China's Credit Profile Can Withstand the Impact of the 10% Tariff by the US

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China faces additional tariffs from the US with the new government under President Trump. Moreover, these tariffs come at a time when China's economy is already grappling with domestic challenges, such as a slowdown in the property sector and weak consumption. As a result, there is increasing focus on what measures China will take next to support its economy, especially as it seeks to rein in its elevated off-budget debt.

CareEdge Global believes that the credit profile of China [rated 'CareEdge A (Unsolicited)'] should be able to bear the near-term impact of the current 10% additional tariff imposed by the US. The tariffs are expected to reduce exports to the US, lower China's sizeable current account surplus marginally, and affect the foreign direct investment flows into the country. Further, real GDP growth could decline by around 25 basis points in 2025, and disinflationary pressures might increase. This global environment can add to the challenges of a troubled property sector and a weakening domestic consumption.

In response, China may provide an economic stimulus in an attempt to partly offset the negative impact on economic indicators. Some currency depreciation may also be likely, consistent with the previous experience. The country may also impose additional tariffs on its imports from the US. These measures can help partly offset the evolving global and domestic economic environment for China.

However, the country's strengths, such as a strong external position, a low current interest-to-revenue ratio of the general government and a high share of domestic funding of government debt, will enable it to manage the impact on its credit profile. Moreover, China's export dependence on the US has reduced since the first trade war, which should also offer some support to its credit profile. China's exports to the US now account for 2.8% of its GDP (2024), down from 3.5% before the start of the first trade war (2017). Further, this time, given that other countries are also facing tariff threats from the US, the impact on China's trade may be lower relative to other countries. As a result, the actual impact of the additional 10% tariff on China may be limited. Nonetheless, any further increase in tariffs in the future may add to the uncertainty. In this context, a key monitorable for CareEdge Global will be the likely future policy direction on the trade front, which will be known once the upcoming United States Trade Representative (USTR) report is released in the next few months.

New Tariffs Under Trump 2.0

On February 1, President Trump signed an executive order imposing an additional 10% tariff on all US imports from China. He also suspended the de minimis treatment for Chinese goods, which allowed imports worth less than USD 800 to enter the US duty-free. However, this suspension has been delayed due to operational challenges.

In response, China retaliated by imposing tariffs on US imports, including a 15% tariff on coal and liquefied natural gas and a 10% tariff on crude oil, agricultural machinery, large-displacement cars and pickup trucks. China has also introduced non-tariff measures, such as export controls on items related to tungsten, tellurium, bismuth, molybdenum and indium. Additionally, China added a few US-based companies to its blacklist of unreliable entities and launched an investigation into a large technology company for a suspected violation of its anti-monopoly law.

Looking ahead, it remains to be seen whether the US and China will have any negotiations that will result in an agreement offering China some reprieve similar to the one given to Mexico and Canada. The threat of additional tariffs also looms, with President Trump proposing 60% tariffs on Chinese goods during his presidential campaign. A key development to watch is the upcoming USTR report. The report is set to review the Economic and Trade Agreement between the US and China and assess whether China is complying with the terms. President Trump has also directed the USTR to recommend appropriate measures, including the imposition of tariffs, based on the findings. The report will be delivered by April 1, 2025, and is expected to play a pivotal role in shaping the US-China trade relations.

