# China has its eyes on long-term strategic objectives, not on current weak economic growth.

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## Introduction

Economic growth is soft, external challenges rise, but China stays the course. This is essentially the conclusion that can be drawn after the Third Plenum and the most recent economic data. The focus of Xi Jinping is not on trying to maximize short-term economic growth, but rather on continuing the transformation and modernization of the economy. As Donald Trump looks set to return to the White House with a new set of tariffs in his MAGA cap, as Europe eventually raises trade barriers of its own, as sanctions on Russia redefine energy and commodity trade flows, China is central to the ongoing emergence of a new world economic order.

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In the context, weak growth like the one pictured by the latest GDP and retail sales data may be an acceptable price to pay for getting rid of past excesses and imbalances such as real estate and local government debt. The export-led growth model that has made China the world's second largest economy remains a powerful and useful driver that has been balancing domestic weakness so far this year. But this growth driver will be increasingly challenged in the future as geopolitics and protectionism redefine global trade flows.

As such, China currently looks like an economy trying to prepare and get ready for the new world order that is taking shape. In this new world order, global trade no longer rhymes with free trade. In this new world order, "opening to the outside world", one of the basic state policies reiterated during the Third Plenum, does not mean "opening to the Western world". In this new world order, "the resilience and security of industrial and supply chains" (another objective stated during the Plenum) requires securing new alliances and partnerships that also allow to move forward on strategic objectives. In this new world order, economic growth must be led primarily by a dynamic and resilient domestic demand.

Those long-term objectives, repeated this week at the end of the Plenum, put recent economic developments in perspective. The authorities remain "firmly committed" to reach the 5% GDP growth target set for 2024 and certainly have the means to do so, via some selected fiscal or monetary policy support. But they have no interest in engineering a short-term economic recovery. China has its eyes on the long-term and prepares for the future.

## Domestic activity still undermined by falling real estate prices.

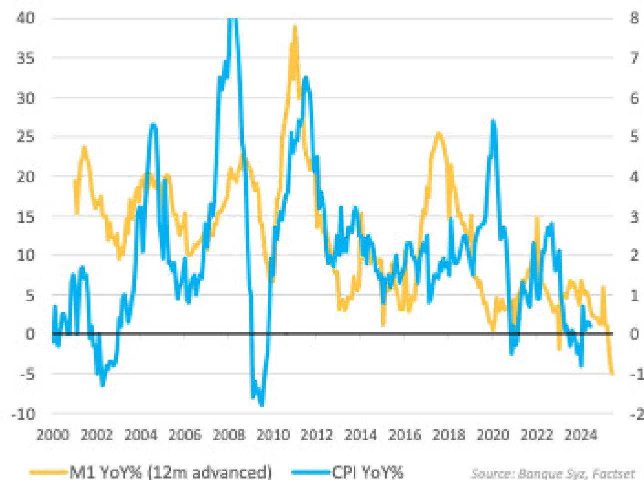
China is currently growing at a subdued pace, as shown by the latest batch of economic data.: GDP was up +0.7% during the second quarter of 2024, the softest quarterly expansion in two years. Yearly GDP growth slowed from +5.3% to +4.7% as a result, just below the official 5% target for the year 2024.

Domestic demand continues to be hampered by falling house prices and depressed consumer confidence, as shown by the Retail Sales' slowdown recorded in June (+2.0 % YoY, the weakest growth rate since the post-Covid reopening). Indeed, real estate prices have been declining for three years in China after the government introduced measures to stem speculation and force a deleveraging of the industry. The correction of this all-important sector has been, and continues to be, a strong headwind for China's expansion. Indeed, it represents a quarter of China's GDP and more than two-thirds of households' wealth, and therefore remains a meaningful drag on domestic sentiment and consumption.

***Consumer confidence is depressed as real estate prices are falling.***

Interestingly, the government has not only triggered this correction, but has also barely done anything to contain its magnitude and impact. Unlike in previous episodes of growth slowdown, there was no large-scale liquidity injections in the economy, only some very selective and targeted interventions to prevent systemic risks. In fact, liquidity conditions in China remain restrictive, reflecting the willingness and acceptance of the authorities for the deleveraging process to continue running its course. The broad measure of money supply (M2) is growing at its slowest pace ever recorded in 2024, while the narrower measure M1 is even contracting this year.

***Tight liquidity conditions and restrictive monetary policy keep China on the brink of deflation.***



In parallel, monetary policy is still very restrictive given current economic conditions despite China being on the brink of deflation. Consumer Price inflation has been hovering around zero for more than a year and Producer Price inflation is negative since 2022, but interest rates remain rather elevated. The short-term rate stands at 2.50% since last summer and had only been marginally lowered following the Covid pandemic (it stood at 3.25% at the beginning of 2020). This level of real interest rates is clearly restrictive for economic activity and explains the weakness of new loans. It prevents any meaningful rebound in economic activity for the time being.

