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China Musings | Asia Pacific

Beijing Will Fine-tune, Not Pivot

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April-May data indicate China's two-speed economy is deepening with weaker domestic demand. This should raise policy urgency at home, with faster fiscal rollout targeting strategic infrastructure. Abroad, manufacturing strength amid weak domestic absorption may fuel targeted protectionist measures.

China's two-speed economy is becoming harder to ignore. While exports and production remain resilient, April-May data point to a clearer softening in domestic demand. We think this slowdown in domestic demand does not signal an abrupt downturn that warrants policy pivot; however, the need for policy fine-tuning is rising. Abroad, the widening K-shaped pattern may intensify trade frictions.

Domestic demand is cooling, not slumping. April-May data confirm a deepening two-speed pattern: production and exports remain firm, while consumption and investment are softening. The key question is whether the slowdown is partly reversible or signals the start of an organic deceleration that could become concerning enough for policymakers to "pivot" rather than merely "fine-tune" policy implementation. Our view is that the moderation is real, but headline YoY figures for FAI and retail sales likely overstate the pace of slowdown. As such, we expect policy to be fine-tuned rather than pivoted.

(1) FAI data – direction matters more than magnitude: The post-February deceleration appears partly policy-driven. The central government's emphasis on a "correct view of performance and achievements" since late February may have pushed local governments away from new projects and toward resolving hidden debt (Exhibit 2). Some previously overstated and front-loaded FAI reporting may also be corrected.

(2) Consumption is confronting a high base from trade-in programs…: The negative YoY retail sales in May largely reflects a high base from last year's trade-in subsidy program (Exhibit 1). On a two-year CAGR basis, May looks slightly better than April.

…although the slowdown is more than a base effect. The 2Y CAGR in April-May still shows a visible step-down from 1Q. A softer labor market, ongoing property market adjustment, and oil-related pressures are weighing on spending. Meanwhile, export strength has had limited spillover into the job market due to automation and rising capital intensity. These are reflected in renewed softening in the NBS consumer confidence index (Exhibit 4).

(continued on the next page)

Continued Musings

(3) The perspective from oil – growth drag manageable, but reinforces the K-shaped economy: Investors have questioned whether the slump in crude imports, combined with limited evidence of strategic reserve drawdowns, signals a collapse in China's oil consumption – and, by extension, economic activity. Our view is that this is only partly the case. Consumers appear to be cutting back on non-essential oil consumption, including ICE vehicle usage (Exhibit 5) and air travel (Exhibit 6). However, overall industrial activity appears to be cushioned by several buffers: commercial crude inventories, resilient coal imports and domestic coal production, and still-robust electricity generation (Exhibit 7).

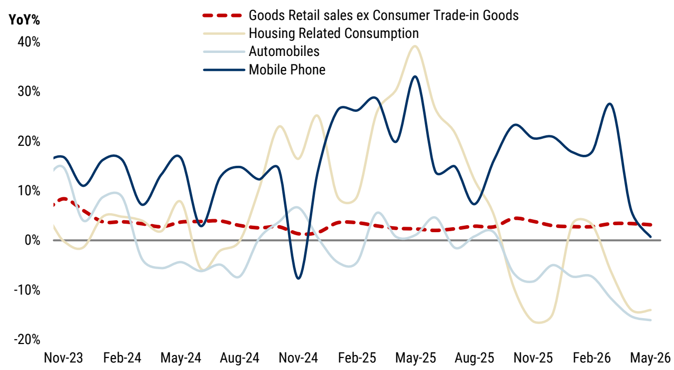
Domestic policy implication – renewed urgency for fiscal fine-tuning, with scope for catch-up: Softer April-May data now challenge policy complacency after a strong 1Q. 2Q GDP is tracking around 4.4%. If unaddressed, full-year growth could approach, or undershoot, the lower end of the 4.5-5% target range. This raises the need for policy fine-tuning rather than a broad pivot. In our view, the near-term response will likely focus on faster implementation of approved budgets, a stance that should be reaffirmed at the July Politburo meeting. The room for catch-up is visible: ~60% of the annual government bond quota remains unused. More importantly, rollout of the Rmb800bn in quasi-fiscal financing tools for infrastructure – as proxied by policy bank bond issuance in Exhibit 3 – remains slow.

