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# CHINA HORIZONS

DEALING WITH A RESURGENT CHINA

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## 10 Challenges facing China's economy

*China's economic problems are structural; the response so far has not tackled the root causes*

*Alicia Garcia-Herrero*

Bruegel



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## Abstract

China faces a series of structural and policy challenges that threaten its economic growth, including high public debt, limited monetary policy flexibility, weak domestic demand, overcapacity, a struggling real estate sector, demographic decline, and technological constraints due to international competition. Current fiscal and monetary measures are insufficient to address these issues, and without significant reforms to promote consumption-driven growth and stronger social welfare, the country risks prolonged economic stagnation.

## Key findings Ten challenges facing China's economy

Understanding where the Chinese economy is heading is important for the whole world. This requires an assessment of both China's strengths but also the challenges it faces, of which ten can be highlighted.

China is already suffering from entrenched deflation, which the government does not seem fully ready to fight. Laxer fiscal policy is a reality with the official deficit eased from 3 percent to 4 percent of GDP and monetary policy has been easing but too slowly to fight such strong deflationary forces.

Thus, China exports its industrial overcapacity problem to the rest of the world. China has also confirmed it will continue to step up manufacturing as a growth engine – there is no intention of correcting overcapacity by reducing supply. Because the increase in the fiscal deficit seems directed at supporting the debt restructuring of local governments and infrastructure and because China's labor market remains weak and disposable income stagnant, Chinese consumption cannot be expected to jump substantially in 2025.

Europe is therefore on the front line, facing the direct economic consequences of China's domestic policies. Chinese products may further flood the European market but also third markets in which European and Chinese companies compete. Finally European companies in China will face even tougher competition from Chinese players with continuous cuts in prices.

When it comes to strategic competition with the US China intends to step up self-reliance, including in critical technologies without much attention to the cost. This is another strain on China's finances, together with rapidly increasing military expenditure, which offers little room for welfare state related spending or for fiscal support to consumption

China's economic recovery will hinge on how effectively its top ten challenges are addressed. These challenges boil down to the limited fiscal room, the monetary policy constraints stemming from a weak RMB and the already very low profitability of the banking sector which cannot put up with lower interest rates. Furthermore, the external challenge of fragile external demand, coupled with overcapacity and deflationary pressures are also key. The still weak real estate sector also contributes asset price deflation and to the low return environment. Finally, a shrinking population and US technological containment are to be added to the list of challenges.

Ultimately, China's path to sustainable growth is clearly challenged by a reluctance to enact the very structural reforms it needs. In an increasingly difficult external environment, Chinese economic policymakers should accept that structural deceleration is unavoidable, rather than further pushing industrial capacity without introducing measures to increase consumption: structural imbalances need structural reforms. In particular, the creation of a well-functioning welfare state and fostering consumption. Neither of the two are in sight at the moment.

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# Introduction

Depending on how it is measured, China's economy is now the world's largest or second largest. It is also the world's second-most intertwined in terms of trade relationships, after the European Union, and is a major investor and lender in the emerging world. Understanding where China is heading is important for the whole world. This requires an assessment of both China's strengths – and also the challenges it faces, of which ten can be highlighted.

According to Chinese policymakers, the economic outlook is positive, despite the trade war ignited by President Donald Trump, and China's growth target has been kept at 5 percent. However, to reach that level in 2024, China needed a massive \$1 trillion trade surplus. Chinese trade is now threatened by a more protectionist external environment. Laxer fiscal policies have seen the official deficit eased from 3 percent to 4 percent of GDP, the largest on record, and a less strict monetary policy. However, no stimulus has been announced – a rather conservative response to the external environment. Meanwhile, China's inflation target has been cut from 3 percent to 2 percent<sup>1</sup> but the reality is that China is already suffering from entrenched deflation, which the government does not seem ready to fight.

This may be because of the need to remain competitive in export markets, even at the cost of a deflationary environment. Export prices fell in 2024 and have continued to fall in 2025. Even consumer prices in China have fallen since February 2025. While pushing prices down to compete is not without risk ([Japan's experience in the 1990s is a good example](#); García-Herrero and Xu, 2025), President Trump's tariffs and the ongoing weakness of the dollar do not leave China much space.

China has also confirmed it will continue to step up manufacturing as a growth engine – there is no intention of correcting overcapacity by reducing supply. Because the increase in the fiscal deficit seems directed at supporting the debt restructuring of local governments rather than boosting domestic consumption, and because China's labour market remains weak and disposable income stagnant, Chinese consumption cannot be expected to jump substantially in 2025. China will thus need to continue to force exports to reduce overcapacity.

