

JANUARY 2026

China in Transition: Implications for the global economy

Mark Williams, Julian Evans-Pritchard, Marcel Thieliant

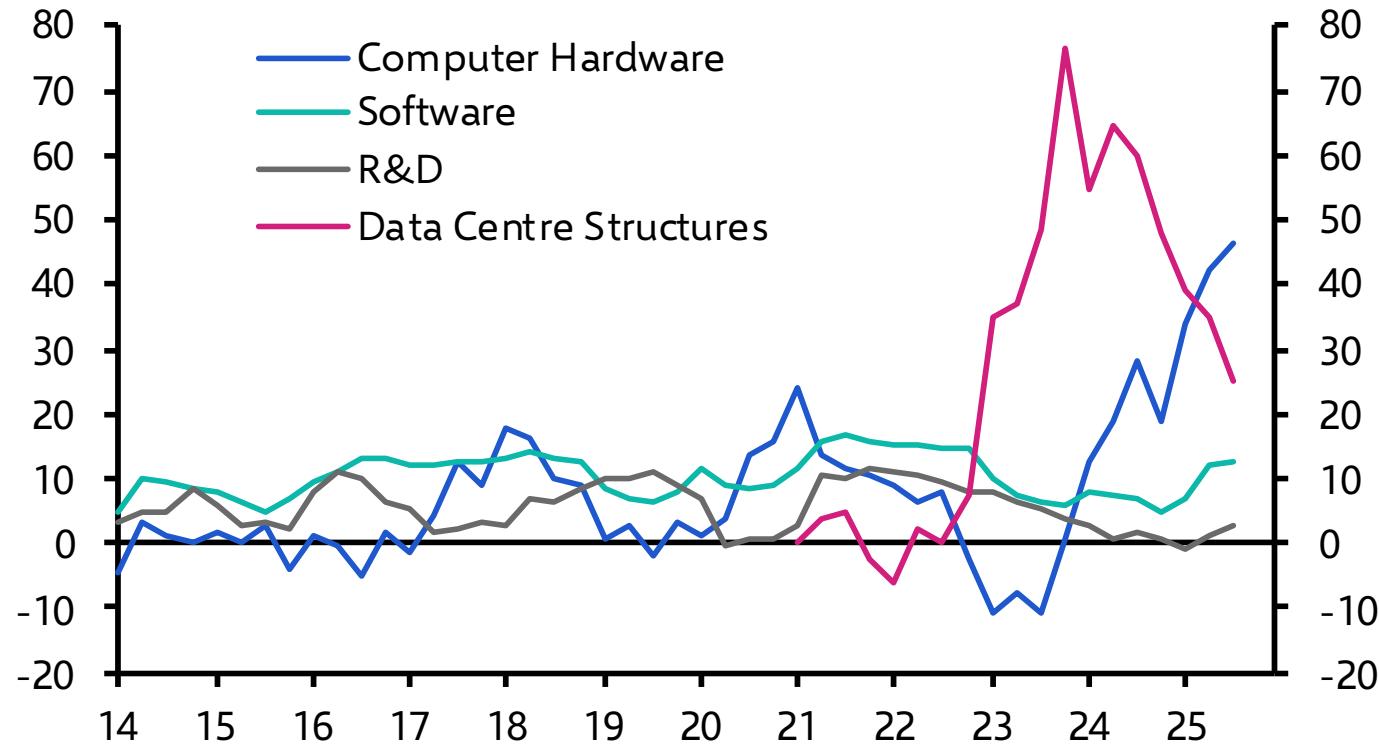
Agenda

- The outlook for the US and other developed economies (Mark Williams).
- China in transition (Julian Evans-Pritchard).
- The implications for the rest of Asia (Marcel Thieliant).
- China and the rest of the world (Mark Williams).
- Q&A