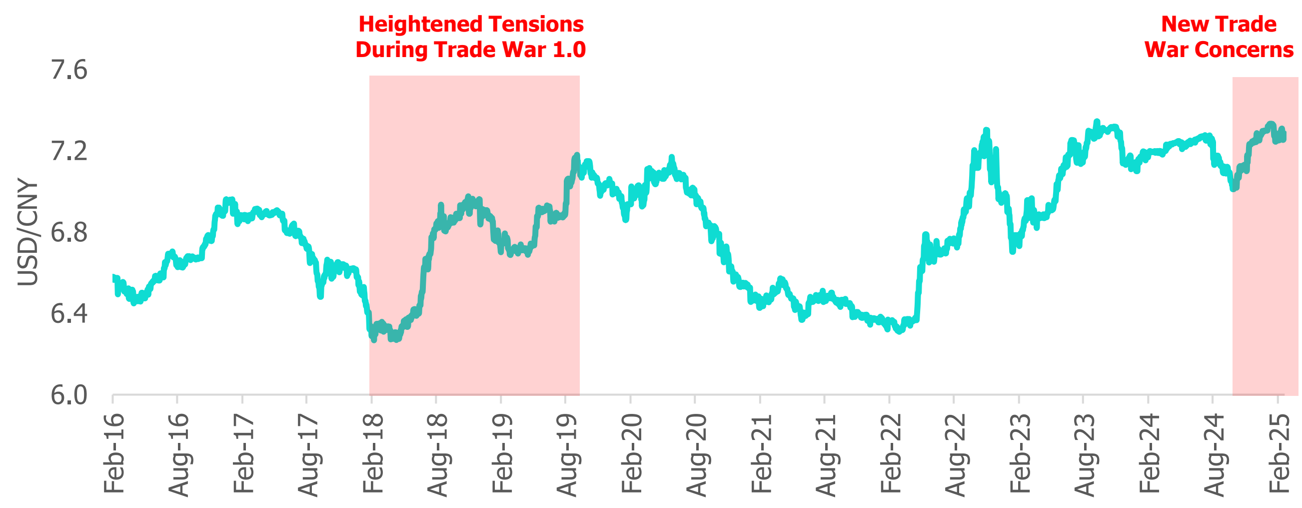
Reflecting on the First Trade War: China's Response & Possible Strategies Amid New Tariffs

During the first US-China trade war, the trade-weighted tariff rate on Chinese goods increased sharply, rising to around 21% in 2019 from around 3% in 2018. These tariffs were mainly imposed by the US due to its large trade imbalances with China.

In 2020, the US and China signed a Phase One trade deal aimed at easing tensions. As part of the agreement, China committed to purchasing US goods and services, while the US agreed to modify its tariffs. As a result, the US trade-weighted tariff rate on Chinese goods decreased slightly to around 19%, but it remained significantly higher than the pre-trade war level.

To mitigate the impact of these tariffs, China adopted several strategies. The yuan depreciated by 10-12% against the dollar during the trade war (Refer to Exhibit 1). This would have helped offset more than 50% of the tariff hikes. Further, some reports suggest that some rerouting of exports to the US may have happened.

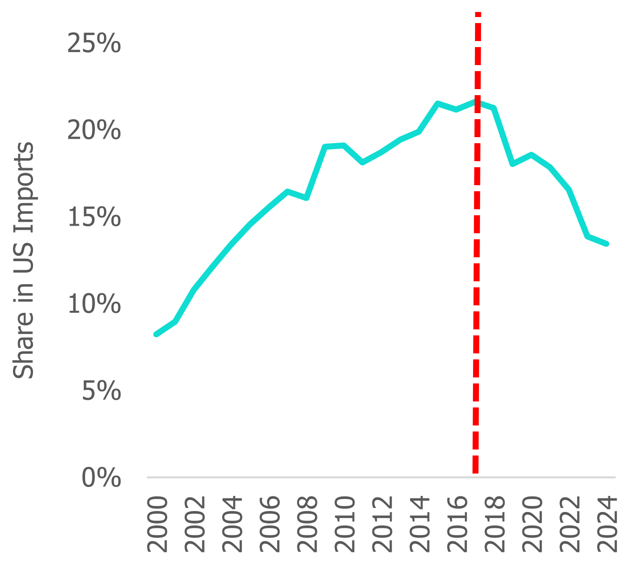
Exhibit 1: CNY Depreciation Helped Mitigate Some Tariff Impact During First Trade War



Source: Refinitiv. Data as of February 26, 2025.