For Europe these trends are worrying because Chinese products may further flood the European market and because European companies in China will face even more competition from Chinese players, given the strong deflationary pressure.

China also intends to step up self-reliance in critical technologies, including artificial intelligence (AI), quantum computing and semiconductors – areas in which China still lags the US (García-Herrero et al, 2025). Large-scale US investment programmes such as the Stargate AI project<sup>2</sup> have pushed Beijing to channel more resources to AI and quantum<sup>3</sup>, with

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<sup>1</sup> Bloomberg News, 'China May Struggle to Hit Inflation Target Even After Cutting It', 5 March 2025, <https://www.bloomberg.com/news/articles/2025-03-05/chinese-policy-makers-set-annual-inflation-target-at-around-2>

<sup>2</sup> João da Silva, Natalie Sherman & Imran Rahman-Jones, 'Tech giants are putting \$500bn into 'Stargate' to build up AI in US', BBC, 22 January 2025, <https://www.bbc.com/news/articles/cy4m84d2xz2o>

<sup>3</sup> Sharveya Parasnis, 'Bank of China Announces Investments Worth 1 Trillion Yuan to Develop AI Industry', Medianama, 28 January 2025, <https://www.medianama.com/2025/01/223-bank-of-china-announces-1-trillion-yuan-ai-industry-investment/#:~:text=The%20Bank%20of%20China%2C%20a,an%20announcement%20on%20January%202023>

China looking much more credible after the launch of the DeepSeek AI platform in January 2025 (Martens, 2025).

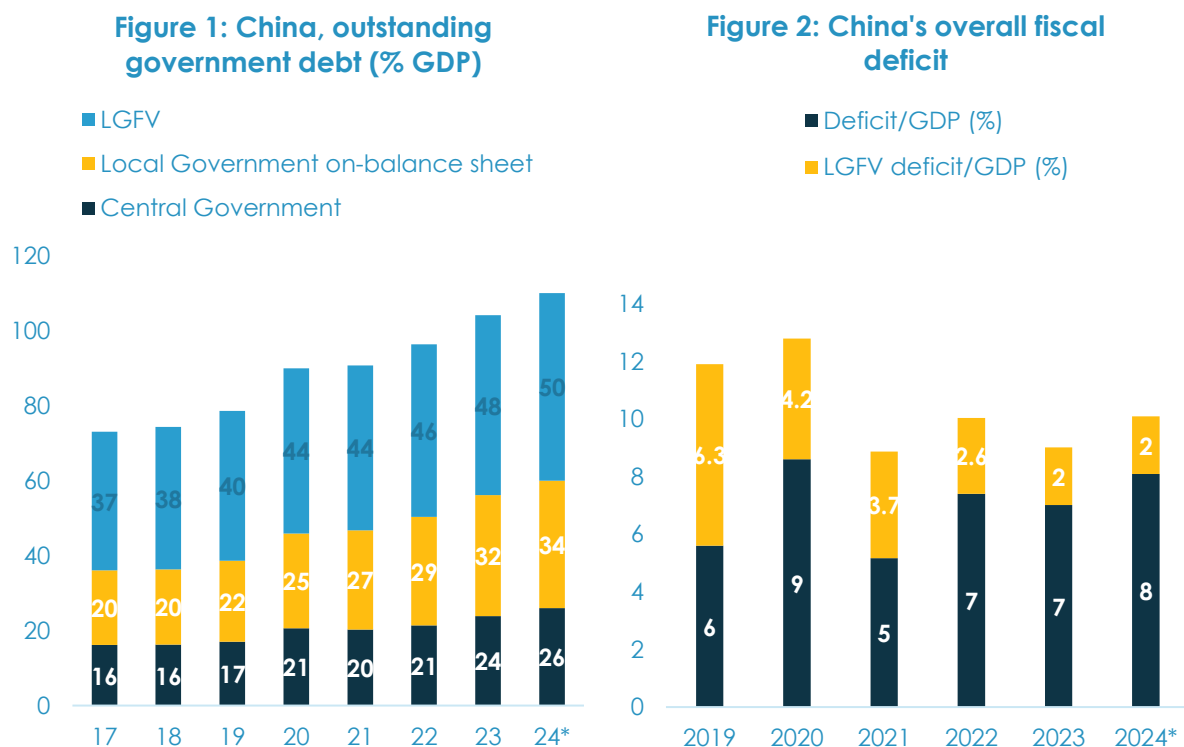
## Will it work? China's 10 economic challenges

Whether China's strategy will re-ignite its economy or mitigate its structural deceleration, will depend on the extent to which the responses tackle China's ten biggest challenges.

