China: The game of chicken, its economic impact and policy choices

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US and China are stuck in an unprecedented, and expensive, game of chicken, and it seems that both sides are unwilling to back down. The first real battleground of the tariff war is financial markets, especially stock markets. The financial markets of both economies have been severely hit, and the worst might be yet to come. We expect China's stabilization funds (hereinafter "national teams"), supported by the PBoC, to intervene significantly in stock markets over coming weeks. Beijing will also very likely vow to speed up and increase fiscal spending to bolster demand, especially consumption demand. The PBoC, in addition to funding the national teams, could also implement high-profile RRR cuts and policy rate cuts sooner than what had been planned. Unlike in 2018-19, and considering a property market crisis, we believe that the PBoC, in order to maintain domestic financial and property market stability, will not choose to devalue RMB or engage in/allow for any substantial currency depreciation.

Given the extraordinarily fluid situation, it is impossible to reasonablly estimate the impact of the ongoing US-China trade war on China's economy. We maintain our 2025 GDP growth forecast of 4.5%, which is below Beijing's target of "around 5.0%". Another reason for us to maintain our growth forecast is that we have already to a large extent taken into account *a significant worsening* of tensions between the US and China, and Beijing's policy stimulus to counter the tariff impact. As US tariffs will dent exports and largely exert disinflationary pressures, we lower our forecasts for export growth and CPI inflation for this year to -2.0% and 0.0%, respectively, from 0.0% and 0.1%.

Beijing needs to be more innovative and courageous in its policymaking

We also believe Beijing needs to be a bit more innovative and courageous in its efforts to boost domestic demand. As short-term boosts such as trade-in programs cannot be used too often, Beijing might need to consider longer-term structural policies to support consumption. In our view, reforms to the social security system, including a large increase in basic pension payments to low-income households and an increase to subsidies for basic medical insurance, would be the most effective long-term policies to bolster consumption and reduce inequality. The establishment of a national childbirth subsidy system to encourage births could also boost consumption demand while addressing a long-term issue. The property sector has been falling for four years. In our view, it should be Beijing's responsibility to clean up the mess and truly stabilize the real estate sector. China's fiscal system should also be revamped, as most local governments will never be able to regain the lost revenue from land sales.

The game of chicken: Trump threatened an additional 50% tariff against China

On the night of 7 April Beijing time, amid *the tit-for-tat retaliation from Beijing* , Trump posted on the Truth Social platform, declaring that "if China does not withdraw its 34% increase above their already long-term trading abuses by tomorrow, April 8th, 2025, the United States will impose ADDITIONAL Tariffs on China of 50%, effective April 9th." Beijing's resolute and decisive retaliation last Friday evidently caught markets off guard, and perhaps Trump as well, as nations/trading blocs worldwide hastened to contact the White House to pursue various forms of negotiation, including Vietnam, Japan, Israel and the EU.

This morning, right before the market opened, the Ministry of Commerce issued a strongly worded statement in response to Trump's newly threatened 50% tariffs. In one paragraph, it unequivocally stated its stance by saying that "China will never accept it. If the US persists in its course, China will fight to the end." In our view, this serves as a clear indication that Beijing will not only stand firm on the 34% tariffs but is also likely to retaliate commensurately, should Trump proceed with the newly proposed 50% tariffs.

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The potential damage to China's economy

The situation is so fluid that it is impossible to reasonably estimate the impact of the ongoing US-China trade war on China's economy, so we start with some key facts. The 54pp additional US tariffs will surely impact China's export sector and weigh on economic growth. Including rerouting via Mexico, Vietnam and other countries, the US share of China's total exports was still a hefty 20.6% in 2024 (Figure 2). China is still heavily dependent on exports, which account for around 14% of its GDP in terms of value added. Using these two numbers, we estimate that the US, via its imports of Chinese goods, directly accounts for 2.9% of China's GDP. The ending of the de minimis exemption is set to hit many Chinese exporters, which account for around 11% of China's exports to the US.