Beijing's preferred demand support remains strategic infrastructure: Specifically, the focus is on projects that stabilize near-term growth while advancing longer-term goals around energy security, technology self-sufficiency, and supply-chain resilience. The "Six Networks" framework provides the clearest policy bridge: water management, new-type power grids, computing-power networks, next-generation communications, urban underground pipelines, and logistics infrastructure. Within this framework, AI computing networks, data centers, and smart grids are likely to see the most immediate support. On the other hand, we do not expect to see major pivotal policies targeting private consumption. The economy will likely remain distinctly K-shaped even with additional domestic demand support.

Is our above-consensus 4.8% GDP forecast still reachable? In our base case, growth reaccelerates to around 4.8-4.9%Y in 2H, as aforementioned policy easing on domestic demand is complemented by a partial unwind of the oil overhang. With progress toward a US-Iran peace deal, our global oil strategist now expects dated Brent to settle at around US$80/bbl from 4Q26 onward, indicating a more balanced supply-demand outlook. For China, lower energy prices would reduce terms-of-trade losses and indirectly support exports by reinforcing the global trade and investment cycle. Consistent with this, our Asia economists now see modest upside risks to the region's growth outlook and have greater conviction in the ongoing industrial and capex super-cycle.

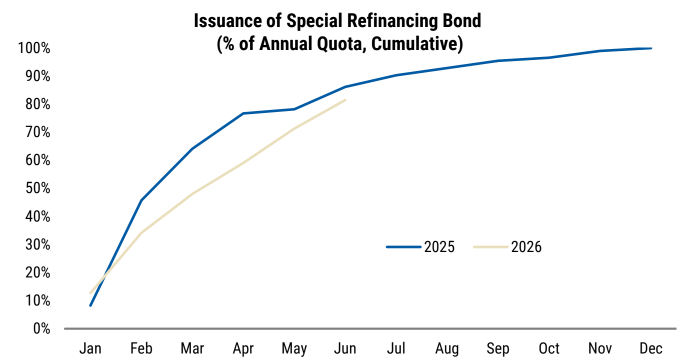
The deepening two-speed economy has an external corollary: Weak domestic absorption means more of China's manufacturing output is being directed toward export markets, accelerating market share gains abroad. This is most visible in the EU, where the bilateral trade relationship has arguably become increasingly competitive rather than complementary. China's share in steel, EVs, batteries, solar, and chemicals has risen meaningfully over the past two years. Europe's response, if any, is likely to be targeted rather than systemic. Policy tools may include sector-specific tariffs, foreign-subsidy investigations, procurement restrictions, domestic content rules, and anti-dumping measures. While this is unlikely to become a major macro shock — particularly given China's countermeasure leverage in areas such as rare earths and luxury goods imports — the direction of travel matters. If Europe progressively narrows access in high-value manufacturing segments, China's export engine risks being redirected toward lower-friction but lower-margin markets.

Exhibit 1: Retail sales YoY weakened due to a high base and a softening job market



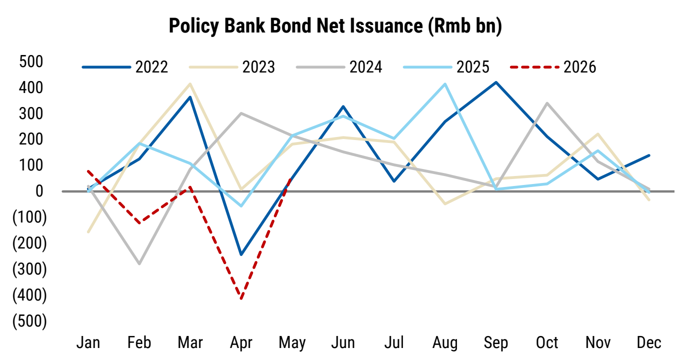
Source: CEIC, Morgan Stanley Research.