### Challenge 1: Hardly any fiscal room

For years, China has been the envy of many other economies because of its fiscal space, which allowed it to conduct a massive stimulus during the global financial crisis in 2008 when demand for its exports plummeted. But that huge stimulus provoked a ballooning public debt, which now equals 100 percent of GDP (Figure 1). This is a lower level than the US, but still massive compared to countries with incomes per capita similar to China.

China's growing public debt stems from huge fiscal deficits, especially when the total local government borrowing is taken into account, including that generated through special vehicles widely used to finance real estate and infrastructure projects<sup>4</sup> (Figure 2).



Source: Bruegel. Note: 2024 data based on IMF forecasts.

Source: Bruegel. Note: 2024 figures and LGFV data for 2023 are estimates.

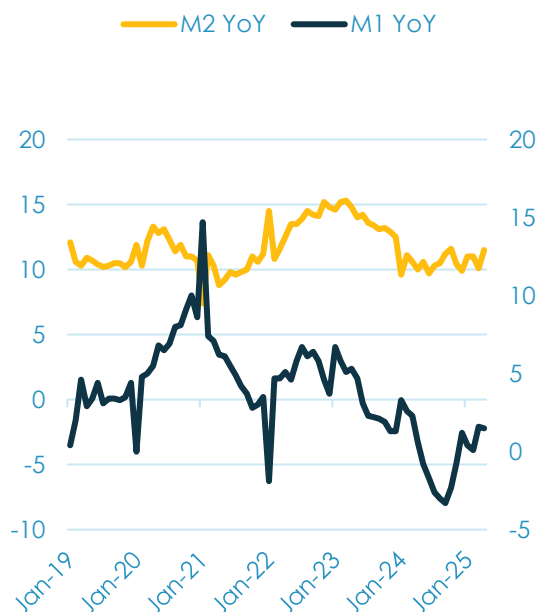
<sup>4</sup> Yuke Xie, 'China's local governments step up plans to issue refinancing bonds to tackle LGFV debt', South China Morning Post, 11 October 2023, <https://www.scmp.com/business/banking-finance/article/3237511/chinas-local-governments-step-plans-issue-refinancing-bonds-tackle-lgfv-debt>

## Challenge 2: Monetary policy constraints

China long had monetary policy headroom, especially after developed economies in particular introduced ultra-lax monetary policies in response to the COVID-19 pandemic in 2020, bringing their interest rates close to or even below zero. China instead maintained interest rates above 3 percent for most of that period but has had to cut them more recently as a response to a stagnant economy.

There is still space for the People's Bank of China (PBoC) to cut rates, or even introduce quantitative easing, but the reality is that monetary policy remains restrictive both in terms of the high level of real interest rates, because of deflation, and slowing monetary aggregates (Figure 3). Two major constraints explain this 'reluctant' tightening. First, the rather weak renminbi leaves less room for the PBoC to ease monetary policy. Second, Chinese banks, already suffering from very poor profitability, would find it difficult to bear an even lower net interest margin stemming from further rate cuts.

**Figure 3: Money Supply (% YoY)**



Source: Bruegel. Note: M1 refers to the most liquid forms of money. M2 builds on M1 by adding less-liquid assets including savings deposits, time deposits and money market funds.

**Figure 4: Dollar/yuan CFETS Index**



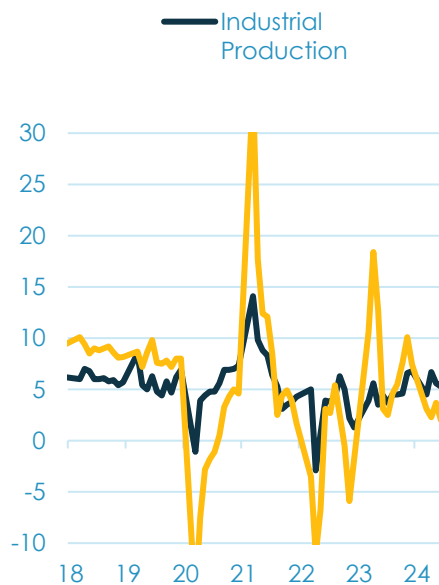
Source: Bruegel. Note: Data as of 9 June, 2025. CFETS = China Foreign Exchange Trade System, <https://www.shibor.org/english/bmkidxrud/>.

