.0 percent on a USD value basis. High-tech products performed particularly well, suggesting China's export boom still has significant room for growth: mobile phone exports rose 21.2 percent in June and automotive exports surged by 70 percent. While export volumes have grown, import volumes have remained largely flat. Rather than importing significantly more goods, China is simply paying more for them due to rising prices for commodities and high-tech products.

Recent months have delivered important foreign policy wins for Beijing that bode well for China's exporters. Firstly, the meeting between presidents Donald Trump and Xi Jinping in May provided some relief in the US-China trade conflict, delivering some tariff reductions and deals signed on Boeing aircraft and agricultural trade. Although the summit fell far short of any breakthrough, it calmed the waters and gave China space to continue its drive for self-reliance.

Second, China has successfully navigated the shockwaves from the turmoil in the Middle East. Its energy system has shown remarkable resilience. The secure positioning of China's oil supply was evident from the drop in oil imports in May. Earlier stockpiling and high inventories enabled China to curb its oil purchases to avoid high prices on global markets. Still, China is not completely immune and is far more exposed to the secondary shock on oil and natural gas related goods. For instance, Beijing recently suspended exports of helium – a crucial input for semiconductors – to safeguard domestic supply. Given the fact that hostilities between the United States and Iran reignited in early July, shipping disruptions could still lead to further price increases in China and dampen global demand for Chinese goods.

China is too reliant on exports to budge in EU trade negotiations

If recent patterns hold true, Beijing will announce new measures to support growth before the year's end, in response to the downturn in Q2 and international uncertainties. We can expect additional funding for major projects, channeled via local governments, such as the extra 500 billion CNY announced in September last year that supported projects covering the digital economy, AI, urban renewal efforts, etc. This would help generate additional short-term growth and cushion the decline in fixed asset investment. But doing so would add to government debt, which policymakers have been striving to keep in check. A Politburo meeting in late July will likely provide clues on Beijing's plans.

Even with the surge of exports, Beijing will need to aim for at least moderate growth in consumption and investment to avoid a broad-based slowdown and keep its growth target within reach. Net exports accounted for 20.9 percent of GDP growth in Q2. As imports are also at elevated levels, exports will struggle to make up a continued shortfall in investment and consumption. And yet serious steps to boost consumption are not on the cards. Beijing's professed commitment to raising household spending is a long-term goal which would require difficult structural reforms. Even substantive reforms would take several years to have an impact.

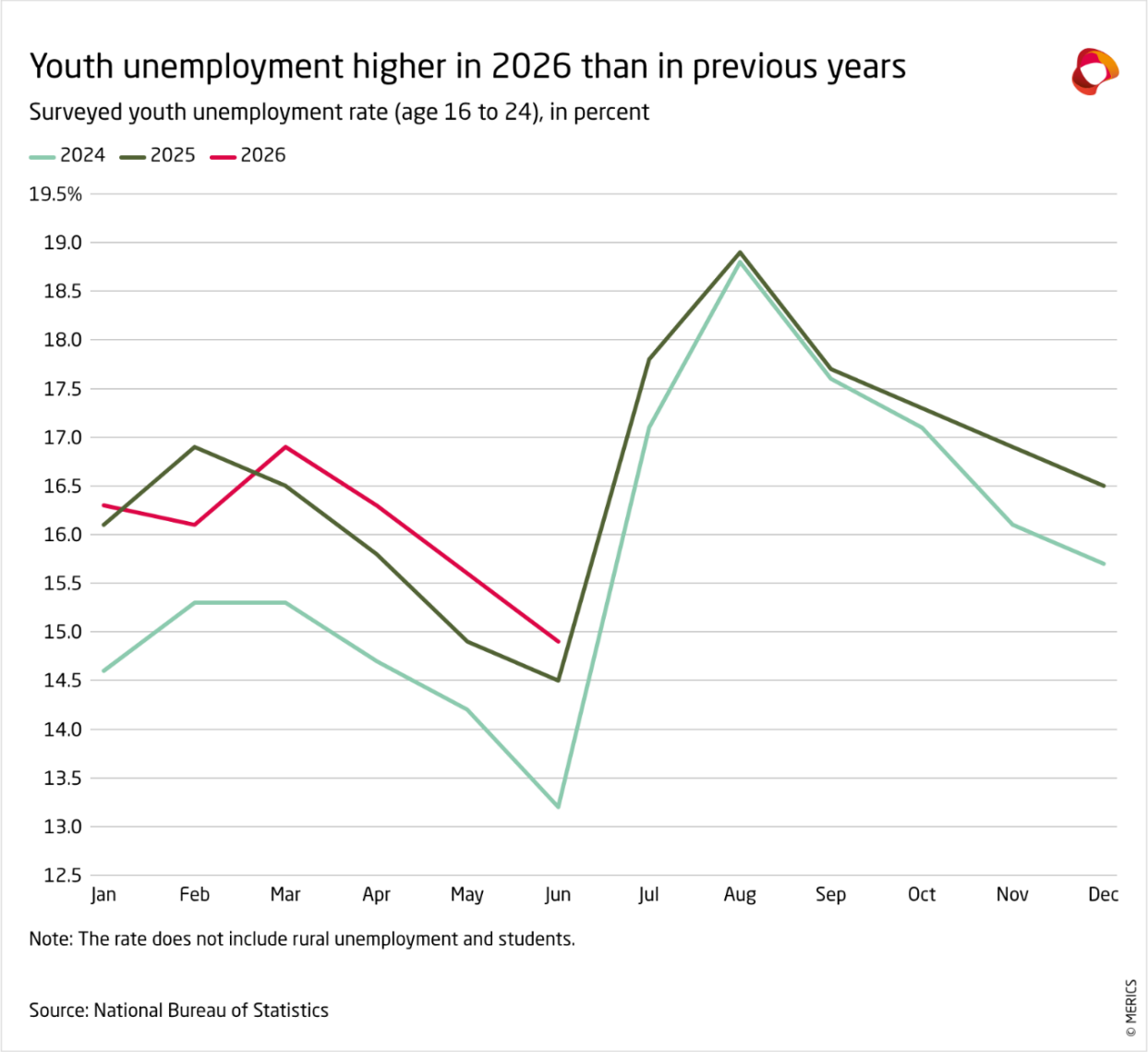
Consequently, while the government will continue to pay lip service to boosting consumption, its main goal will be supporting exports for the rest of the year. This can generate an immediate economic boost, without expanding debt – a win-win for China. Industries in foreign countries are left to bear the cost. The growing inflow of Chinese goods to Europe has catalyzed a review of the EU's trade defense toolbox. Even the German government has dropped its usual caution about criticizing distortions generated by Beijing's industrial policy to speak more candidly on China's unfair trade practices. However, EU policymakers should not expect any concessions from Beijing during discussions on trade and investment. Given the economic pressures it faces at home, China is likely to be as intransigent as ever.

Beijing is failing to meet the challenge of weak domestic demand

By **Esther Goreichy** and **Sophia Pradels**

China's leadership set a feasible-sounding 2026 economic growth target of 4.5 to 5 percent during the National People's Congress in March. Yet they have done little, so far, to tackle a structural imbalance that threatens economic growth in the long run: consumption remains weak, so Beijing relies heavily on exports to drive growth.