Exhibit 2: Firm pace of resolving hidden debt after a relatively slow start



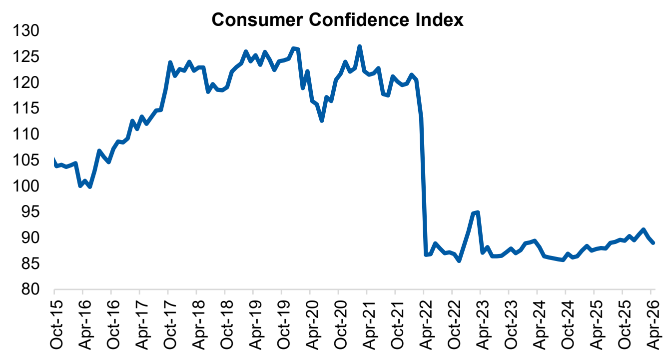
Source: Wind, Morgan Stanley Research.

Exhibit 3: Policy bank bond issuance has seen a net contraction YTD



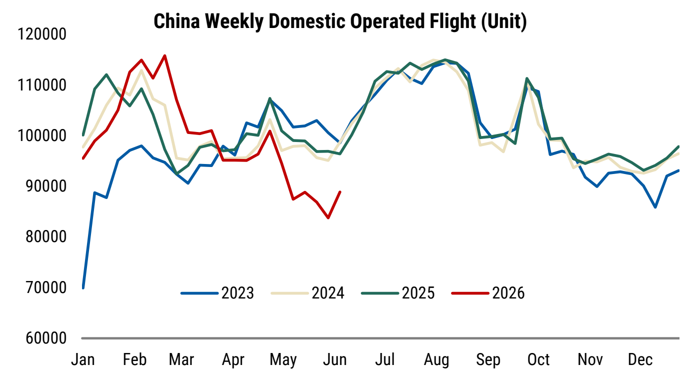
Source: CEIC, Morgan Stanley Research.

Exhibit 4: Consumer confidence has dipped again after a period of modest improvement



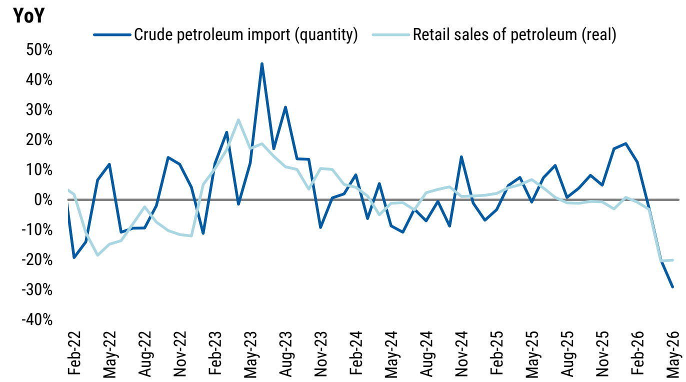
Source: CEIC, Morgan Stanley Research.

Exhibit 5: Domestic flight weakened from 2Q amid the energy shock



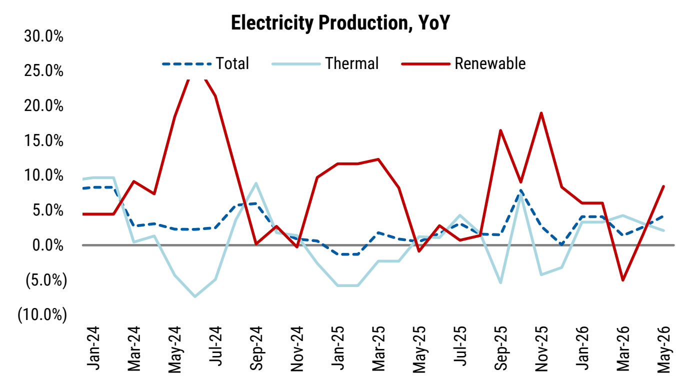
Source: CEIC, Morgan Stanley Research.

Exhibit 6: Domestic petroleum retail volume slumped



Source: CEIC, Morgan Stanley Research.

Exhibit 7: Electricity generation remains robust



Source: CEIC, Morgan Stanley Research.

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