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PRESS RELEASE

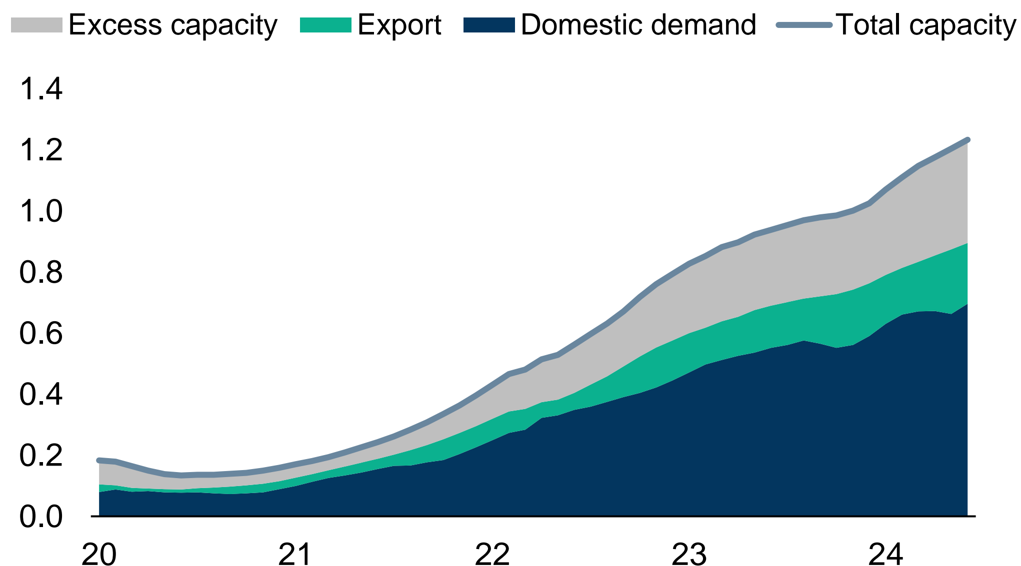
Made in China. How China can deal with its industrial overcapacity

Hong Kong S.A.R, November 14, 2024 – Production overcapacity is not new to China but is common in more products this time. The excess supply in a wide range of products makes it difficult to resolve by simply boosting consumption or slashing production domestically. The shortfall in domestic market may still have to be made up by external demand through exports, or increasingly, through outbound investment. But at a time of rising protectionism, this is set to intensify global trade tensions and disrupt global trade dynamics.

Overcapacity not new to China

China has long accustomed to an investment-driven growth model, which is central to its stellar economic growth over the past three decades. But it also makes the economy susceptible to supply-demand imbalances, leading to recurring episodes of industrial overcapacity. These can be traced back to the 1990s, when accelerated market reforms led to a glut of labor-intensive manufactured goods. A more recent episode occurred in 2014-2016, when the massive investment-led stimulus that followed the global financial crisis triggered an oversupply of construction materials.

China: Supply and demand of new energy vehicles
Million unit, 12m rolling average



Source: General Administration of Customs, Coface
N.B. Total capacity and excess capacity estimated by Coface

While this playbook is not new, the imbalances have become evident again since the COVID-19 outbreak, largely due to a production-driven stimulus aimed at reducing social interaction. But as the economy emerged from the pandemic, household consumption has failed to pick up enough to stomach the increases in production. And amid the international race of green transition, China's production surplus in clean technology products also became a focal topic globally as its excess capacity could be enough to double the exports of these products.

Current overcapacity more widespread

At first glance, the extent of overcapacity appears to be milder than the last severe episode, gauged by industrial capacity utilization rates. But this problem could worsen if growth in fixed investment continues to outstrip that of production, accentuating the excess capacity, especially if domestic demand does not keep pace. Meanwhile, excess capacity risks are not confined to specific sectors but evident across consumption goods, construction materials as well as machinery and transportation equipment.

Revitalize domestic market to absorb excess capacity takes time

Government measures have been taken to regulate capacity expansion through industrial upgrading, while boosting demand to absorb it. For example, higher quality requirements have been imposed on the production of lithium-ion batteries, solar energy and cement clinker. But these measures are unlikely to be replicated across a broad range of sectors since doing so also hurts near-term economic growth. A more sustainable solution is to stimulate demand, with recent fiscal support shifting more towards subsidizing goods and facility consumption rather than construction. But with consumer confidence near historic lows, the economy cannot just rely on domestic demand and endure chronic overcapacity. Because this will amplify deflationary pressures, affect corporate profits and hinder business expansion.

Era of easily accessing export markets seems fading

Exports have historically made up for the shortfall in domestic demand. But the golden days of free trade - which had allowed China to prosper – look to have passed as trade barriers are growing, likely at an even faster pace under a second Trump presidency. Despite China's efforts to strengthen ties with the global South, many emerging nations have also erected trade barriers in order to protect domestic jobs and manufacturers. Indonesia, for example, is considering imposing tariffs of up to 200% on a range of basic industrial goods imported from China.

More outbound investment to seek a win-win outcome

The increased trade friction may in turn prompt Chinese companies to invest directly in recipient countries to bypass such hurdles. This measure may be

welcomed by some trading partners as direct investment could create jobs and bring technologies, while boosting exports of Chinese intermediate goods.

ASEAN[1] remains the main destination for Chinese investment in 2022-2023, while Hungary is the main beneficiary in Europe, receiving 4.5% of Chinese FDI. Nevertheless, Chinese investment is coming under increasing scrutiny from governments in developed countries, not least for reasons of national security. In Europe, although scrutiny has intensified, some countries such as Hungary, Poland and Italy continue to welcome such investment, particularly in the electric vehicle sector.

Read the full study here

MEDIA CONTACTS

COFACE ASIA-PACIFIC

Karen Yik: +852 2585 9121- karen.yik@coface.com
Leo Chak: +852 2585 9132 - leo.chak@coface.com

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[1] The Association of Southeast Asian Nations (ASEAN) comprises 10 member states. Created by Indonesia, Malaysia, Singapore, Thailand and the Philippines in 1967, it was joined by Brunei (1984), Vietnam (1995), Laos and Burma (1997) and finally Cambodia (1999).