Limited rerouting opportunities now

Rerouting will be much more difficult, as the US government uses "reciprocal tariffs" to plug the loopholes. During the 2018-19 trade war, China adeptly mitigated the effects of US tariffs by rerouting exports through third countries, most notably Mexico and some ASEAN countries. This approach relied on the absence of US tariffs on these nations, allowing Chinese goods to reach the US market indirectly. However, the reciprocal tariffs introduced by President Trump on 2 April have transformed this landscape. A baseline tariff of 10% now applies to all imports, with significantly higher rates – such as 46% on Vietnam, 36% on Thailand, 24% on Malaysia, and 26% on India – targeting countries previously used for rerouting. This broad and stringent tariff regime effectively seals off the rerouting channel, severely limiting China's capacity to bypass US tariffs through intermediary nations and reducing the viability of this once-effective strategy.

On the positive side – reduced substitution effects

The widespread imposition of tariffs significantly weakens the substitution effects observed during the 2018-19 trade war, in our view. At that time, firms could redirect export orders or relocate production from China to nations such as Vietnam or India to avoid US tariffs. However, the current tariff regime imposes steep duties on these countries too, diminishing the cost advantages of such shifts. This reduced incentive to move operations away from China may lessen the decline in its export volumes. Although China now faces an additional 54% tariff, we believe weakened substitution effects could mitigate the overall adverse impact on its exports compared to the previous trade conflict.

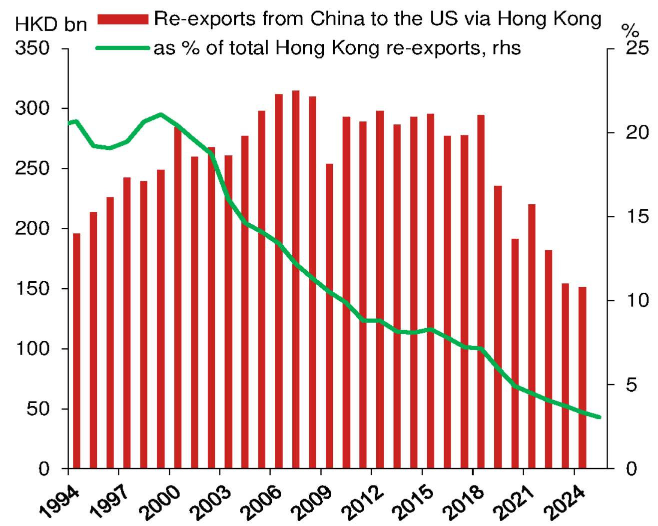
The negative impact on FDI outflows should be smaller this time

For largely the same reason, unlike the post-2018-19 trade war period, when firms rushed to shift production away from China to these countries to circumvent US tariffs, which resulted in increased FDI outflows from China, the new tariff structure erodes the cost advantages these nations once offered. Thus, the new reciprocal tariffs greatly diminish the incentive for both multinational corporations and Chinese manufacturers to relocate factories away from China, as the high tariffs on ASEAN countries, India and Mexico reduce their appeal as alternative manufacturing hubs. Consequently, this could marginally benefit China by stabilising its manufacturing base and curbing FDI outflows, as the relative economic penalty of staying in China is lessened – at least on the margin – compared to moving to these now heavily tariffed regions. While China still faces substantial direct export challenges due to the new 54% tariff, the broader tariff net cast over its competitors may inadvertently preserve its position in global supply chains, at least in the short term.

We lower our export growth forecast for this year to -2% and maintain our GDP growth forecast