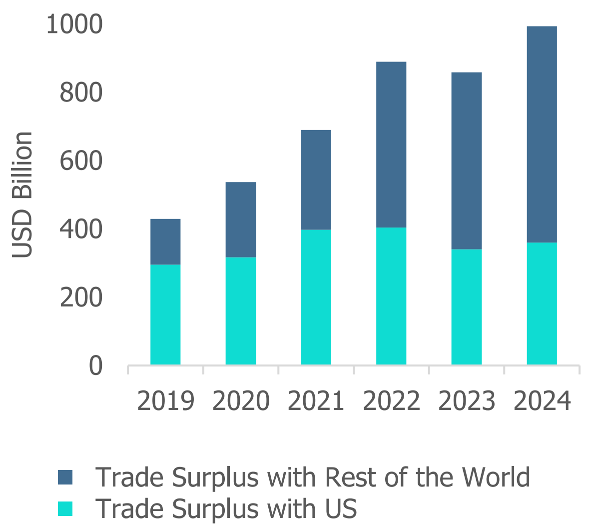
Still, the share of Chinese goods in US imports has fallen to 13% in 2024 from a peak of 22% in 2017 (Refer to Exhibit 2). China's trade surplus with the US has also seen some moderation in recent years, falling to USD 360 billion in 2024 from a peak of USD 404 billion in 2022, according to China's Customs data. However, China's overall trade surplus has grown, reaching an all-time high of nearly USD 1 trillion in 2024. This growth is supported by an increase in China's trade surplus with the rest of the world, as it explores new markets (Refer to Exhibit 3). China's advancement up the value chain, focusing on high-tech exports such as, electric vehicles, lithium-ion batteries, and solar panels, has also supported its trade profile.

Exhibit 2: Share of Chinese Goods in US Imports Declining



Source: US Census Bureau, CEIC

Exhibit 3: China's Trade Surplus with the US Has Seen Some Moderation Recently



Source: General Administration of Customs, CEIC

We believe China will use similar strategies this time to navigate the tariffs.

The yuan has depreciated by around 3.4% between October 2024 and February 2025 (as of February 26), driven by concerns over a new trade war and widening interest rate differentials with the US. However, the People's Bank of China (PBOC) has taken measures to prevent a sharp depreciation, such as setting stronger USD/CNY daily fixings. It has also suspended treasury bond purchases to limit the fall in yields and has raised offshore borrowing limits to allow more foreign exchange inflows. Additionally, the PBOC has issued warnings against yuan speculation.

We expect the USD/CNY to trade with a depreciation bias in the near term, as the US Fed keeps interest rates higher for longer and China keeps monetary policy loose to support its economy. While the yuan may weaken further as a countermeasure against President Trump's aggressive tariff actions, the pace of depreciation will likely be slow to contain capital outflows. The yuan may also not depreciate too much, as this could provoke tariff threats from other countries at a time when trade protectionism is rising globally.

China could take further retaliatory actions if the US increases tariffs. Additionally, over the past years, Chinese companies have set up factories abroad, which could allow them to shift some of their US-bound production overseas to avoid tariffs. The government may also provide some stimulus to mitigate the impact of tariffs.

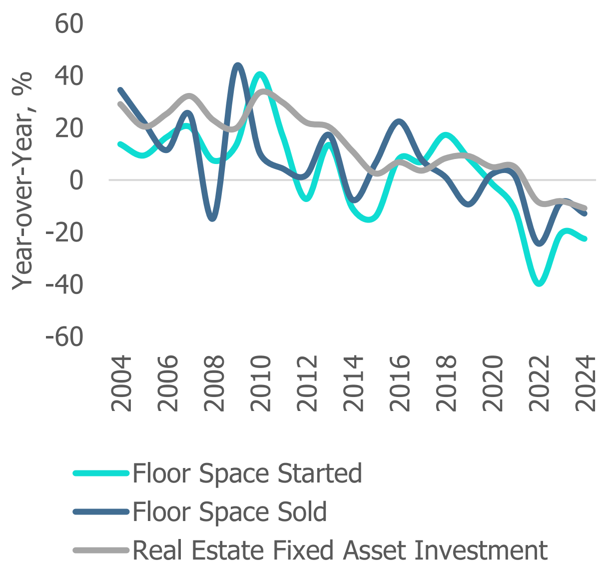
Domestic Challenges Remain: Property Sector Troubles and Weak Consumption

China's real GDP growth stood at 5% in 2024, in line with the government's official target. However, it was lower than the 5.4% growth in 2023. Domestically, two key challenges continue to weigh on the economy - the ongoing troubles in the property sector and weak consumption.