## Challenge 3: Domestic demand

China continues to produce well beyond what it can sell domestically (Figure 5). While manufacturing has always been China's growth engine, this trend has intensified massively since 2021, in the context of the collapse of the real-estate sector (see challenge 7). Fixed-

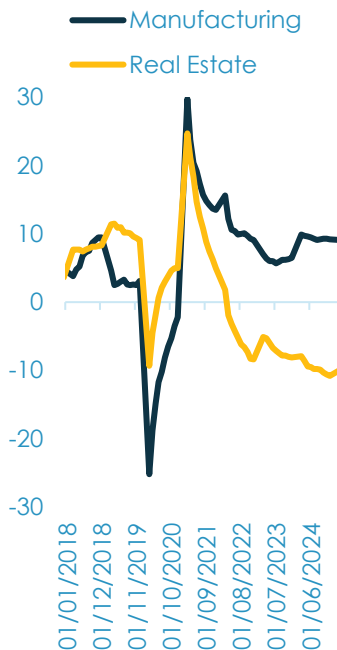
asset investment in manufacturing is increasing much faster than GDP, while real-estate investment has plummeted (Figure 6). In some industries, notably green tech, capital investment by Chinese companies is so massive that it amounts to nearly 90 percent of the global total – as seen with solar panels (Figure 7).

**Figure 5: China's industrial production and retail sales (% YoY)**



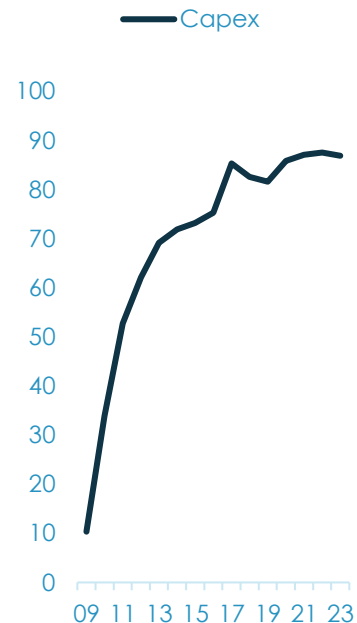
Source: Bruegel based on Natixis, WIND.

**Figure 6: China, fixed asset investment (% YoY)**



Source: Bruegel based on Natixis, WIND.

**Figure 7: Chinese solar investment as % of the global investment**



Source: Bruegel based on Natixis, Bloomberg.

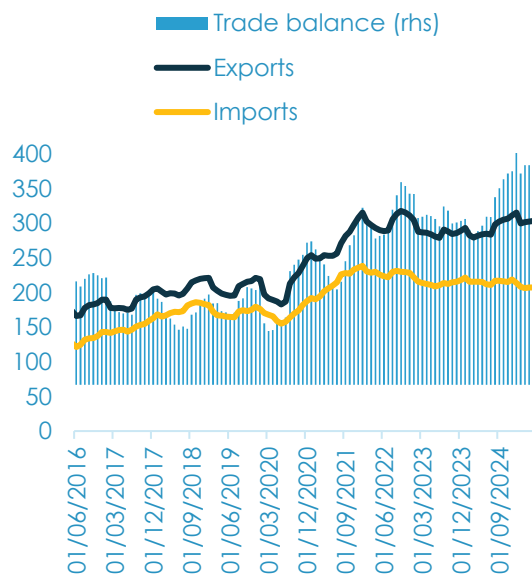
## Challenge 4: External demand and geopolitical challenges

The good news for China is that the world has accommodated even more Chinese exports since the COVID-19 pandemic. Chinese imports have been stagnant, so this has meant a very large trade surplus, which has been crucial for growth (Figure 8). However, the surge in manufactured goods exports, pushing China's share to 18 percent of global manufacturing exports, might be hard to sustain in the context of greater protectionism everywhere (Figure 9).

The US has already reduced its imports from China, while the EU and the emerging world have seen increases (notwithstanding EU tariffs on Chinese electric vehicles). It seems hard to believe that China's massive industrial capacity can continue to rely on foreign markets as much as in the past.

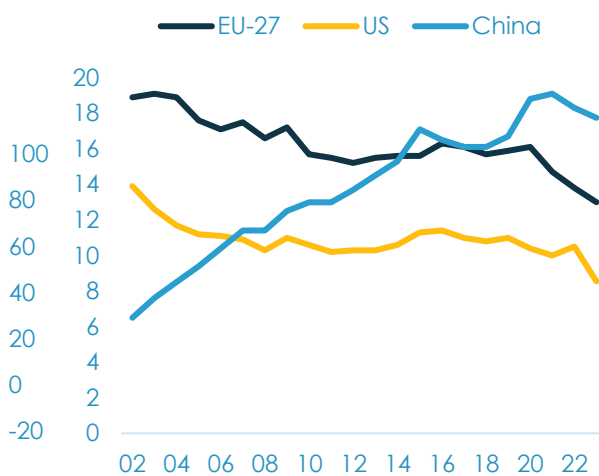


**Figure 8: China, international trade (\$ billions)**



Source: Bruegel based on Natixis, CEIC. Note: exports, imports and trade balance are based on six-month moving average. Data is up to May 2025.