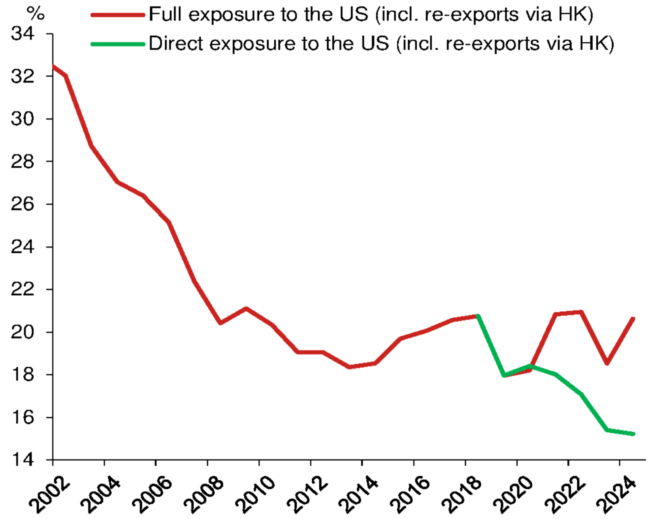
As such, we tentatively lower our export and import growth forecasts for 2025 to -2.0% and 1.0%, respectively, from 0.0% and 2.0%. The drop in export growth would have dented GDP growth, but we expect Beijing to step in with a more spending to fill the gap. We maintain our GDP growth forecast at 4.5% for this year, which is below Beijing's target of "around 5.0%". Another reason for us to maintain our 4.5% GDP growth forecast is that we have already to a large extent taken into account *a significant worsening* of tensions between the US-China and Beijing's policy stimulus to counter tariff impact.

Fig. 1: China-US trade plays a less important role in Hong Kong's re-exports than it did decades ago



Note: 2024 data refers to January and February.
Source: Consensus & Statistics Department, CEIC, Nomura Global Economics

Fig. 2: China's total export exposure to the US if estimated re-routing via Mexico and ASEAN are considered



Source: CEIC, Wind, Nomura Global Economics

A small cut to our CPI inflation forecast

The latest US tariffs introduce a dynamic interplay of inflationary and disinflationary forces affecting China's inflation outlook, with four key counteracting effects at play. First, reduced external demand from the US is likely to push Chinese producers to redirect some export-bound goods to the domestic market, exerting disinflationary pressure. Second, as other countries grapple with steep US tariffs, they may dump more goods into China's markets, further dampening domestic price pressures. Third, China's retaliatory tariffs on US imports could drive up the cost of those goods, leading to some directly imported inflation that raises consumer prices (more below on agricultural product imports). Fourth, with fewer US imports competing in China's markets, domestic producers may gain stronger pricing power, potentially increasing prices and adding inflationary pressure. Balancing these factors, combined with expectations in global crude oil prices, we estimate disinflationary forces will still modestly prevail, dragging headline CPI inflation down by 0.1pp. As a result, we cut our 2025 annual CPI inflation forecast from 0.1% to 0.0%.

Effects on food prices

The latest tit-for-tat blanket tariff hikes from Beijing on imports from the US, including agricultural products, have raised some concerns about their impact on China's domestic food price inflation. The US accounted 7.2% of China's total imports in 2024. The US supplies approximately 15% of China's imported agricultural products and 20-25% of its imported grain, with only 8-10% of total domestic grain consumption met by imports. This suggests only moderate direct pressure on food prices. China's ability to partially shift to alternative suppliers, like Brazil (and potentially Ukraine), and leverage strategic reserves further mitigates this impact, as seen during the 2018-2019 trade war, when food inflation remained moderate at 2.8%. However, price increases for specific commodities like sorghum, where the US holds a larger share, could be more pronounced, potentially nudging meat prices higher. Overall, with government interventions and diversified sourcing, the tariffs are unlikely to significantly disrupt food price stability, keeping inflation contained despite the US's role in these import proportions.

Moreover, given the recent plunge of global commodities prices – from energy to base metals – and the darkened outlook of the US economy and Asia EMs, we think the more direct impact on China's domestic inflation outlook from the latest US tariffs is indeed on factory gate prices. As such, we cut our 2025 annual PPI inflation forecasts to -2.0% from -1.5%.

Beijing's strategy to respond to Trump's tariffs

US and China are stuck in an unprecedented, and expensive, game of chicken, and it seems both sides are unwilling to back down. While many countries remain undecided on how to respond to Trump's latest reciprocal tariffs, Beijing hit back decisively with a 34% "reciprocal" retaliatory tariff on all US imports, effective 10 April. It placed further restrictions on exports of rare earth minerals, adding seven more elements to the existing list. 16 more US entities were added to Beijing's Export Control List and 11 more US entities were added to the Unreliable Entity List.