Data shows that key property sector indicators such as 'floor space started' and 'floor space sold' continued to contract in 2024. Real estate fixed asset investment also fell by around 11%, contracting for the third consecutive year (Refer to Exhibit 4).

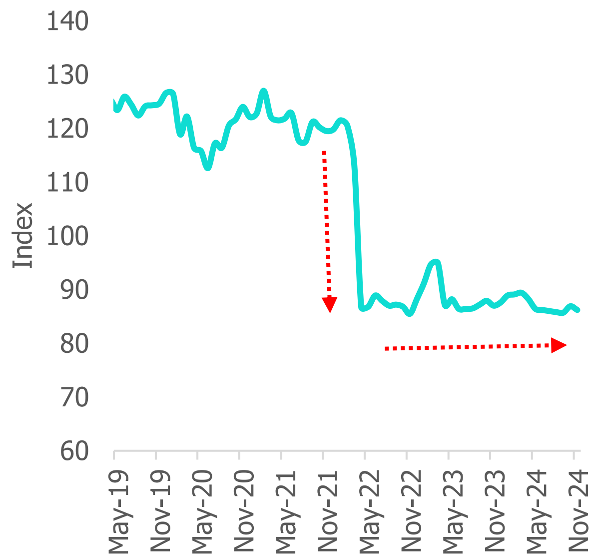
Consumer confidence in China has remained near historically low levels, failing to recover since the second wave of Covid (Refer to Exhibit 5). Negative wealth effects from the property sector slowdown, along with elevated youth unemployment, continue to dampen consumer sentiment. As a result, consumption remains weak, with its contribution to real GDP growth declining (Refer to Exhibit 6). This weak consumption is also keeping inflationary pressures muted, with consumer price inflation averaging just 0.3% over the past year and producer prices contracting for over two years (Refer to Exhibit 7).