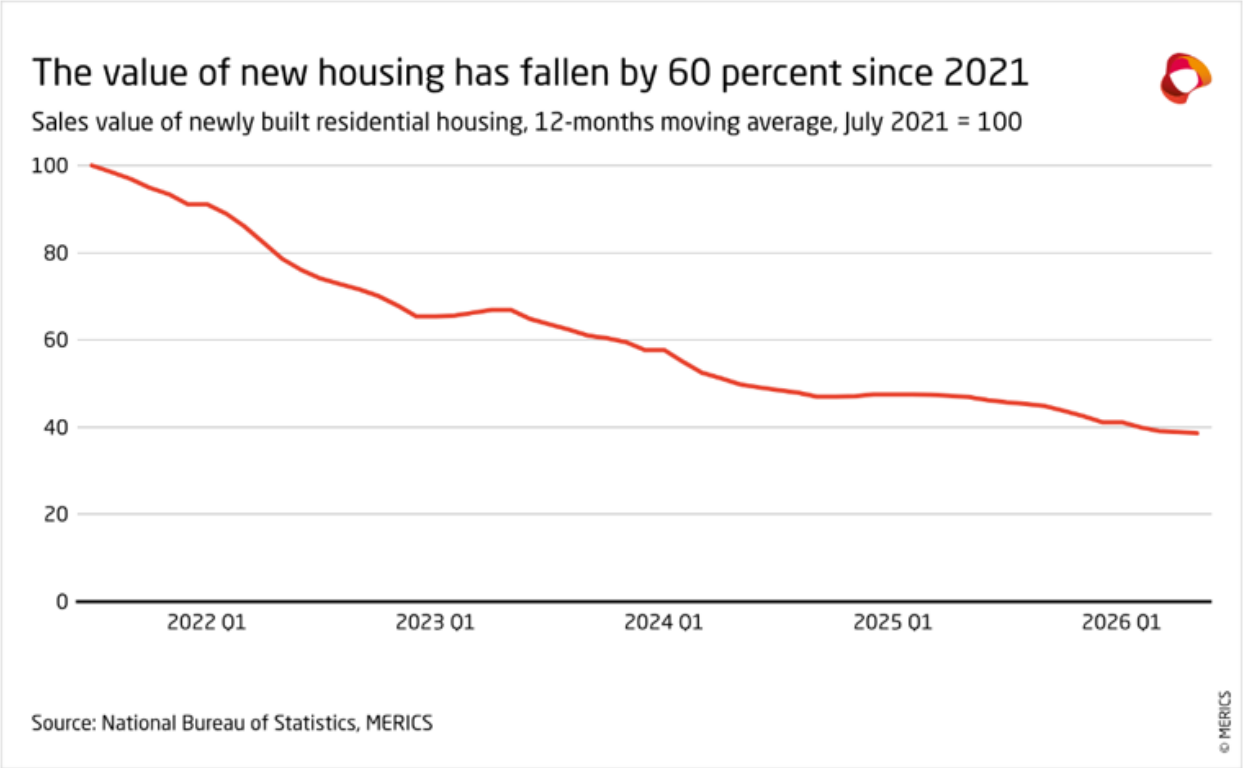
There has been much lip-service to rebalancing the economy toward consumption. In 2020, the idea was codified in Xi Jinping's explicit call for protective self-reliance. His so-called Dual Circulation Strategy (国内国际双循环) promotes a mix of more domestic consumption and innovation-driven growth, to reduce China's dependence on external demand. But this has not materialized. Net exports contributed 1.6 percentage points to China's GDP growth in 2025, or nearly one-third of the total, and still 0.8 percentage points in H1 2026.



China's weak consumption is rooted in structural features of the economy; a weak labor market, a persistent real estate crisis and limited social safety nets. These show no sign of easing. A record 12.7 million students will graduate from Chinese universities in 2026, roughly 4 percent more than 2025's record cohort. Competition for high-skilled jobs will be intense; youth unemployment was already at 15.6 percent in May. Only 21 million jobs were created in the last five years, less than half the total for the preceding five years. Poor graduate employment prospects ratchets up the economic pain for China's middle class. Middle-aged workers have to support their working age children and aging parents when the real estate investments they used to rely on keep losing value.

The ongoing decline in home prices has far-reaching consequences for the middle class. Many households are still repaying mortgages agreed when property valuations were significantly higher. The financial burden restricts other spending and creates psychological pressures.

These structural issues feed prolonged public pessimism about economic prospects, so people spend less, thereby reinforcing weak consumption. This pessimism is visible in a recent online trend where young consumers share their extreme money-saving strategies.



Efforts to restore household confidence remain marginal

Policy signaling ahead of the release of the 15th Five-Year Plan (2026-2030) in March raised hopes that serious efforts would be made to strengthen the domestic market through increased social transfers and household support.

However, consumption-boosting policies have been far too limited to match this ambition. The 15th Five-Year Plan lists "building a strong domestic market" as a top priority but puts it third, after modernizing the industrial system and pursuing technological self-reliance and leadership.

Ambitious steps like increasing the monthly pension for rural residents or hiking up salaries would imply diverting resources from the first two priorities, already identified as strategic. Beijing has not signaled that it is about to make that switch. Such actions might resemble the "welfarism trap"（福利主义的陷进）decried by Xi Jinping.

Consumption-boosting measures since 2025 have shown only incremental progress on structural issues. They have largely focused on short-term economic measures to boost the supply side and stimulate demand, such as trade-in subsidies for buyers of big-ticket items.

None of the moves aimed at China's structural issues (low incomes, the limited social safety net and weak labor market) come close to the necessary and costly reforms. Despite regular minimum wage rises across most provincial jurisdictions in 2025,[1] the monthly minimum wage is still between 2,740 and 2,070 CNY (352 to 266 EUR). The average monthly pension is only 246 CNY (31 EUR) for urban unemployed and rural populations and 3,825 CNY (492 EUR) for retired urban workers. As for the nationwide rollout of direct childcare cash transfers for newborns, the sum remains trivial for higher-income regions, though in lower-income ones like Henan Province it can equal at least half the median monthly salary.[2]

Even with increasing pressure from the central government to guarantee public services for all registered permanent residents, including those without a local household registration or *hukou*, implementation will prove difficult for debt-ridden local governments. Employment support measures consist of broad calls to support youth and vulnerable groups (like gig workers) that lack meaningful detail.

All the signs show the government is sticking to its usual playbook of lifting consumption through short-term measures, aimed mainly at the supply-side. Any demand boost should come from firms investing to upgrade their supplies of goods and services, such as electric vehicles, AI-enabled home appliances, travel and elderly care services. There is, therefore, little perceived need to increase welfare payments or wages.

The consumer goods trade-in program for vehicles, household appliances and electronics did initially help lift retail sales; they rose 3.7 percent year-on-year in 2025. Its impact is already waning. Retail sales fell to 0.6 percent growth in May this year, their first drop since 2023, suggesting a rush of one-off purchases rather than any meaningful rise in household spending.

Even the newly released five-year plan to expand consumption – the first of its kind – doubles down on this supply-side strategy. Responsibility falls on an already cash-strapped private sector to promote wage and employment growth, and to scale and upgrade its services and goods offering at an attractive price. Yet this also has drawbacks, as already-low prices constrain business performance and drag on wage growth and employment, further constraining household confidence and consumption.