We expect tensions between these two mega economies to worsen significantly, especially as China has been making large strides in high-tech sectors, including AI and robotics (see our detailed analysis at *Asia Special Report - US-China tensions: Calm masks growing risks* , 27 Feb 2025).

Beijing's policy choices

The first real battleground of the tariff war is financial markets, especially stock markets. We expect China's national teams, supported by the PBoC, to actively intervene in stock markets in coming weeks.

To deliver a stable growth, Beijing will look to a variety of measures to boost domestic demand, especially by accelerating the fiscal spending planned at the NPC meeting. In the near term, the PBoC might guide funding costs lower by increasing its bond purchases via outright reverse repo or direct purchases of CGBs, before cutting the RRR and policy rates. Beijing will very likely speed up some existing spending programs to stabilize demand when exports are being hit. Beijing might also step up supportive measures to clean up the mess in the property sector. As it is difficult to assess the economic damage, and perhaps as Beijing does not want to be perceived as in chaos, Beijing may stay in a wait-and-see mode and take its time to increase the budget deficit and new bond financing quota.

To bolster domestic financial and property markets while promoting RMB internationalization, Beijing most likely won't allow a sharp RMB depreciation against USD. On other monetary measures, we maintain our forecasts for a 50bp RRR cut and a 15bp rate cut in Q2. On 3 March, we *removed* our forecast for a 50bp RRR cut in Q1 but maintained our post-Q1 easing outlook, with 100bp of total RRR cuts and 30bp of total rate cuts, evenly split between Q2 and Q4. In the same report, we highlighted that, "if US-China tensions flare up sharply, triggering substantial stock market selloffs, the PBoC could still quickly respond with RRR cuts to shore up market sentiment, like *the case in May 2019* ." Considering the larger-than-expected tariff announcement on 2 April EDT, the PBoC is likely to start a new round of monetary easing in Q2, and the exact timing might be earlier (within Q2) than we had forecasted.

After the latest military exercises around Taiwan, Beijing might further step up actions showcasing its abilities to seal off seas and skies around the Taiwan Strait. Just before the additional new US 10% tariff took effect, China launched a two-day intense military drill, Strait Thunder-2025A, targeting areas near Taiwan. Taiwan recorded 76 Chinese military aircraft on 1 April and 36 on 2 April, plus 15 navy ships and 4 official vessels, one of the largest aircraft mobilizations since the Joint Sword-2024B exercise in October 2024. Though China's military moves appear tied to a long-term military strategy, the timing of this recent military exercise implies that it may also have served as leverage against US tariffs.

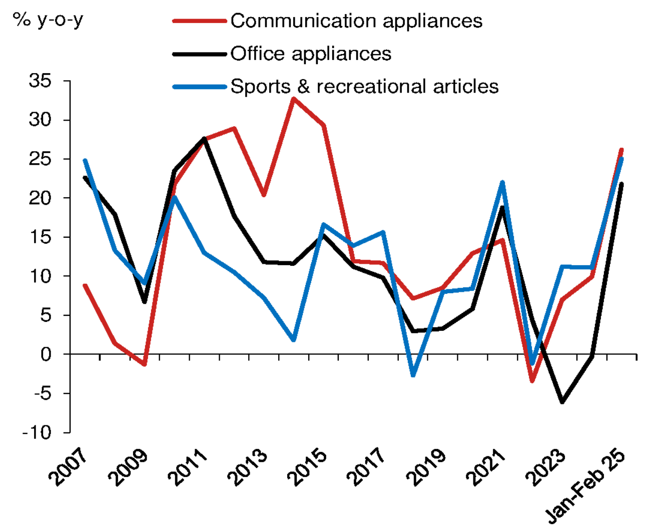
The boost from consumer trade-in program is unlikely to sustain

Between September and December 2024, RMB150bn of ultra-long CGB funding was allocated to stimulate purchases of autos and home appliances in the first round of the trade-in program. Retail sales of autos and home appliances jumped from -7.3% y-o-y and 3.4%, respectively, in August to 3.6% and 33.6% in Q4 2024. According to official estimates, the RMB150bn of ultra-long CGBs funding boosted sales of covered products by more than RMB1.3trn in 2024, which translated into a 1.0pp increase in national retail sale growth (annual growth in 2024: 3.5%).