Exhibit 4: Property Sector Woes Persist

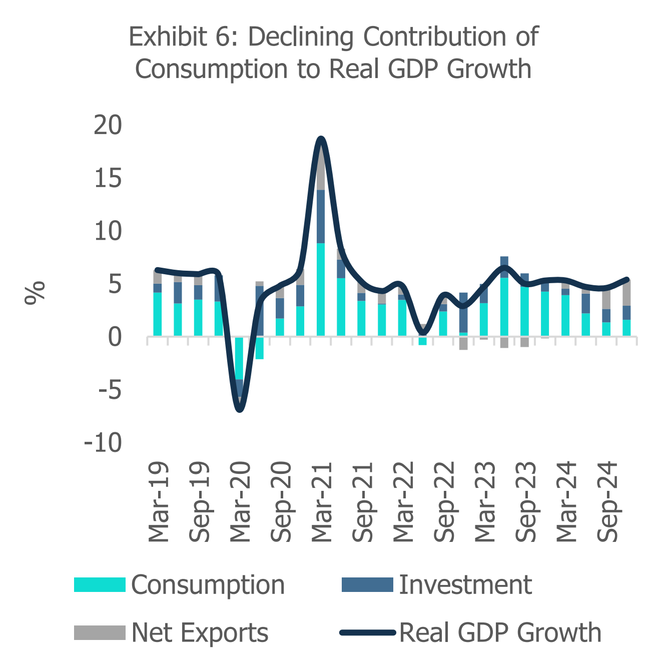


Source: National Bureau of Statistics, CEIC

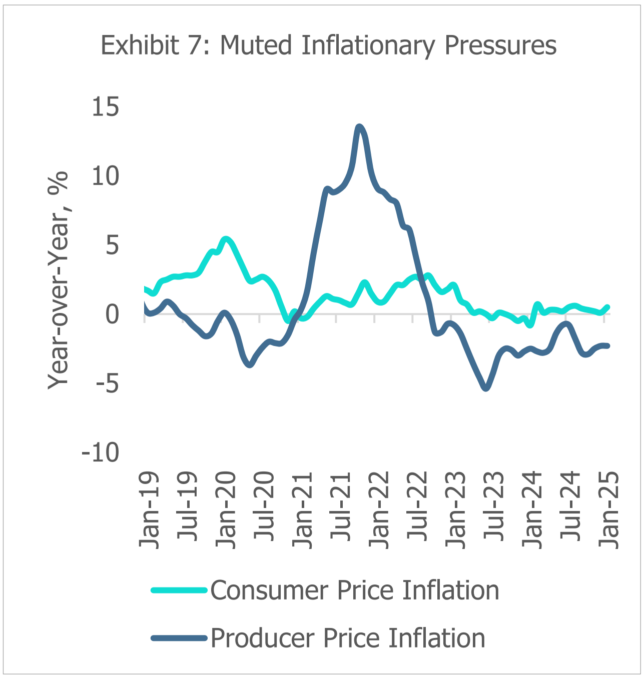
Exhibit 5: Consumer Confidence Fails to Recover



Source: National Bureau of Statistics, CEIC



Source: National Bureau of Statistics, CEIC



Source: National Bureau of Statistics, CEIC

In 2024, China's policymakers ramped up stimulus efforts to support the economy. However, the ability of these measures to meaningfully revive growth is yet to be seen.

Below are some of the key stimulus measures announced:

A. Monetary Policy Measures
- China reduced interest rates and reserve requirement ratios to lower borrowing costs and inject more liquidity into the economy.
- The floor on mortgage rates was removed and downpayment requirements for second homes were relaxed to support the property sector.
- The PBOC pledged RMB 300 billion worth of support to financial institutions to lend to state-owned enterprises for purchasing unsold but completed houses.
- The PBOC also announced measures to support equity markets, including a RMB 500 billion swap facility to facilitate stock purchases by non-bank financial institutions and a RMB 300 billion relending program for share buybacks by listed companies.

B. Fiscal Policy Measures
- China announced the issuance of RMB 1 trillion (approximately 0.8% of GDP) in ultra long-term special central government bonds to fund priority projects, including key infrastructure projects. These bonds had only been issued three times before - in 1998 (about 3% of GDP), 2007 (about 6% of GDP) and 2020 (about 1% of GDP).
- Policymakers also indicated plans to issue central government bonds for bank recapitalisation.
- A local government debt swap plan was introduced to ease the financial strain on local governments, which have been affected by the property sector slowdown, as they rely heavily on land sales and land-related taxes for revenue. The plan allows local governments to raise around RMB 10 trillion in new debt over five years (until 2028) and swap it for the off-budget debt held by local government financing vehicles. This is

expected to reduce interest costs, as off-budget debt tends to be more expensive than official debt. However, the effectiveness of this plan is still to be seen.

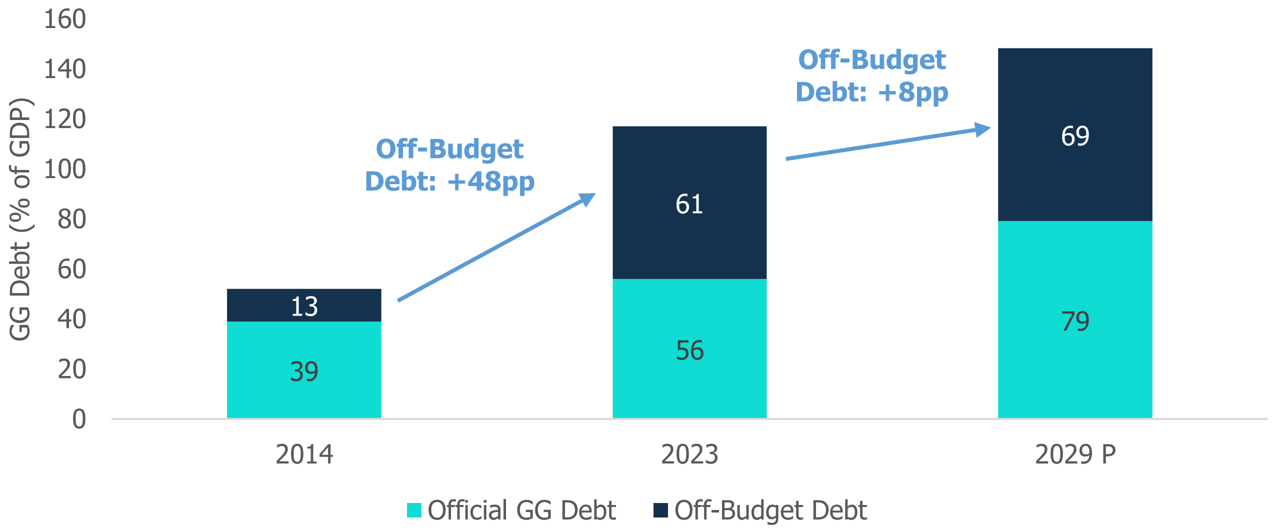
- To stimulate demand, China launched subsidised equipment upgrade and consumer goods trade-in programs. The government plans to expand these programs by increasing subsidies and broadening the categories covered.