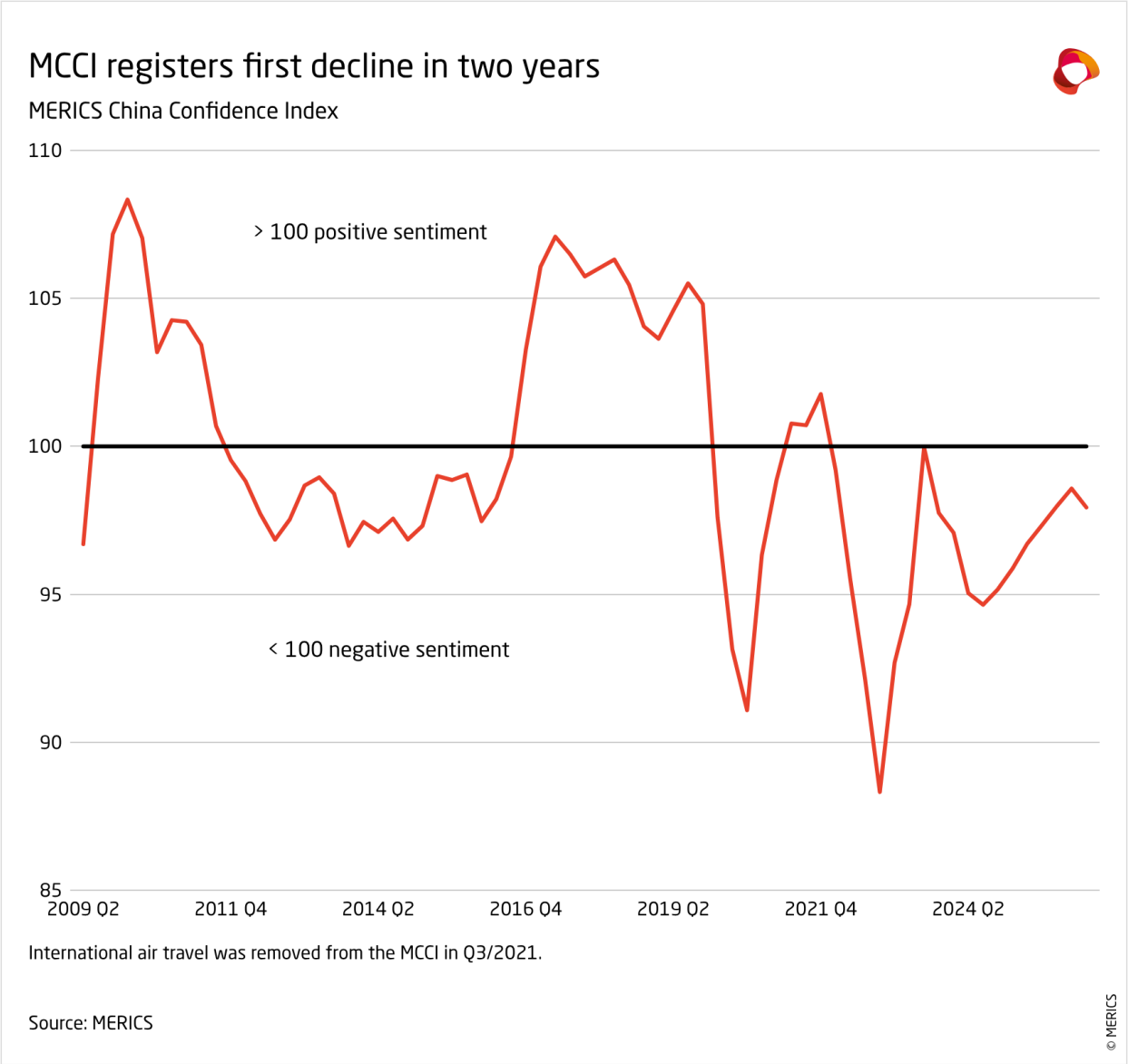
[1] The increases are determined at the local level and are regularly reviewed based on local living conditions and costs.
[2] The direct cash transfer is RMB 3,600 per child per year, until the age of 3. According to data from the National Bureau of Statistics, the average monthly salary in Henan is RMB 7,183 for urban non-private employees and RMB 4,218 for private enterprise employees.

Beijing is hosing down fires, not tackling their causes

China's leadership has clearly identified weak consumption as a structural problem, and is highlighting the issue in its rhetoric. But actual measures taken show that the priority remains to boost industrial demand and demand for services. Beijing has chosen to manage the weaknesses rather than tackle the underlying problems.

Beijing is likely to stick to its strategic choices to systematically prop up industrial enterprises over consumers. A true shift toward increasing social transfers and welfare benefits to boost spending would require a costly overhaul of the economy and re-shuffling of priorities which support the current export-reliant growth model. As long as third countries continue absorbing Chinese exports, Beijing will not need to change course.

MERICS CHINA CONFIDENCE INDEX (MCCI)



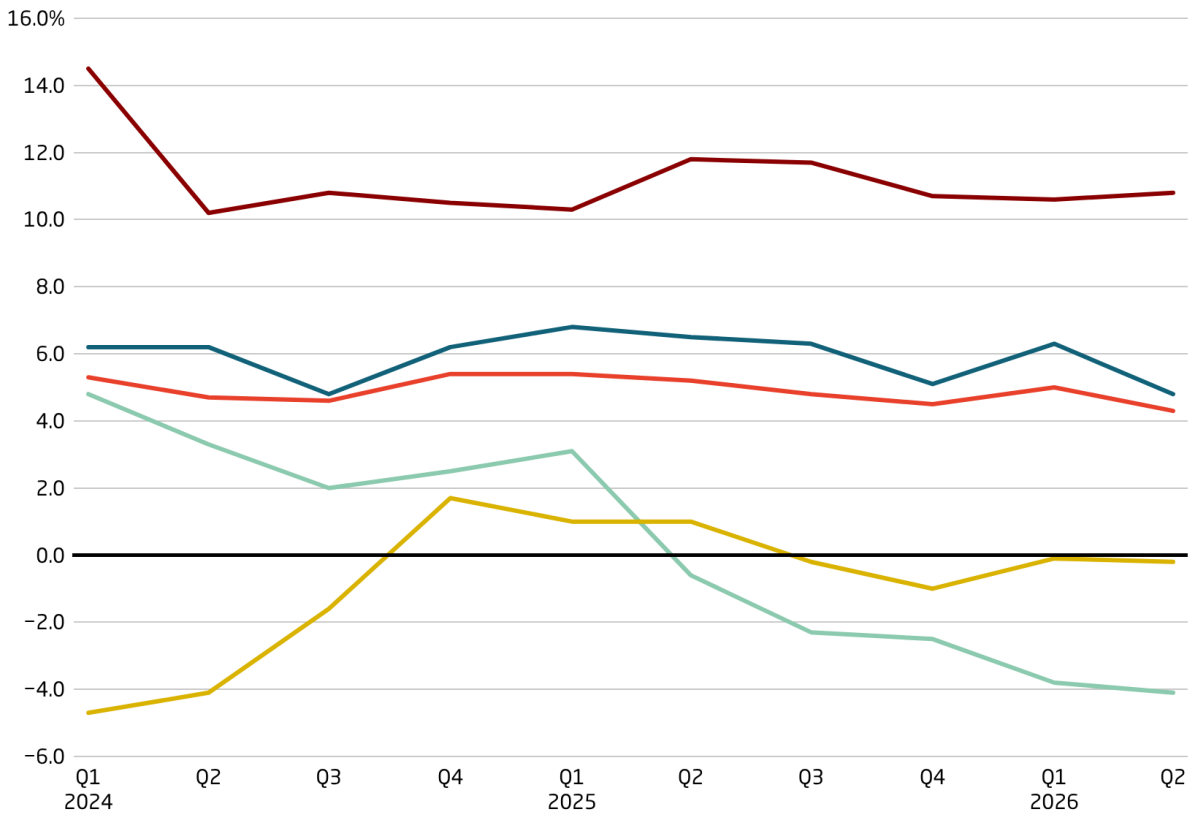
- **First decline in two years:** The MERICS China Confidence Index (MCCI) fell from 98.4 to 97.9 in Q2, its first fall since Q3/2024.
- **Broad-based slowdown:** The MCCI's decline reflected deterioration in other indices, such as new orders in manufacturing, new business in the services sector and consumption expenditure as a share of income.

The MERICS China Confidence Index (MCCI) – first developed in 2017 – 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 index is weighted between household and business indicators.