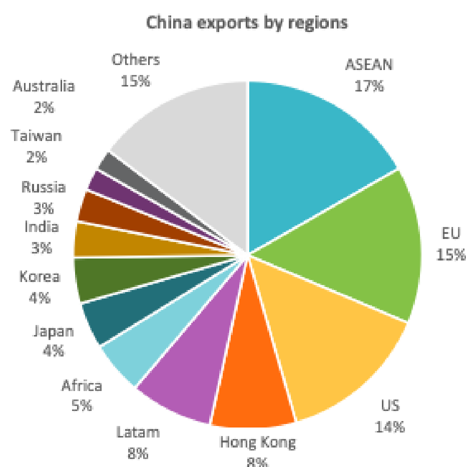
## A rebound in industrial activity driven by external demand.

In parallel, industrial activity has picked up since the end of last year. Firm demand for exports, in a context of positive global economic growth, has spurred the production of goods. Exports growth has reaccelerated since the end of last year and the trade surplus reached a record high in June, as imports remain subdued in the meantime, due to weak domestic demand.

The main and fastest growing destination of Chinese exports remains Southeast Asia economies of the ASEAN, but exports to the US and to Europe also picked up recently. Total Chinese exports are up 3.6% in the first half of 2024 compared to the same period last year, led by exports to neighboring ASEAN countries and to Latam (+11%). Exports to the US have recovered (+2%) while exports to the European Union are still down (-3%) compared to the first half of 2023, reflecting the growth slowdown experienced by Europe in the second half of last year. Exports to Russia have stabilized after surging in 2023 but remain a small part of China exports so far despite rising bilateral trade between the two nations.

Overall, the rebound in global demand for Chinese goods has driven the pickup in industrial activity witnessed since the end of last year. In a context of depressed domestic demand, the positive dynamic in external demand has been supportive for economic growth so far in 2024.

***Southeast Asia is now China's largest export market as it diversifies its external relationships.***




## Risks build up around external-led growth.

While the recent growth impulse coming from external trade has been welcome to balance persistent internal weakness, this trend appears unlikely to extend for long. Firstly, favorable base effects following the export slump of the first half of 2023 will gradually fade away, and the contribution from external trade will become less visible, especially in a context where two of the main export markets (the US and Europe) are now facing softer growth momentum.

More importantly, tariffs are back on the forefront of political agendas in Western economies and are already planting the seeds of potential significant trade tensions in the coming years. In the US, there is a bipartisan agreement on protecting US companies from Chinese competition, on patents and technological transfers as well as on production capacities. The Biden administration has followed suit on the tough stance initiated by the first mandate of Mr Trump, with restrictions and control, especially on chips designed in the US, and selected tariff increases, especially on Electric Vehicles (from 25% to 100%, effectively excluding China EV makers from the US market). In Europe, tariffs on EVs have also be announced to prevent domestic markets from being flooded with cheaper Chinese supply.

The US Presidential election is likely to result in a continuation or even an acceleration of this trend. As polls currently stand, Mr Trump appears likely to get elected for a second term. A key part of his economic program is the imposition of a 60% tariff on all US imports from China, while keeping a 10% tariff on imports from other countries. Higher tariffs on Chinese goods in the US and Europe will inevitably trigger retaliatory measures from China, in what may turn into a proper Trade War. This looming threat and the potential disruptions that it will have on global trade dynamics will likely weight on the contribution of external trade to China's economic growth going forward.

## China prepares for rising global challenges.

China has been facing pushbacks on its trade policies for some time now, and ongoing developments are only part of what appears to be a structural and defining trend at play since the last decade. The share of the US trade balance in China's trade surplus has been consistently declining and is now the lowest since China joined the WTO. China has diversified its export markets toward non-Western markets such as Southeast Asia or Latam. The prospects of higher tariffs and a proper trade war with the US and Europe in the years ahead will only reinforce this dynamic.

Strikingly, Foreign Direct Investment has been consistently declining in China since last year and is down 30% over a year. The lack of visibility around the outlook for trade, coupled with uncertainties regarding the regulatory environment, are likely weighting on foreign investors' decision to invest in the world's second largest economy.

Interestingly, the Chinese government has refrained so far to use the FX lever to try to stimulate its economy. Since the beginning of 2023, the yuan has only slightly drifted lower versus the US dollar (-5% in eighteen months) in a strong Greenback environment. The Japanese yen lost -20% over the same period... More generally, since the Covid pandemic, Chinese authorities haven't used fiscal, monetary or FX policies to engineer a rebound in economic growth. They have been true to their word of promoting "high-quality development" and correcting excesses in some sectors, simply reacting with targeted measures in order to prevent disorderly consequences caused by the process of adjustment.

## For further information

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