Encouraged by the strong rebound in auto and home appliance sales, Beijing doubled the funding for the trade-in program this year to RMB300bn and expanded the program to include digital products, such as smartphones. Thanks to the expanded program, retail sales growth of communication appliances, office appliances and sports & recreational articles jumped to 26.2% y-o-y, 21.8% and 25.0% (Figure 3), respectively, in January-February from 14.0%, 9.1% and 16.7% in December.

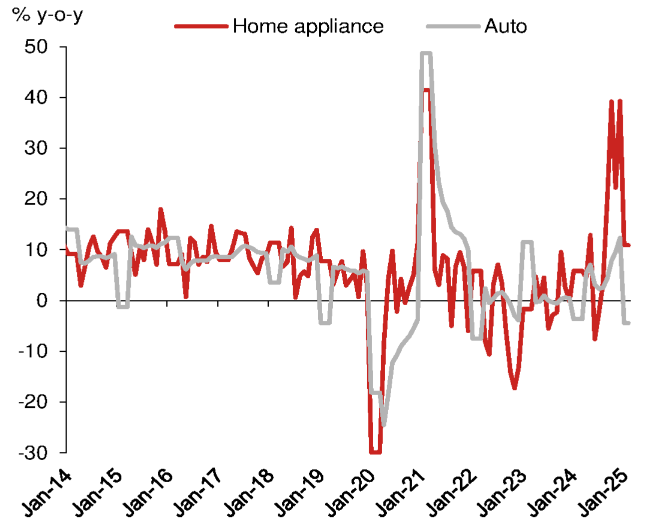
However, the boost from the trade-in program could be short-lived. Retail sales growth of autos and home appliances, which had already been significantly stimulated in the first round of the trade in program last year, dropped to -4.4% y-o-y and 10.9% (Figure 4), respectively, in January-February from 0.5% and 39.3% in December. High-frequency data from the China Passenger Car Association (CPCA) show that volume growth of passenger car retail sales dropped to 5.0% y-o-y in Q1 from 13.3% in Q4.

Fig. 3: Expanded trade-in boosting sales of digital products



Source: NBS, Wind, Nomura Global Economics.

Fig. 4: Monthly retail sales of home appliances and autos



Source: NBS, Wind, Nomura Global Economics.

More spending on social welfare of low-income group

As short-term boosts, such as from trade-in programs, cannot be used too often, Beijing might need to consider longer-term structural policies to support consumption. In our view, a reform to the social security system, including a large increase in basic pension payments to low-income households and raising subsidies for basic medical insurance would be the most effective long-term policy to bolster consumption and reduce inequality. At the March NPC annual meeting this year, Beijing raised subsidies for basic pension payments and medical care by the same amount as the last year. We believe Beijing could do more in this regard, especially given the highly unequal social welfare system.

First, the marginal propensity to consume of the rural elderly could be quite high due to their extremely low incomes. Second, the administrative cost of increasing pension payments to the rural elderly would be low, as China has already built the infrastructure for such a pension system over the past decade. Third, behind the 173mn rural elderly (Figure 5), there are close to 300mn migrant workers that are sons and daughters of the rural elderly. Increasing pension payments to the rural elderly would not only reduce the burden on those migrant workers, but could also reduce their saving rates, as they would expect higher pensions when they become pensioners.