MACROECONOMICS

Q2 GDP growth dips as construction activity falters

GDP growth by sector, real yoy



Source: National Bureau of Statistics

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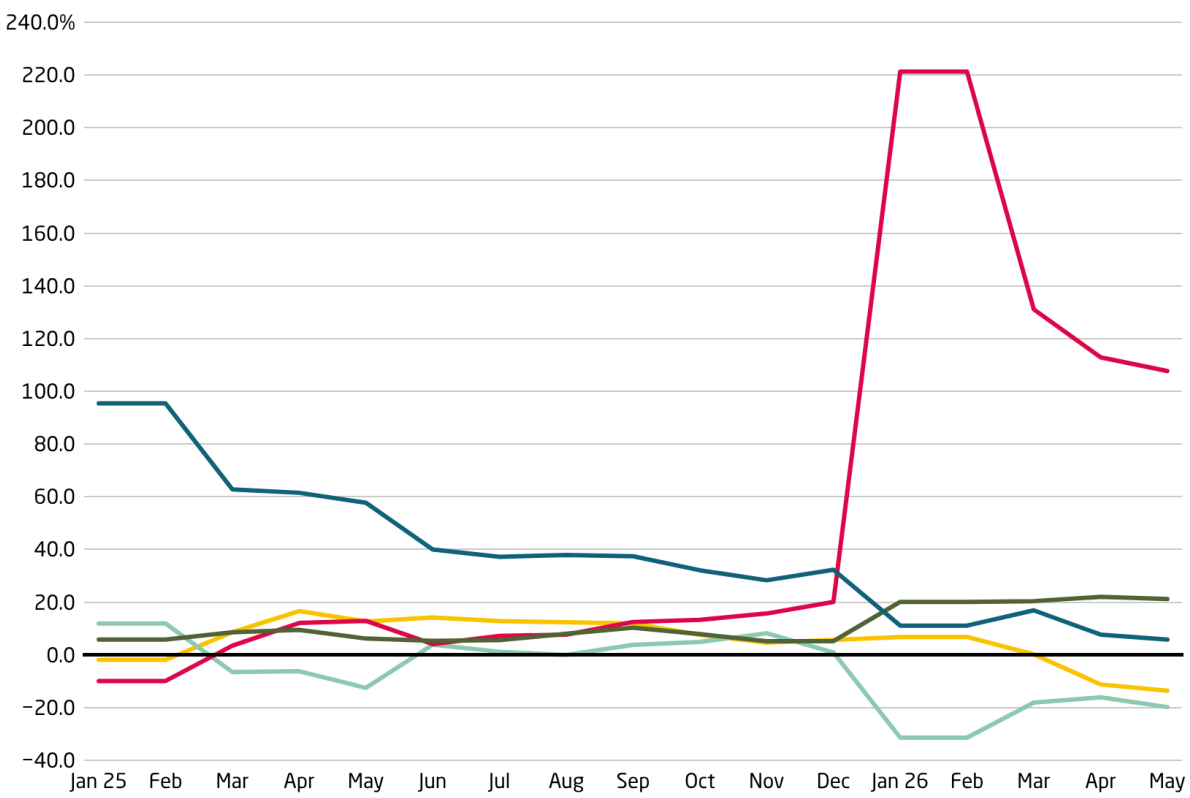
- **Growth weakens:** GDP growth was 4.3 percent in Q2, down from 5.0 percent in Q1 and the lowest value since Q4 2022. The fall was mostly due to a steep drop in activity in the secondary sector, where Q2 growth was just 3.0 percent compared to 4.9 percent in the preceding quarter.
- **Building paused:** Growth in manufacturing fell by 1.5 percentage points down to 4.8 percent in Q2, while construction activity contracted by 4.1 percent. The shrinking construction and stagnant real estate sectors have been important factors in the decline in investment levels over the last 12 months.
- **Patchy progress:** However, growth in the tertiary sector remained robust, up 5.1 percent in Q2. Software and IT services stood out as a major source of economic dynamism. This shows China's focus on high-tech sectors is delivering results, while leaving broad sections of the economy out in the cold.

INDUSTRY

Surge in ICT equipment income lifts overall manufacturing profits

Operating profit by sector, yoy, ytd



Source: National Bureau of Statistics

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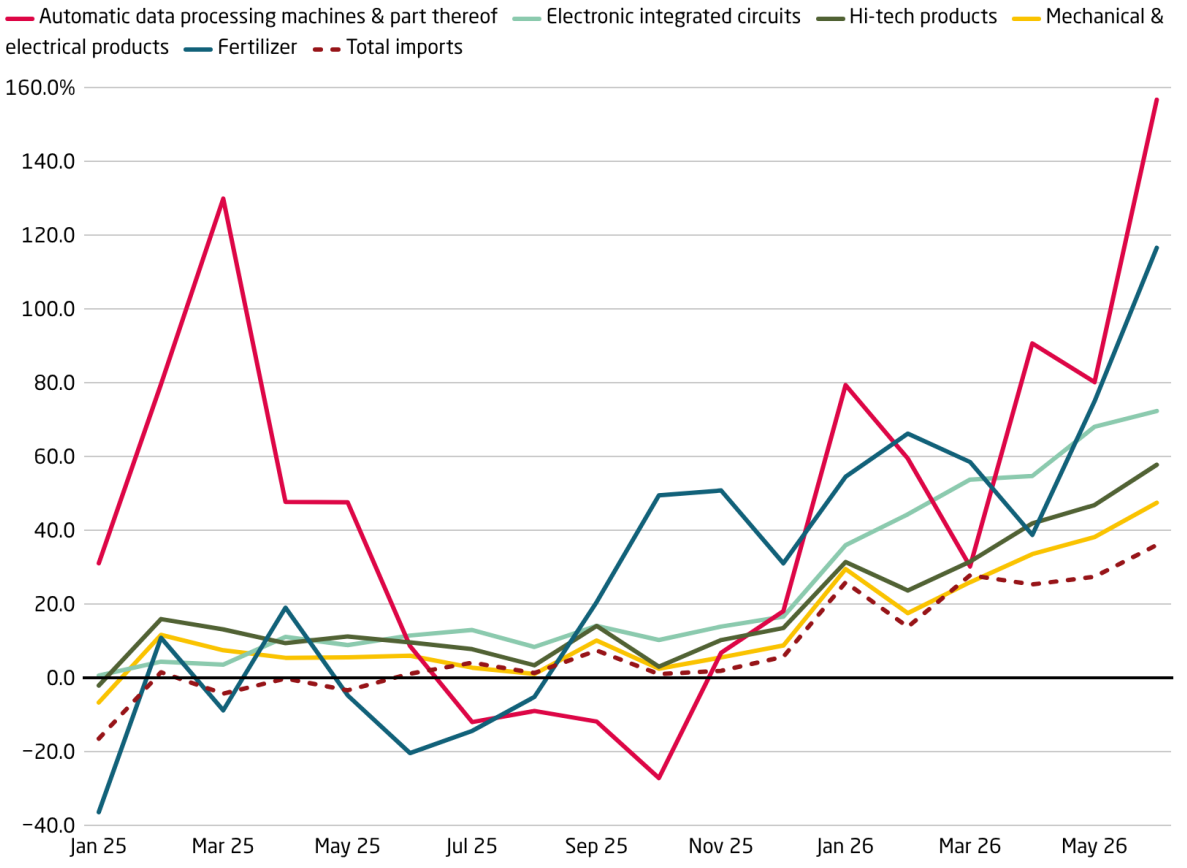
- **Bottom line:** Overall operating profits for industrial enterprises continued to rise in Q2, reaching 19.9 percent for the January-May period. But business conditions varied substantially by industry. Among the 41 sectors covered in the National Bureau of Statistics update, 22 recorded shrinking profits during the period January to May.
- **Irresistible chips:** Profits in the ICT sector rose by 108 percent. This huge growth is linked to the global AI boom, which has spurred demand for related technologies at home and abroad. China's value-added output of integrated circuits climbed by 23.1 percent and exports in USD terms rose 96.1 percent in the first half of the year.
- **Fierce foes:** Companies in the automotive sector have seen profits contracting by 19.8 percent. Ruthless competitive behavior among Chinese firms, referred to as "involution", has put downward pressure on profits in many sectors, including autos. More than ever before, European firms are likely to be confronted with Chinese firms willing to sell products below cost to gain market share.