During the December Politburo meeting, China's policymakers committed to implementing a moderately loose monetary policy and a more proactive fiscal policy in 2025. As a result, further stimulus measures are expected going forward, especially in the light of a new trade war with the US. These measures may focus more on boosting consumption and supporting viable investments, in contrast to previous stimulus efforts that led to unsustainable expansion in the infrastructure and property sector.

However, we believe the current consumer goods trade-in program may not be sufficient to drive long-term consumption growth. To achieve more sustainable consumption-driven growth, China may need to focus on improving its employment situation and strengthening its social safety net.

Further, we believe China aims to rein in its off-budget government debt, which increased significantly during previous phases of policy easing when local governments borrowed extensively through local government financing vehicles to provide stimulus (Refer to Exhibit 8). As a result, this focus on managing off-budget debt might limit the scope of stimulus this time around.

Exhibit 8: China Expected to Rein in Off-Budget Government Debt, Which May Limit Stimulus Scope



Source: IMF Article IV. Note: GG = General Government, P = Projection, pp = Percentage Points

Looking at Tariffs from a Sovereign Credit Rating Perspective

We believe the additional 10% tariff imposed by the US does not pose significant near-term risks to China's credit profile [rated 'CareEdge A (Unsolicited)'].

While the additional tariff could reduce China's exports to the US, we expect China's current account balance to remain in surplus due to its critical role in global supply chains and advancement up the value chain, though the foreign direct investment into China could get affected if the trade tensions negatively impact investor sentiment. However, any such challenges to the credit profile are likely to be offset by China's strong external position, reflected by its low external debt (around 14% of GDP in 2023) and substantial foreign exchange reserves (around USD 3.2 trillion as of January 2025).

As far as economic growth is concerned, China's real GDP growth was already expected to slow in 2025 due to ongoing issues in the property sector, weak consumption and a broader structural slowdown. With the additional tariff, growth could slow slightly further due to reduced exports and weaker consumption and investment sentiment. However, China's export dependence on the US has declined since the first trade war which should help partly offset the impact of tariffs this time. China's exports to the US now account for 2.8% of its GDP (2024), down from 3.5% before the start of the first trade war (2017).

Our analysis indicates that the additional tariff could reduce China's real GDP growth by around 0.25pp in 2025. As a result, disinflationary pressures may persist in 2025, especially if domestic demand also remains weak. However, the actual impact on growth and inflation will depend on several factors, such as the price elasticity of demand for Chinese goods and the extent of support the government provides to mitigate the impact of tariffs.

From a fiscal perspective, China's debt levels are projected to rise from already elevated levels as the government provides support. According to the IMF, China's augmented government debt (including off-budget borrowings of local governments) stood at 117% of GDP (2023). We expect the fiscal deficit to widen by 1-1.5% of GDP in 2025, resulting from a possible fiscal stimulus in response to China's domestic and external challenges.

Our assessment also considers the government's low interest-to-revenue ratio compared to other economies, which provides some support on the fiscal front. Moreover, a large part of the government debt is domestic, with external debt accounting for only 2.9% of government debt (2023), which helps flexibility.

Still, uncertainty remains high, and it will be important to track how tariff-related developments unfold. The upcoming USTR report is expected to play a key role in shaping the US-China trade relations. The National People's Congress meeting in March will also be crucial, as more stimulus measures are expected to address China's challenges.

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