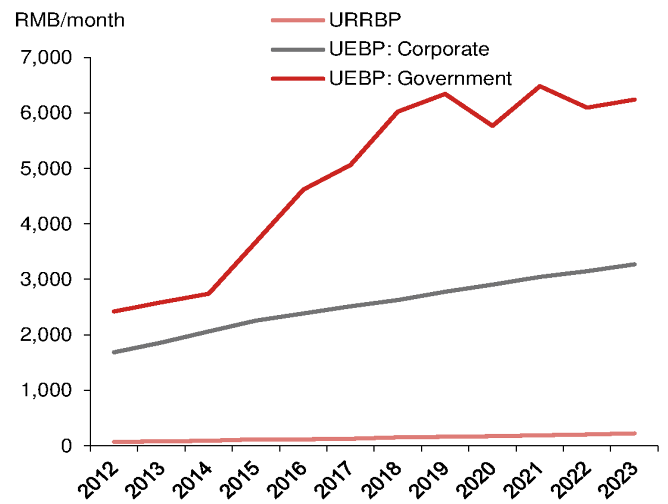
Establish a national childbirth subsidy system to encourage more births

China's population has been steadily shrinking. This downturn in population was driven by a falling number of newborns, which plummeted to 9.02 million in 2023 – a 45% decrease from the 2018 level and a stark contrast to the 16.36 million annual average from 2017 to 2023, reflecting an annualized decline of 9.4% over that period. In 2024, births edged up slightly to 9.54 million, though this modest rebound may reflect a temporary surge tied to the Year of the Dragon, a culturally auspicious zodiac sign that often boosts childbirth rates in Chinese tradition. The *decline in new marriage registrations* also suggests a subsequent drop in the number of births in coming years. According to the Ministry of Civil Affairs, the total number of marriage registrations dropped to 6.1mn couples, the lowest level since 1979. Establishing a national childbirth subsidy system could reduce the burden of raising children and encourage larger families, mitigating the impact of shrining population on the economy.

Clearing the property markets should still be Beijing's top priority

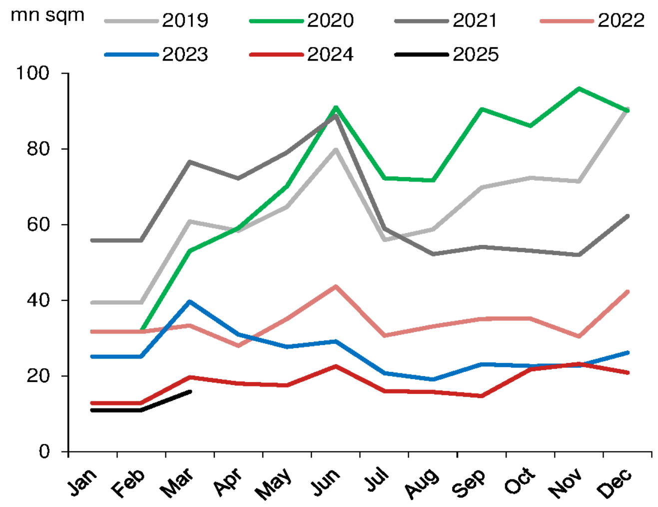
Thanks to a broad set of policy easing measures rolled out since 24 September, China's housing market showed signs of stabilization in Q4 2024. The once deeply negative year-on-year new home sales growth rebounded, approaching zero percent. Existing home prices in some top-tier cities displayed the largest rise since mid-2021. Nevertheless, the stabilization was short-lived, especially outside of top-tier cities. Growth of new home sales turned negative again early this year, with its volume and value growth dropping to -5.1% y-o-y and -2.6%, respectively, in January-February from 0.0% and 0.7% in December. According to alternative data from CRIC, growth of contract sales volume and value of *top 100 developers* dropped to -16.7% y-o-y and -5.9%, respectively, in Q1 from -8.1% and 0.0% in Q4 (Figure 6).

Fig. 5: Pension benefits per capita under the basic scheme



Source: China Labour Statistical Yearbook, Nomura Global Economics.

Fig. 6: New home sales volumes: CRIC's top 100 developers



Source: CRIC, Nomura Global Economics.

Appendix A-1

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