INTERNATIONAL TRADE

Elevated prices for high-tech products and commodities boost imports

Value of Chinese imports in USD terms, yoy



Source: General Administration of Customs

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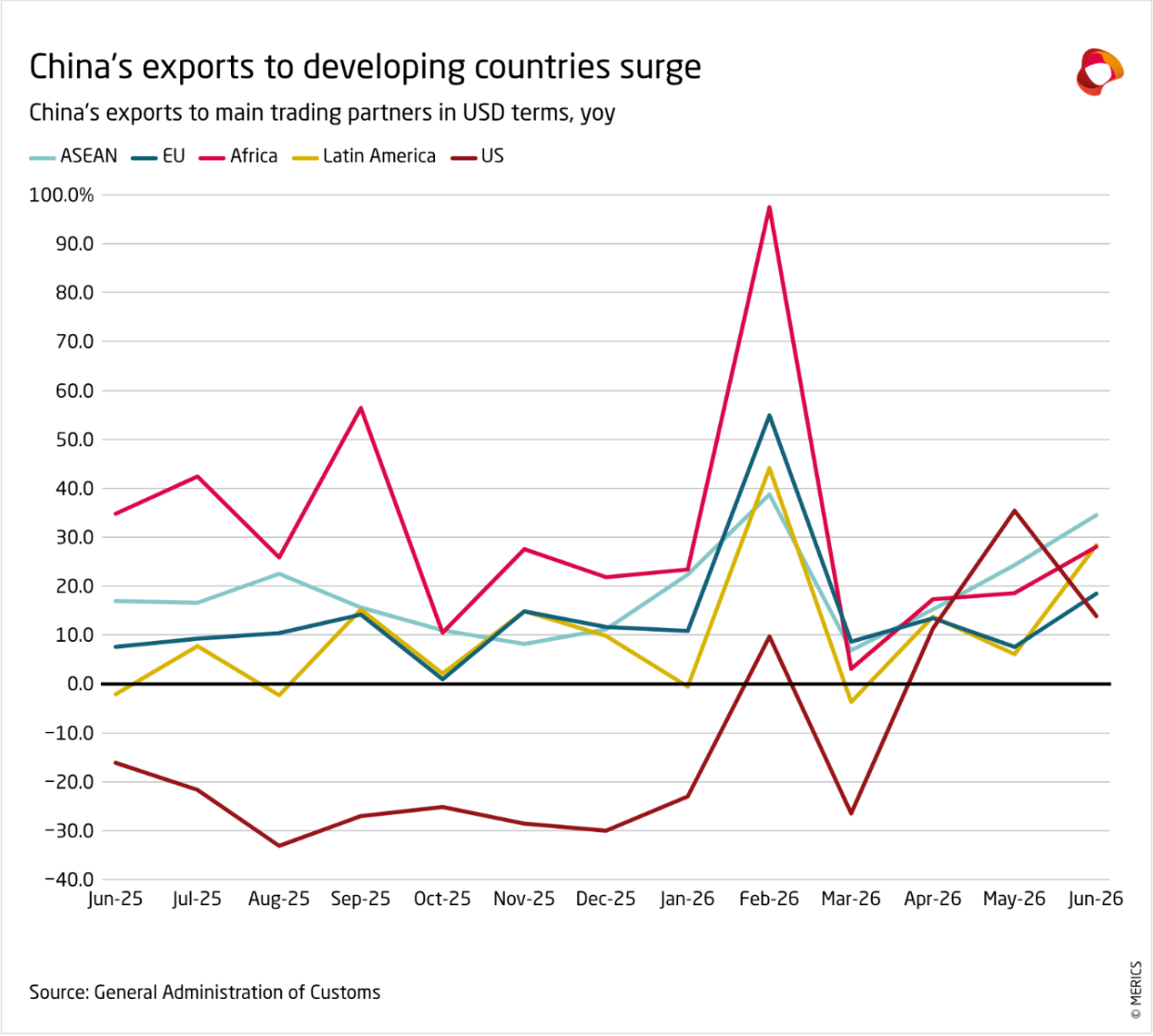
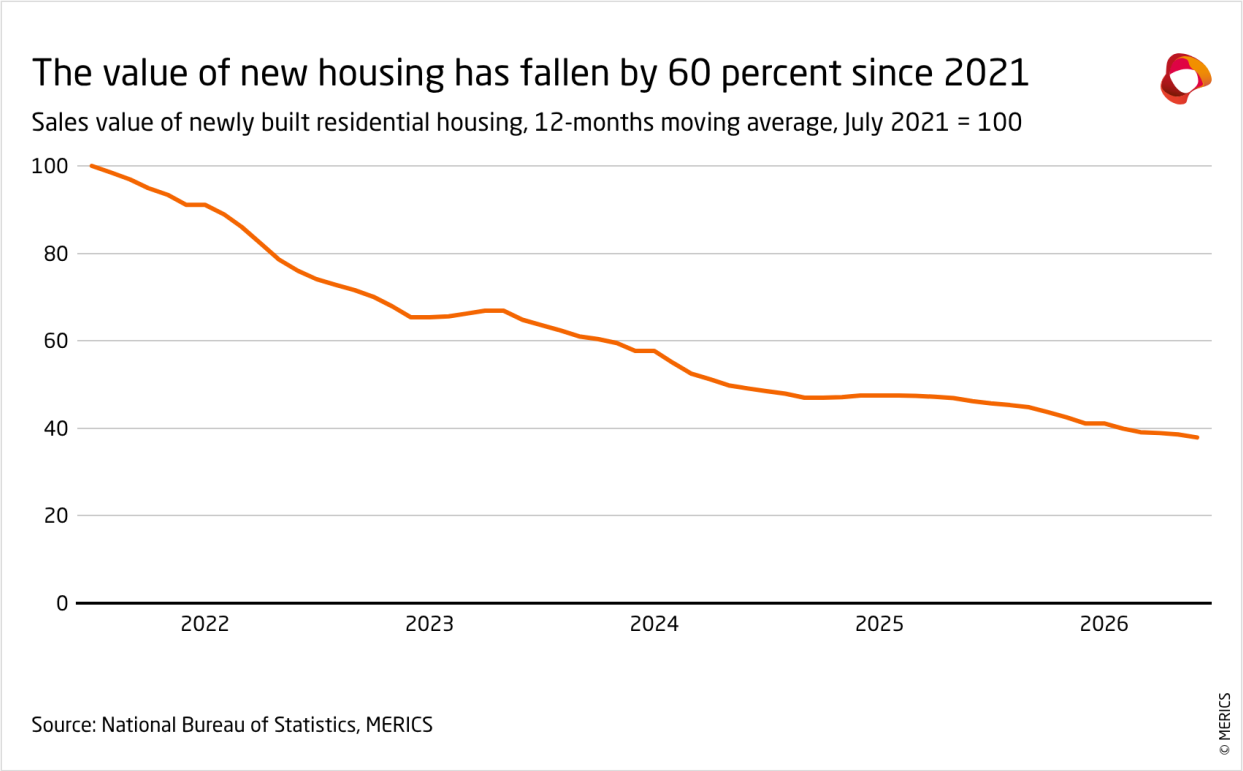
- **Value not volume:** China's surprise import surge did not reflect stronger domestic demand, being mostly driven by price effects. For example, in H1 the year-on-year increase in the import values of diode and similar semiconductors surged 12.4 percent, while electronic integrated circuits soared 55.8 percent. Volume growth rose only 1.8 percent and 8.1 percent respectively.
- **AI boom:** Rising prices for AI-related tech are driving China's rising import data. Semiconductor-related goods were the largest import category, as June imports from major chip manufacturers in South Korea and Taiwan soared 85 percent and 41.1 percent respectively.
- **High-tech exports high:** The export value of China's high-tech products jumped 52.3 percent year-on-year in June, with particularly strong growth in electronics and integrated circuits. Electric vehicle exports also surged, up by over 100 percent by volume and value in June.



- **Fast growth from a low base:** Exports to Latin America and Africa both grew by more than 28 percent in June, though from a low base, while exports to the EU grew by 18 percent. In absolute terms, exports to Europe and Asia were far more valuable; H1 exports to ASEAN totaled 396.23 billion USD and those to the EU 312.26 billion USD, whereas Latin America totaled 159.43 billion USD and Africa 130.01 billion USD.
- **Mixed bag:** Exports to Africa, Latin America, and ASEAN in Q2 grew 21.4 percent, 15.9 percent and 24.6 percent respectively, on sales of intermediate and capital goods, such as machinery, manufactured goods, electronics and vehicles and, increasingly, cleantech. This trend is widening China's trade surplus with Vietnam, which grew by 12.8 percent in H1.
- **EVs surge:** EVs are powering China's exports to ASEAN, hitting a record 1.2 billion USD in May, prompted by sharp fuel price increases caused by the war in Iran. Chinese OEMs are rapidly expanding their footprint, squeezing out European suppliers.