The Outlook for the US and other DMs

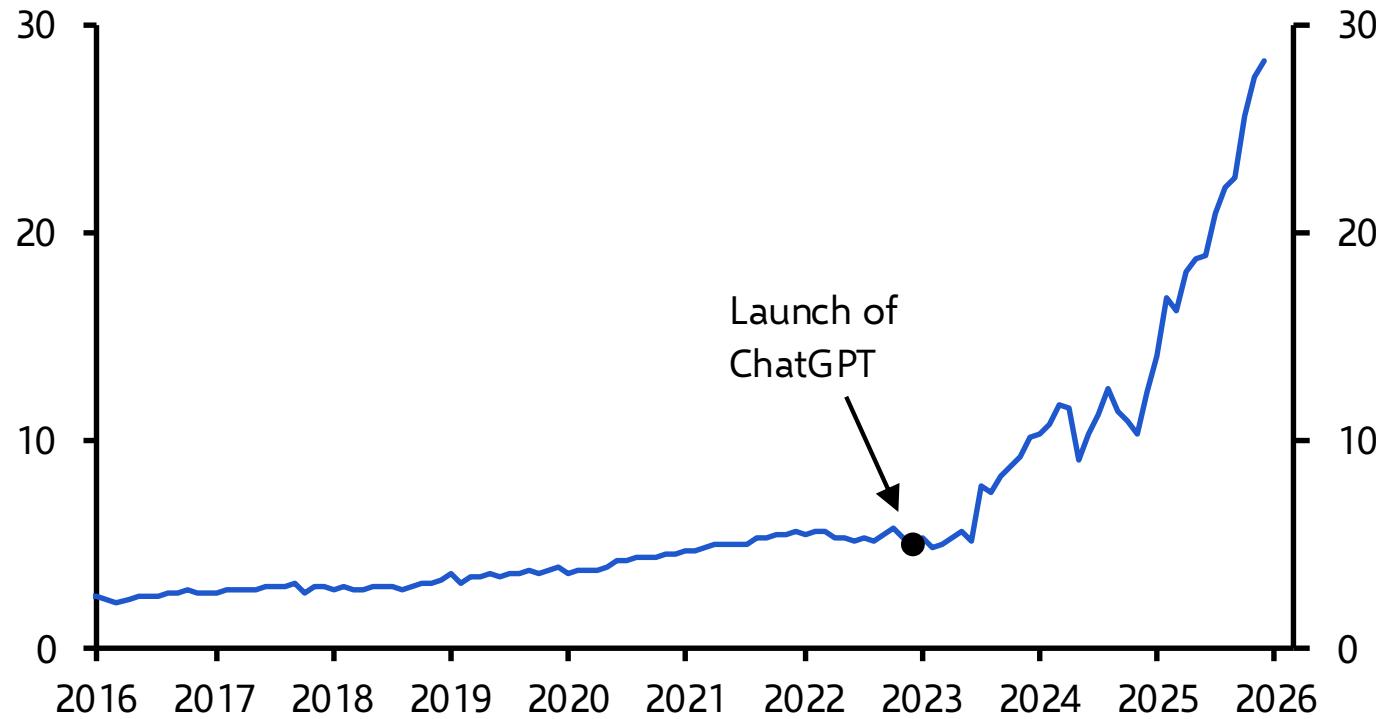
- Can the AI investment boom continue?
- Is the US on the brink of a major labour market downturn?
- Has inflation been vanquished?
- How will the Fed and other major central banks respond?

US Hi-tech Investment (% y/y)