**Figure 9: Exports, share of worlds exports (%)**



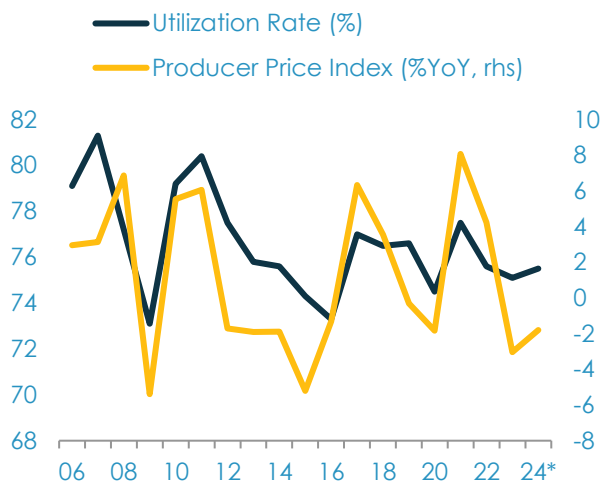
Source: Bruegel based on Natixis, Eurostat.

## Challenge 5: overcapacity and deflationary pressures

Despite the rest of the world importing from it, China's industrial capacity is simply too much to absorb. China's capacity utilisation rate has dropped from a peak in 2021 and is close to the levels seen during the pandemic (though still higher than during China's worst episode of overcapacity in 2015; Figure 10). Still, capacity utilisation might not be the best measure of China's overcapacity, since it is comparable to that of the US<sup>5</sup>. Nevertheless, plummeting producer prices are a signal of the problem, putting downward pressure on companies' margins (Figure 11). Proliferating protectionism can only worsen deflationary pressures in China unless China can foster domestic consumption.

<sup>5</sup>See Board of Governors of the Federal Reserve System release of 15 May 2025, 'Industrial Production and Capacity Utilization', <https://www.federalreserve.gov/releases/g17/current/>

Figure 10: China, manufacturing cycle



Source: Bruegel based on Natixis, China National Bureau of Statistics, WIND.

Figure 11: China, prices (% YoY)



Source: Bruegel based on Natixis, China National Bureau of Statistics, CEIC. Note: data as of May 2025.

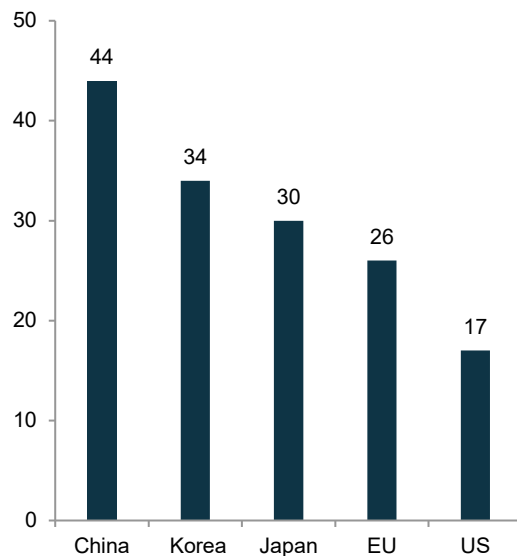
## Challenge 6: stubbornly low private consumption without policy support

There is general agreement that increasing private consumption would help resolve China's imbalances<sup>6</sup>, but it is easier said than done. The ratio of Chinese private consumption to GDP remains stubbornly low, especially compared to fixed-asset investment. While investment is too high, domestic savings are even higher. China continues to have the world's highest savings ratio (Figure 12), as a response to the lack of a welfare state, but also very few private saving opportunities. Changing this would require major reform, such as strengthening the pension system and offering unemployment benefits and public healthcare. None of these reforms seem to be on the government agenda. President Xi Jinping has expressed his reservations about a welfare-state-based model, which he dubs "welfarism"<sup>7</sup>.