HOUSING

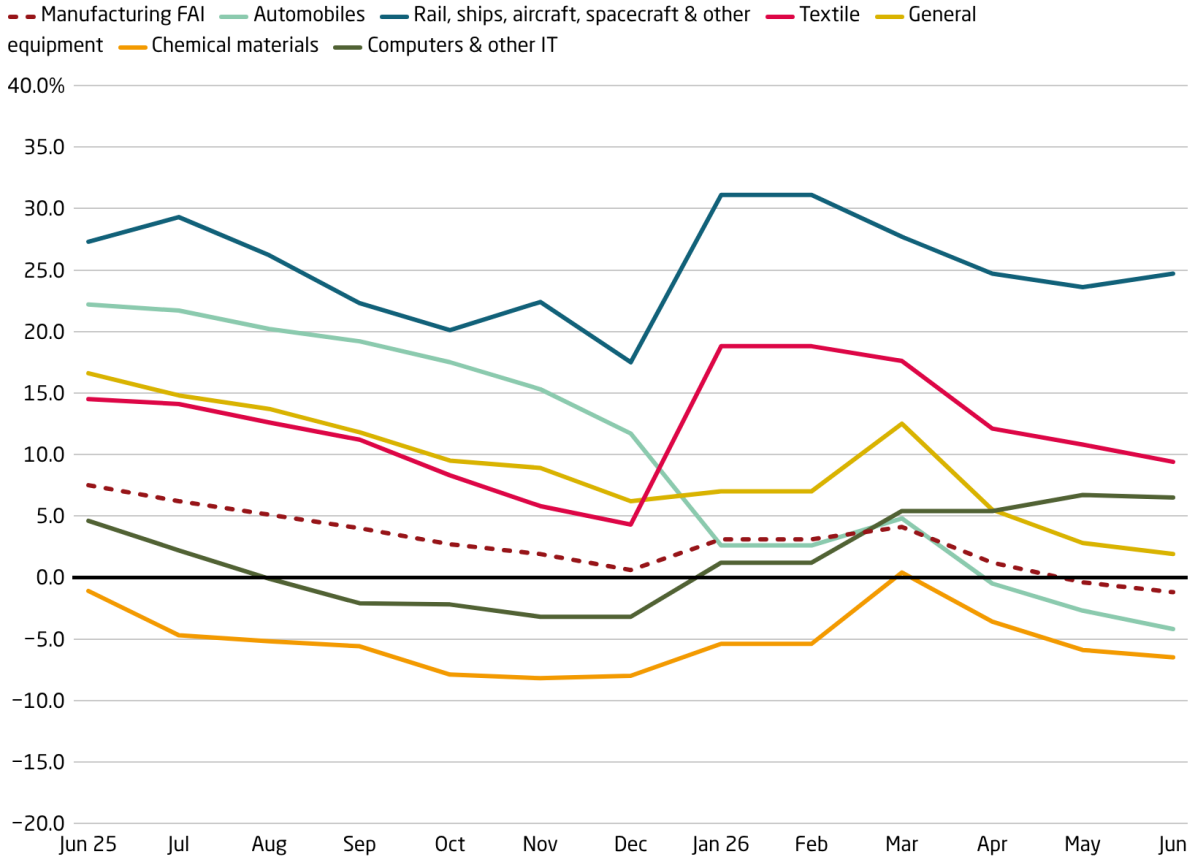


- **The real estate crisis deepens:** New-home prices fell 3.3 percent year on year in June, marking the fifth year of falls in the market. New-home sales value has fallen by around 60 percent since July 2021. Prospects remain weak, with real-estate development investment down by 18.0 percent year on year in H1 2026. Many households are still repaying mortgages agreed when property valuations were higher, so their financial burden restricts fresh spending. Falling land-sales and tax revenues are tightening local governments' already constrained budgets.
- **Squeeze on middle-class tightens:** The ongoing decline in residential sales value is painful for China's middle class, as investment gains melt away at a time when their working age children are struggling to find jobs and aging parents need support. The bleak mood encourages precautionary saving and dampens consumption.