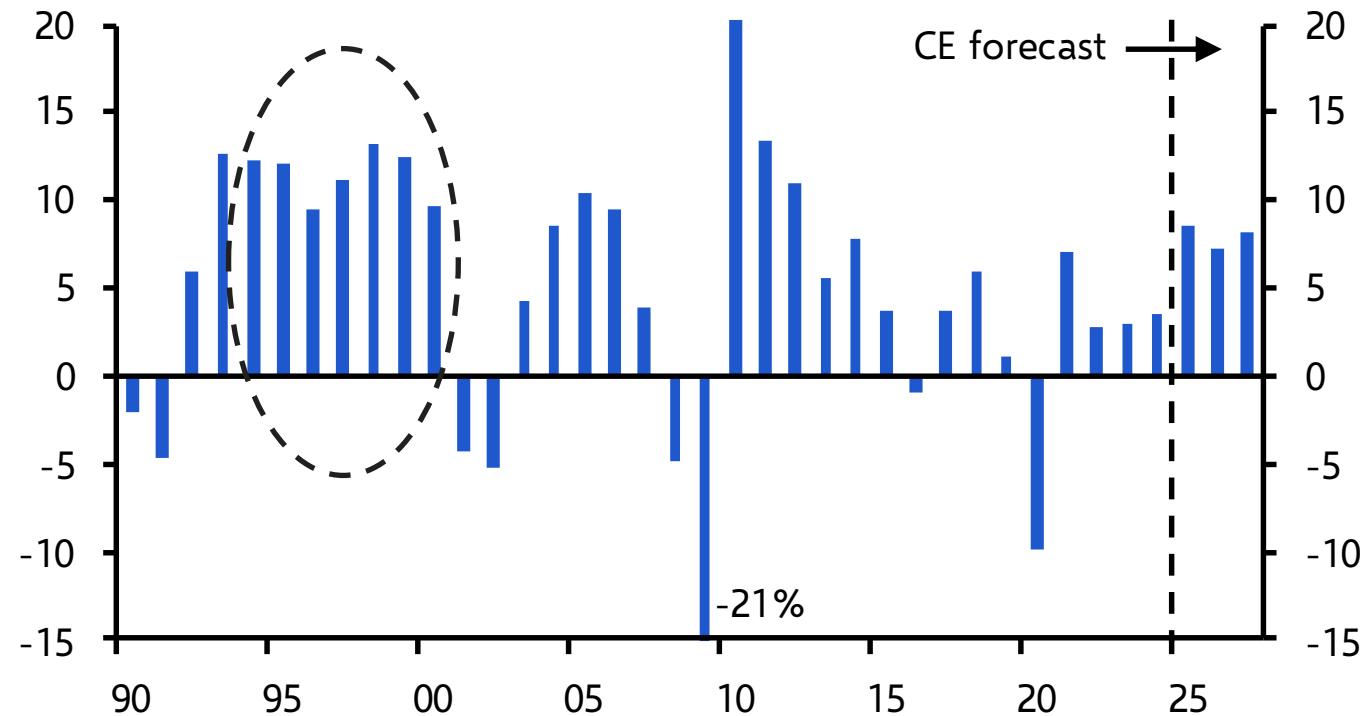
Sources: BEA, Capital Economics

Taiwan's exports of IT products (\$, seasonally-adjusted)



