Executive Summary

1. China's post-COVID economic recovery has followed a two-speed trajectory, with emerging sectors gaining momentum while traditional growth engines remain subdued. New sectors have been expanding rapidly, but they remain relatively small and concentrated, limiting broad-based job creation, income growth, and consumption gains. In the meantime, domestic demand has been constrained by the deleveraging of households and local governments, as the prolonged property downturn has eroded household balance sheets and undermined local government revenues. Moreover, the rise of new-economy sectors has brought its own set of challenges, including risks of cyclical oversupply, intensifying price competition, and protectionist pressures in overseas markets.

2. Growth rebounded in late 2024 as policy support offset the underlying drag. Following the mid-year slowdown, policy pivots in September 2024—featuring a broad stimulus package encompassing monetary easing, fiscal expansion, and targeted property measures—revived growth momentum. Growth accelerated to 5.4 percent in both Q4 2024 and Q1 2025, before moderating slightly to 5.2 percent in Q2. Private consumption, buoyed by fiscal subsidies through consumer goods trade-in programs, accounted for more than half of real GDP growth in H1 2025. Export strength, aided by frontloaded shipments ahead of expected U.S. tariff hikes, also supported the recovery. However, inflation remained subdued in 2025. Headline CPI contracted by 0.1 percent yoy in the first eight months, while core inflation rose only 0.5 percent, despite modest gains from consumer goods trade-in programs.

3. A deep dive into structural weaknesses underscores the policy urgency of addressing legacies in the real estate sector and local government finance.

- The property sector has yet to recover from the downturn, reflecting both structural adjustment and cyclical weakness. Demand is subdued amid oversupply, weak household confidence, and developer distress. Inventories continued to rise in H1 2025, especially in lower-tier cities. Policy measures, such as lower down payments, reduced mortgage rates, expanded credit to viable projects, and local government purchases of unsold stock, have led to a modest rebound in sales. However, the overall recovery is expected to remain slow.

- The property downturn has exposed vulnerabilities in the land-based fiscal model of local governments. The sharp decline in land sale proceeds has strained local government revenues, even as central government transfers and expanded bond issuance have provided some relief recently. While the fiscal stance in 2025 is assessed as expansionary—with the cyclically adjusted primary deficit widening by 0.6 percent of GDP—the overall fiscal impulse is tempered by local governments' constrained capacity. Subdued revenues, mandatory social spending obligations, off-balance-sheet debt repayment pressures, and stricter borrowing controls have constrained many local governments, especially lower-tier ones, to adopt cautious fiscal stances, limiting their capacity to provide countercyclical support.

- Consumer confidence remains fragile amid weak income prospects and property-related wealth losses. Survey evidence indicates subdued consumer sentiment, reflecting wage pressures in sectors such as finance and the public sector and a large drop in second-hand home prices since 2021. While per capita consumption grew by 5.3 percent yoy in H1 2025, supported by policy stimulus such as consumer goods trade-in programs, these measures largely front-loaded demand for durable goods and are unlikely to sustain momentum.

4. China's external sector remained resilient in 2025 despite escalating trade tensions. Goods exports expanded strongly, driven by EVs, auto parts, and robust demand from non-U.S. markets, while sluggish imports widened the trade surplus to record highs. The services trade deficit returned to pre-COVID levels amid a rebound in outbound tourism and rising payments for intellectual property and insurance services. FDI inflows persisted but increasingly shifted toward high-tech and policy-supported sectors. Large and sustained financial outflows pushed the balance of payments into deficit although foreign exchange reserves remained stable at around USD 3.3 trillion.

5. Growth is expected to remain stable through the remainder of 2025 and into 2026. Subdued household income growth, negative property wealth effects, and an uncertain global trade environment will constrain domestic demand and weigh on exports and manufacturing investment. Nevertheless, infrastructure investment and continued fiscal support are expected to help cushion growth. GDP growth is projected at 5.0 percent in 2025 and 4.6 percent in 2026, with headline inflation remaining flat in 2025 and edging up to 0.4 percent in 2026.

6. Risks to China's economic outlook are tilted to the downside. Domestic challenges include a delayed recovery in the real estate sector, rising financial strains on some local governments, persistent weakness in parts of the corporate sector, and deteriorating asset quality among some small and medium-sized banks. Externally, rising geopolitical tensions and trade conflicts could slow global economic growth and deepen geoeconomic fragmentation.

7. China's ability to sustain the recovery and achieve its medium- to long-term growth targets will depend on a successful transformation of its growth model.

- Short-term policy priorities should focus on supporting growth and stability during the economic transition. Continue to implement expansionary fiscal policy to ease pressures on local governments, with targeted measures to bolster household incomes and consumption. Monetary policy should remain accommodative, calibrated as needed to support demand while safeguarding financial stability and complementing fiscal efforts. At the same time, addressing high housing inventories in lower-tier cities requires stronger central–local coordination, ensuring the delivery of pre-sold homes and protecting consumers to restore confidence.

- In the medium term, China must address key structural challenges to advance its growth transition. Achieving sustained, high-quality growth over the longer term will require placing local government finances on a sound and sustainable footing. This calls for further reforms in the central-local fiscal relationships. Equally important is fostering more resilient and inclusive household consumption, underpinned by a higher labour share in national income and a people-centered fiscal framework that prioritizes public services, social protection, and human capital. A successful growth transition will require recalibrating incentive systems that have driven over-investment in a few concentrated sectors. A more disciplined industrial policy could raise productivity, crowd in private investment, and facilitate green and digital transformation. Deeper financial sector and capital markets reforms, supported by stronger monetary policy transmission, will help improve the allocative efficiency of capital. At the same time, upholding a rules-based global trade order and repositioning outbound investment as a tool for shared development will help anchor China’s role in the global economy.