INVESTMENT

Manufacturing FAI turns negative, but investments stay high in key subsectors

Fixed asset investment within manufacturing, ytd yoy



Source: National Bureau of Statistics

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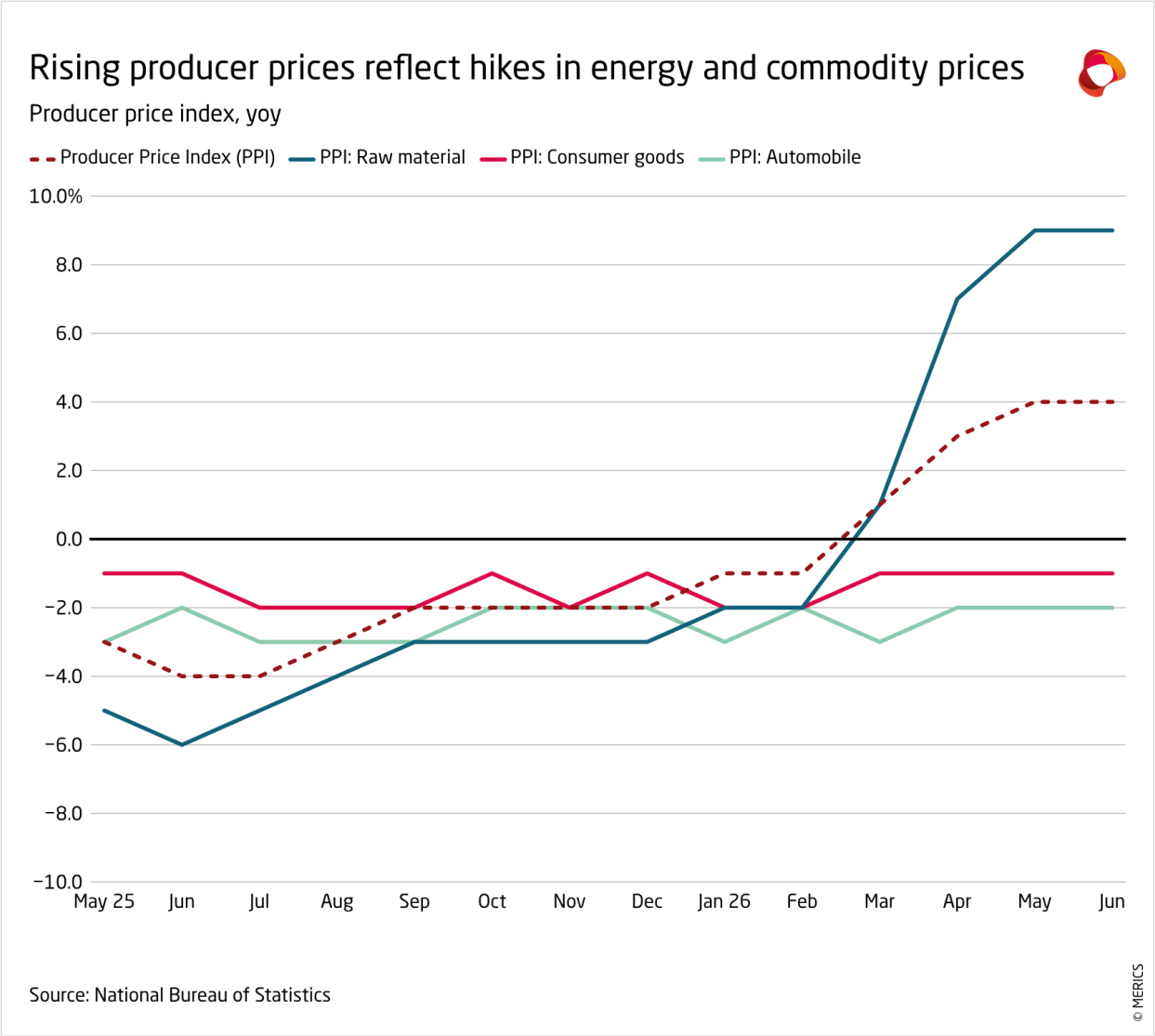
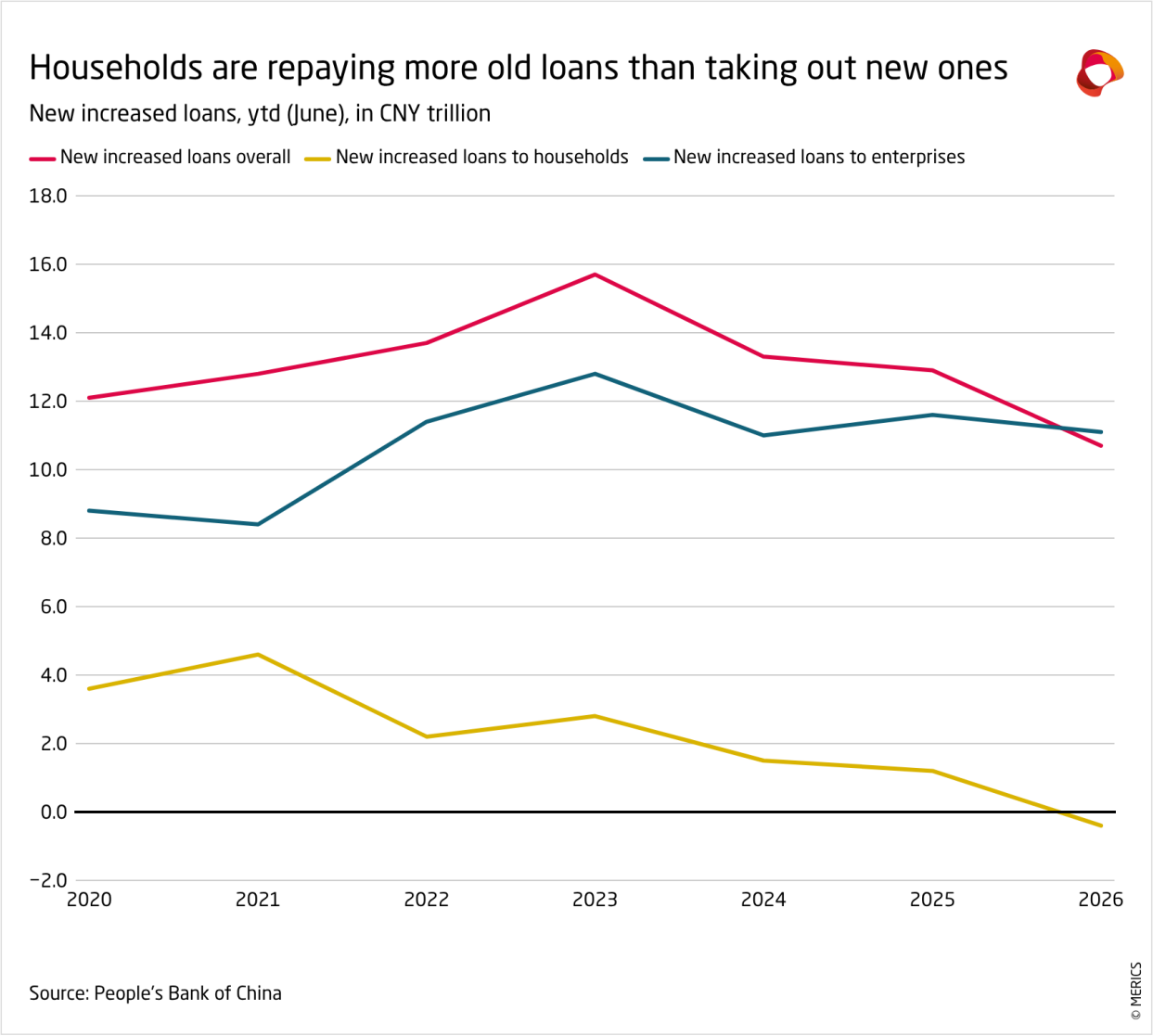
- **FAI decreases again:** Overall fixed asset investment (FAI) fell by 5.7 percent in H1 compared to a year earlier, returning to the pattern of decline seen since last September, after a brief increase in Q1.
- **Manufacturing investment loses momentum:** Alongside a 8.4 percent drop in services, manufacturing FAI dropped for the first time since the start of the COVID pandemic in 2020. Manufacturing investment (usually a strong contributor to overall FAI) fell 1.2 percent year on year in H1, a bad sign for economic growth.
- **Industrial modernization continues:** Manufacturing sectors deemed strategic by Beijing, such as IT manufacturing, rail, aerospace and aircraft manufacturing, continued to benefit from investment. Rising investment in equipment and textiles suggests China's industrial upgrading efforts have not waned and are reaching into traditional industries too.

PRICES



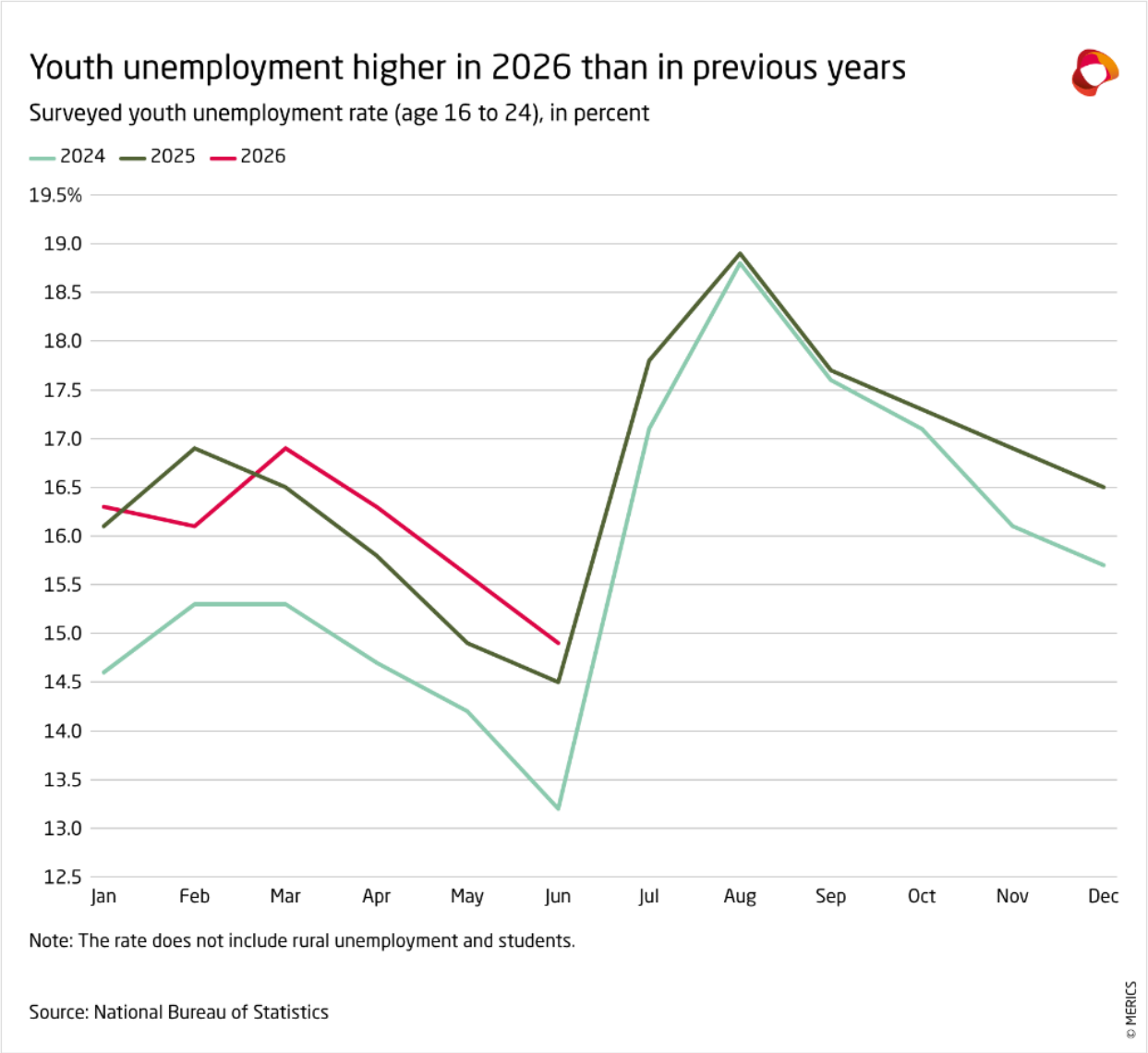
- **Overall PPI and CPI rises driven by higher input prices.** Producer prices (PPI) showed a 4.1 percent increase in June after nearly three and a half years of declines. Likewise, consumer prices (CPI) also showed a modest rise, with a 1.0 percent increase year-on-year in June. However, these gains do not point to recovery in domestic demand; they reflect higher energy and commodity prices caused by the conflict in the Middle East
- **Prices in consumer-oriented sectors keep dropping.** Prices continued falling in most consumer-oriented sectors, such as automobiles, consumer goods or pharmaceuticals, suggesting Beijing's measures to fight overcapacities have not shown results. Electronic equipment was the only major sector with a meaningful price rise (3.3 percent yoy in June) due to demand from the AI boom.