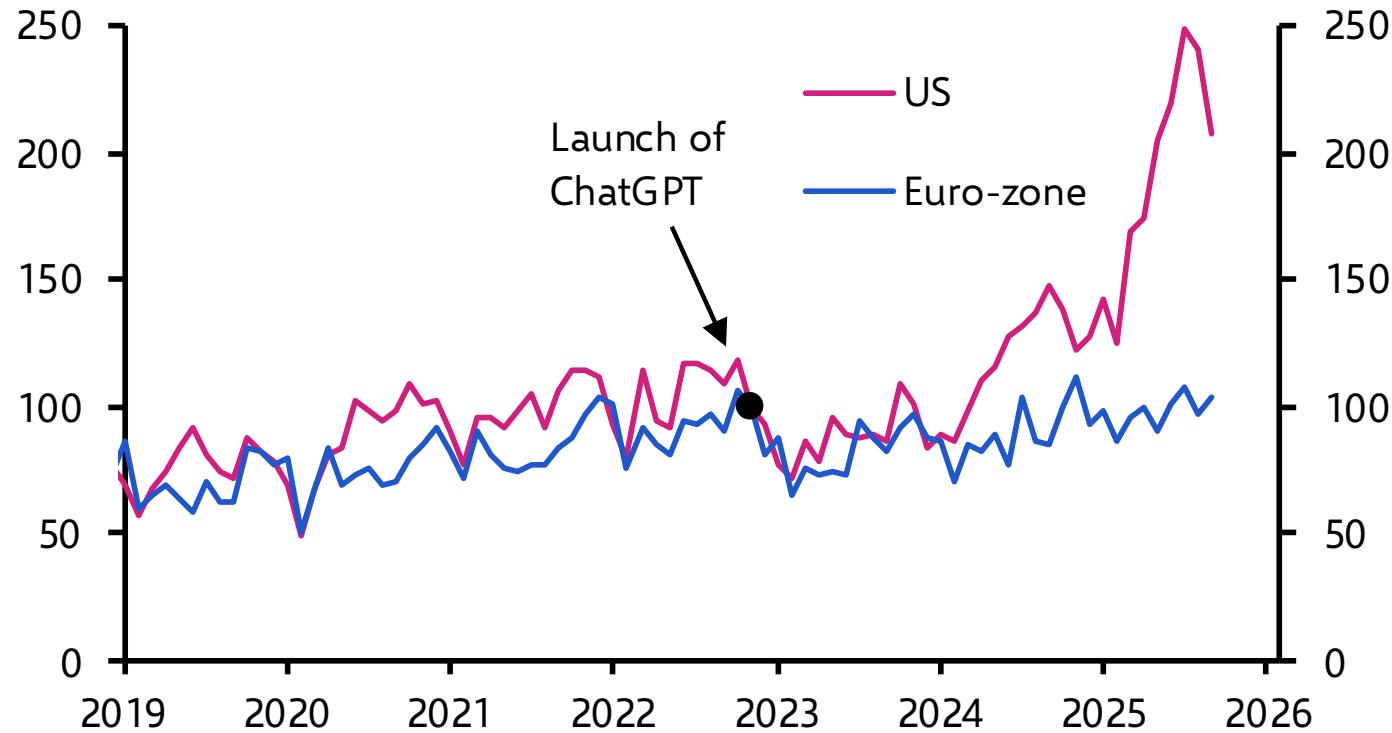
Sources: CEIC, Capital Economics

US Business Investment (% y/y)