<sup>6</sup> Carol Yang, 'Chinese economists call for wider social safety net to nurture consumption', South China Morning Post, 18 March 2025, <https://www.scmp.com/economy/policy/article/3302690/chinese-economists-call-wider-social-safety-net-nurture-consumption>; 'Impact of Household Consumption Growth on China's GDP Growth', Commentary, 16 December 2024, Carnegie China, <https://carnegieendowment.org/posts/2024/12/impact-of-household-consumption-growth-on-chinas-gdp-growth?lang=en>

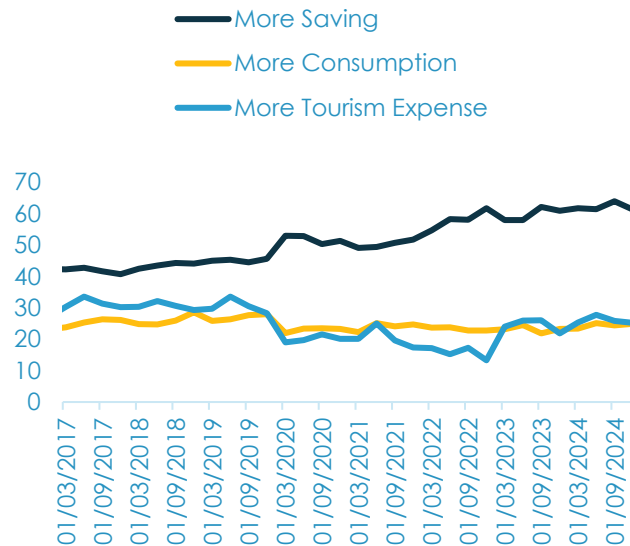
<sup>7</sup> Neil Thomas, 'China's Top Policy Group Encourages Economic Opening, but on Political Terms', Asia Society Policy Institute, 19 July 2023, <https://asiasociety.org/policy-institute/chinas-top-policy-group-encourages-economic-opening-political-terms>

**Figure 12: Gross national saving rate (% of GDP, 2023)**



Source: Bruegel based on Natixis, IMF.

**Figure 13: Chinese household sentiment towards saving and consumption (% of total)**

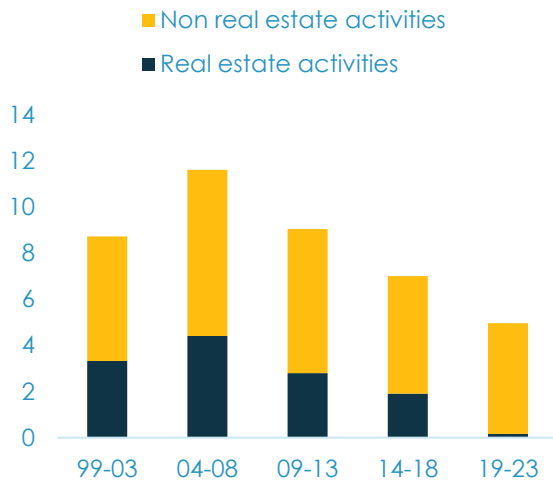


Source: Bruegel based on Natixis, People's Bank of China, WIND. Note: data as of 2024 Q4.

## Challenge 7: real estate still contributing to asset price deflation

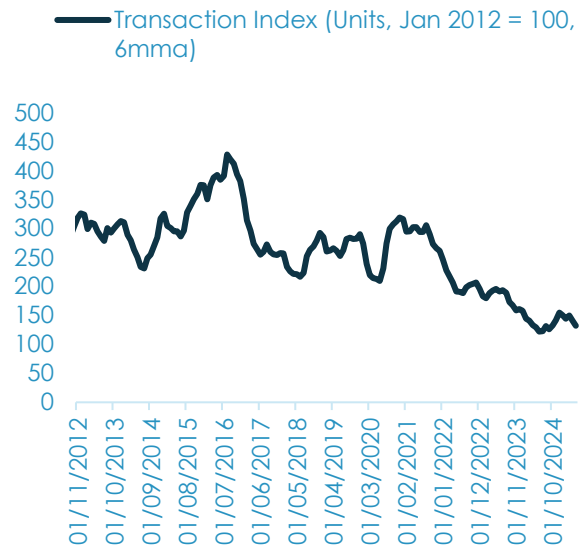
China's real-estate sector, long the main source of growth (one third of the total and also one third of fixed-asset investment), burst in 2021 when China's largest developer, Evergrande, defaulted. Since then, the contribution of real estate to growth has been negative (it was already very low; Figure 14). House prices and real-estate transactions have been falling for years (Figure 15).

**Figure 14: China's GDP: contribution of real estate and non-real estate activities to China's GDP (%)**



Source: Bruegel based on Natixis, People's Bank of China, WIND. Note: data as of 2024 Q4. Source: Bruegel based on Natixis, CEIC. Note: we estimate the effect of real-estate sector value added on China's GDP, and then use the estimated coefficient to calculate the (five-year average) contribution of the real estate sector to China's GDP.