CREDIT



- **Households reluctant to borrow:** For the first time on record, in 2026 Chinese households have repaid more old loans than taken out new ones on a year-to-date basis for the January to June period. New increased loans to households amounted to minus 367 billion CNY at the end of June. The discrepancy was even larger for household loans used for consumption, which stood at minus 1.12 trillion CNY.
- **Weak consumption:** Households remain reluctant to consume. The NBS consumer confidence index is lingering at historically low levels. It stood at 89.9 in May 2026, unlike the entire period on record before 2022, when it was always above 100. The unresolved real estate crisis, weak wage growth, and high youth unemployment are all weighing down consumer confidence.
- **Strong enterprise lending:** New increased loans to enterprises remained steadfastly in positive territory, with new loans surpassing repayments by 11.1 trillion CNY.

LABOR MARKET

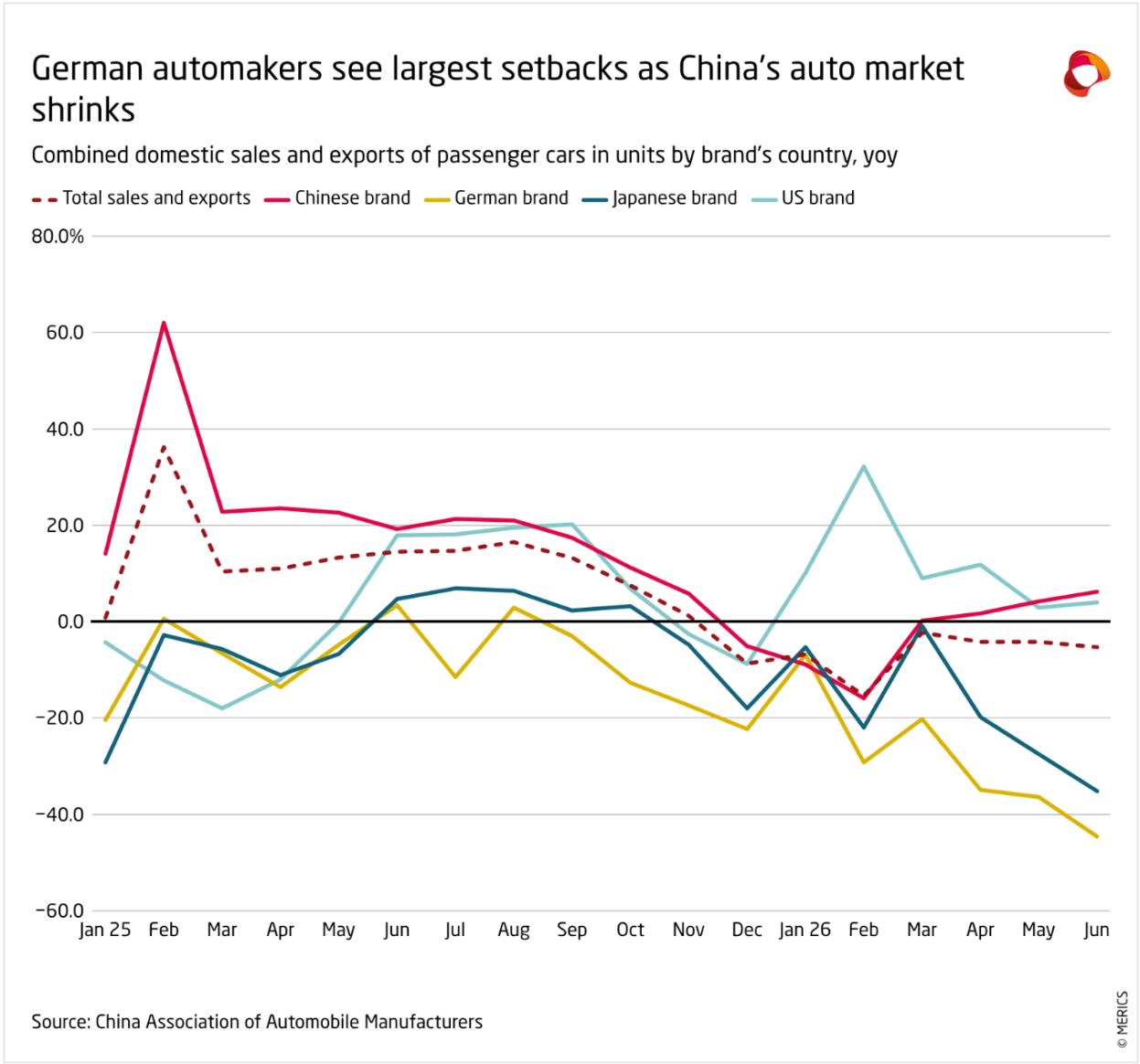


- **Youth unemployment is rising:** It stood at 14.9 percent in June 2026. Although this was less than in previous months, it was higher than at the same time of year in 2025 (14.5 percent) and 2024 (13.2 percent), suggesting that from year to year, youth unemployment is increasing.
- **Hiring is slowing:** This matches developments in hiring, where the number of newly added jobs between January and May has been steadily decreasing for nearly two years, from 5.65 million in 2024 to 5.58 million in 2025 and down further to 5.56 million in 2026.
- **Pressure will increase further:** Ominously, youth unemployment is set to rise again, as 12.7 million new university graduates enter the labor market this summer, roughly four percent higher than last year. Youth unemployment traditionally peaks in August, so the question is how high this year's peak will be and how much pressure will be put on the labor market as a result.

RETAIL

- **Weak demand:** Retail sales only grew 1.3 percent in H1, with particularly weak growth in Q2. Retail sales are likely to continue losing steam throughout the year, dragging down overall growth and exacerbating China's reliance on exports.
- **No splurging:** Automobile and furniture sales continued their decline in June, with autos down 16.1 percent and furniture sales dropping 6.6 percent. Declining demand across these categories shows household's weak appetite for big ticket items.
- **Connecting the rural areas:** Rural consumption is proving more resilient than in urban areas and outpaced urban consumption by 1.3 percentage points in H1. Rural consumption is likely buoyed by lower living costs and the development of rural e-commerce, thanks to improved Internet access and logistics infrastructure.

AUTOMOBILE



- **Domestic sales down:** The number passenger cars sold and exported by manufacturers located in China fell by 5.3 percent in June and by 6.0 percent in H1 overall. In the first half of the year, domestic sales of passenger cars were down by 20.4 percent due to reduced subsidies and weak consumer sentiment. Surging passenger car exports, up 70.6 percent in H1, were not enough to make up for the loss of sales in China.
- **German automakers hit hardest:** Chinese brands weathered the storm, registering a 6.2 percent increase in the number of cars sold or exported in June. German brands have fared most poorly, with sales and exports from their China operations down 44.6 percent in June and trending downwards. The disappointing performance comes despite huge investments made in production and development by German automakers in China in recent years.

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