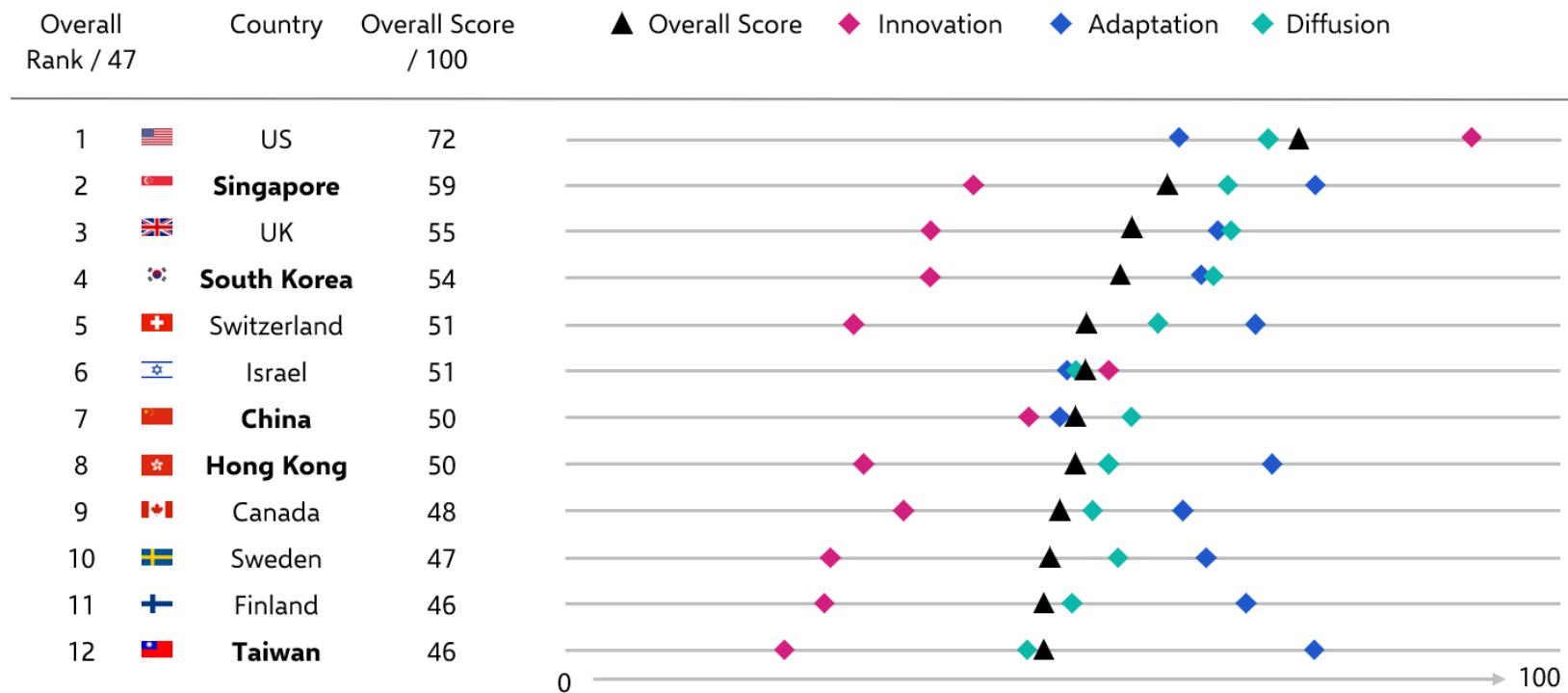
Sources: Census Bureau, Capital Economics

Imports of AI Components (Nov. 2022 = 100)



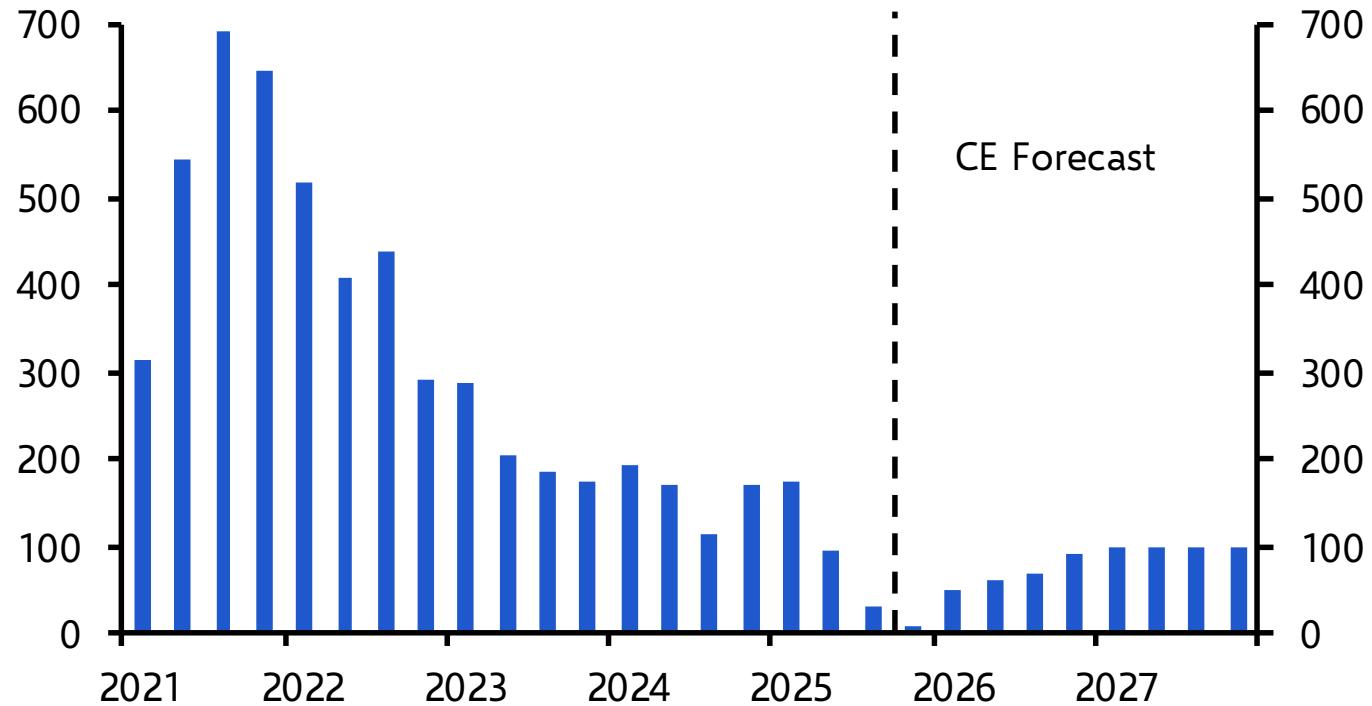
Sources: Eurostat, US ITC, Capital Economics