**Figure 15: New house sales in China**

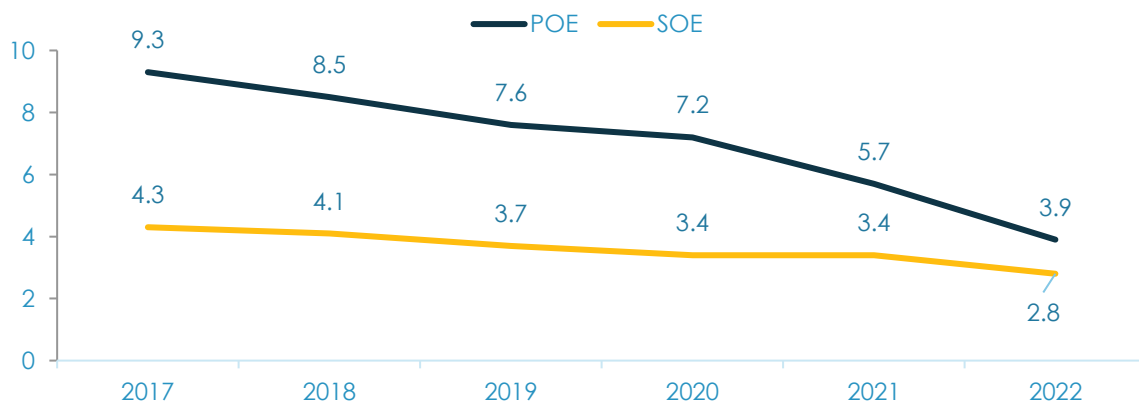


Source: Bruegel based on Natixis, Wind.

## Challenge 8: Over-investment at the cost of increasingly low returns

China's high savings have fed the huge investment boom. This boom certainly helped China grow very rapidly but it has remained the main source of growth for too long, ultimately becoming excessive, as shown clearly in increasingly low returns. Returns on assets are lower for state-owned enterprises (SOEs), as one would expect, but also for privately-owned enterprises (POEs) (Figure 16).

**Figure 16: Chinese corporates, average returns on assets (%)**



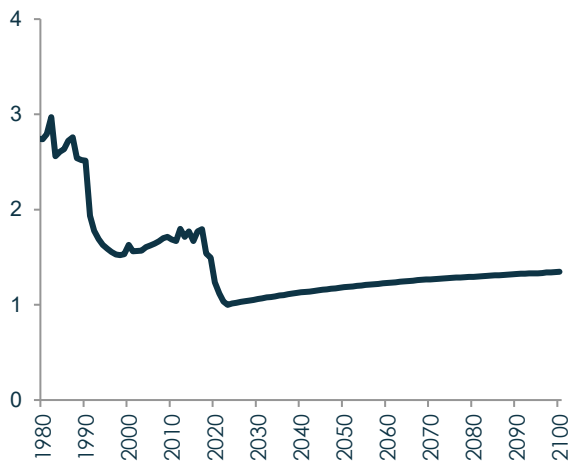
Source: Bruegel based on Natixis, Wind. Note: calculations are based on bond issuing companies.

## Challenge 9: shrinking population

China is an outlier in terms of the speed at which the population has aged. The introduction of the One Child Policy in 1980 explains China's difficult demographics<sup>8</sup>, but the fertility rate has also fallen rapidly since 2019 (Figure 17), possibly because of the much more uncertain environment, leading to a negative sentiment about future economic prospects.

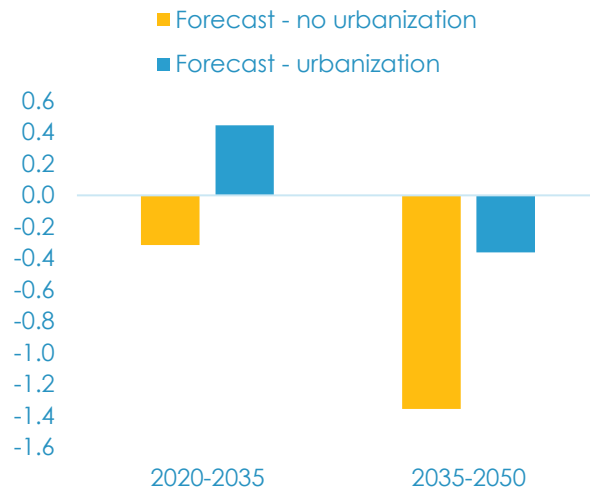
Even if China's population has already peaked and the labour force is declining, the actual contribution of the labour force to GDP growth should remain positive as long as China continues to urbanise. The urbanisation process is estimated to be completed by 2035 (García-Herrero, 2023), which is when the decline in the labour force will also start to be felt in the cities, negatively impacting productivity and shaving off about 1.3 percentage points of growth each year (Figure 18).

**Figure 17**  
China's total fertility rate



Source: Bruegel based on Natixis, United Nations.

**Figure 18: Forecast impact of population aging on China's GDP growth rate (%)**



Source: Bruegel based on Natixis. Note: only the labour supply channel is considered and unchanged labour productivity is assumed.

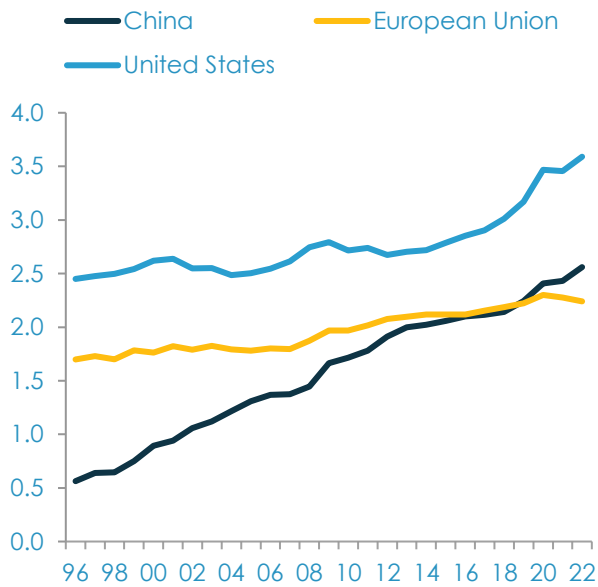
## Challenge 10: US technological containment

China competes with the US on innovation. The US outstrips China on spending on research and development as a percentage of GDP (Figure 19), which means that it will not be easy for China to bypass the US's global technological dominance. Furthermore, the US has sought to contain China's technological advance through different means, including export controls on advanced technology (Figure 20).

<sup>8</sup> He Huifeng, 'How China's 'one-child generation' got trapped in the population pyramid', South China Morning Post, 2 October 2024, <https://www.scmp.com/economy/china-economy/article/3280578/how-chinas-one-child-generation-got-trapped-population-pyramid>

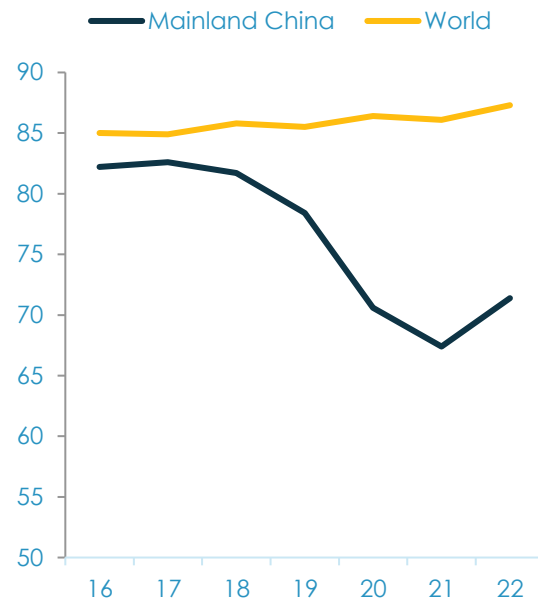
The questions remain of whether the US will succeed in containing China, and whether China's push for innovation will help increase its total factor productivity or, in other words, help mitigate structural deceleration.

**Figure 19:**  
R&D expenditure (% of GDP)



Source: Bruegel based on Natixis, The World Bank.

**Figure 20: Approval rate for US  
export licenses (%)**



Source: Bruegel based on Natixis, US Department of Commerce's Bureau of Industry and Security.

## Conclusions

he challenges faced by Chinese economy have become harder to tackle since the return of President Trump. The Chinese government has announced measures to help stabilise economic growth at 5 percent in 2025, but the measures appear insufficient to meet the challenges.

In an increasingly difficult external environment, Chinese economic policymakers should accept that structural deceleration is unavoidable, rather than further pushing industrial capacity without introducing measures to increase consumption: structural imbalances need structural reforms. In particular, the creation of a well-functioning welfare state would reduce excessively high household savings, which are precautionary in nature. But such reforms do not seem to be in the Chinese leadership's plans.

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