Capital Economics AI Economic Impact Index



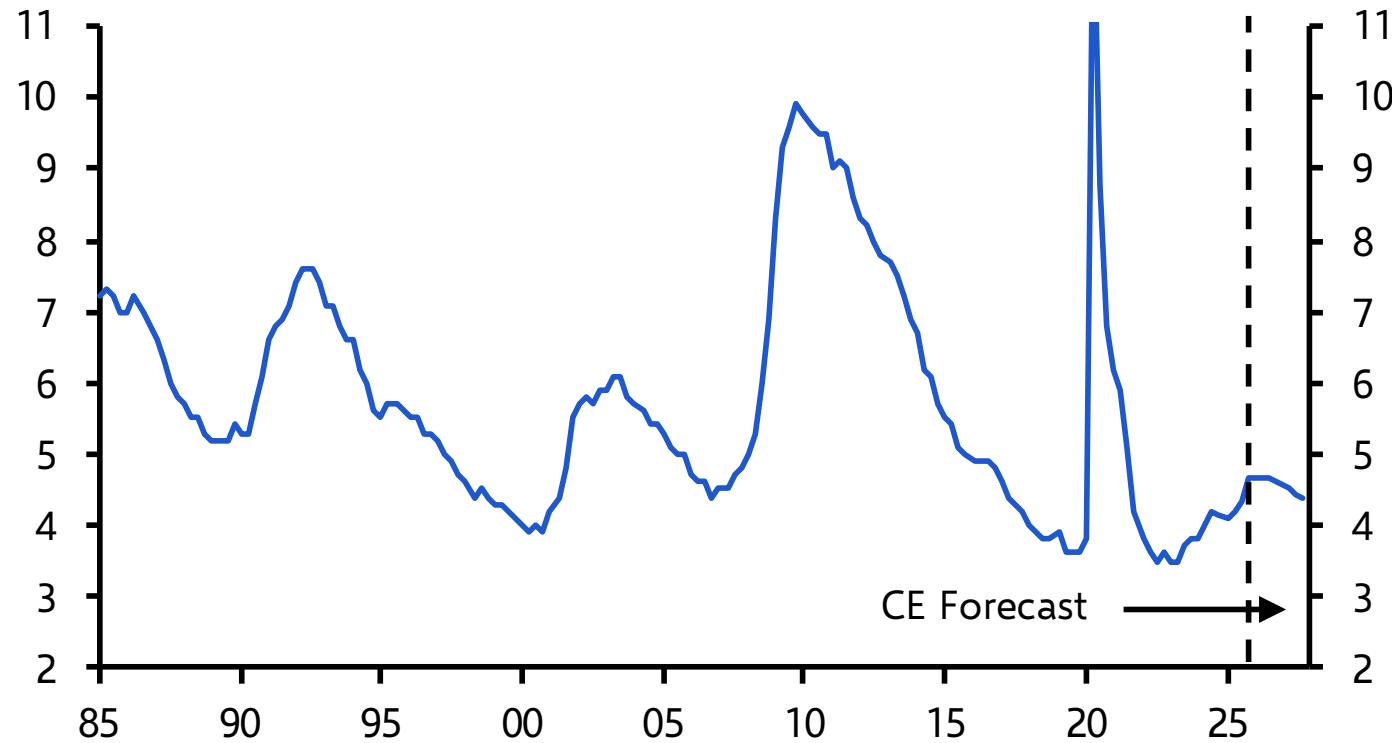
Sources: Capital Economics

US Monthly Change in Payrolls (000s, quarterly average)



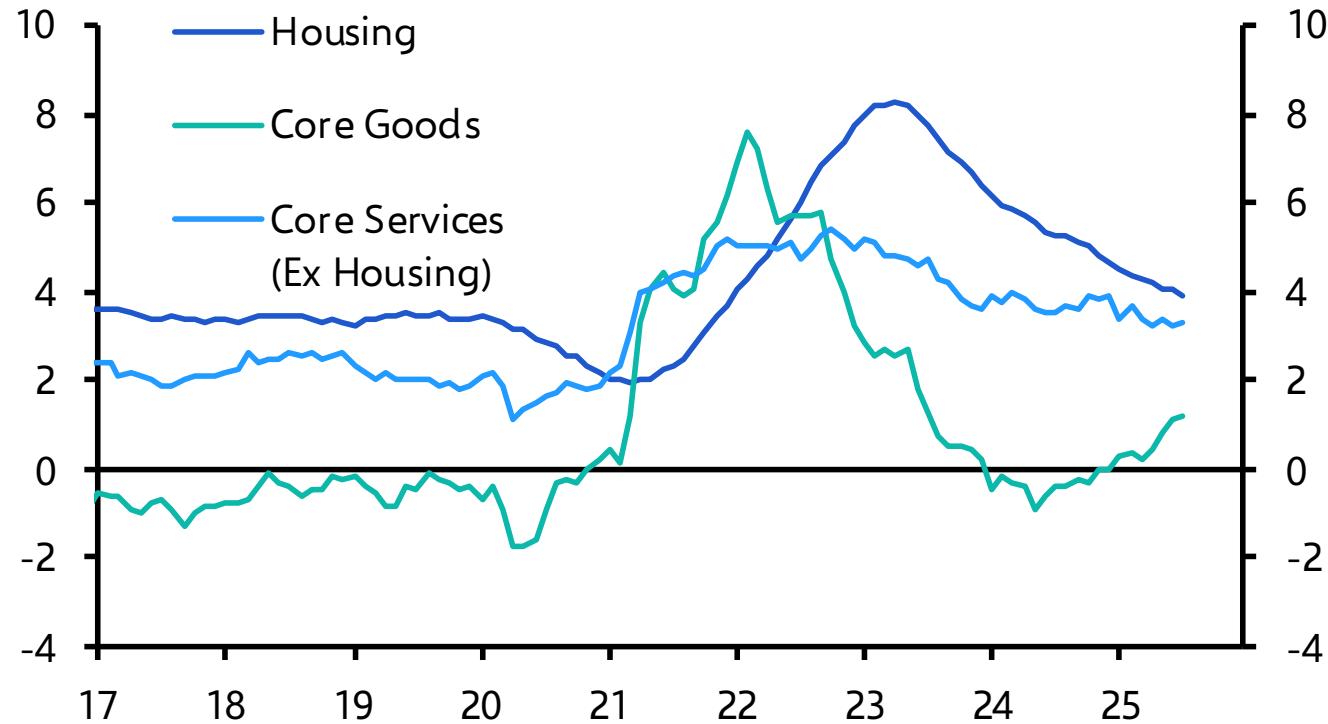
Sources: LSEG, Capital Economics

US Unemployment Rate (%)



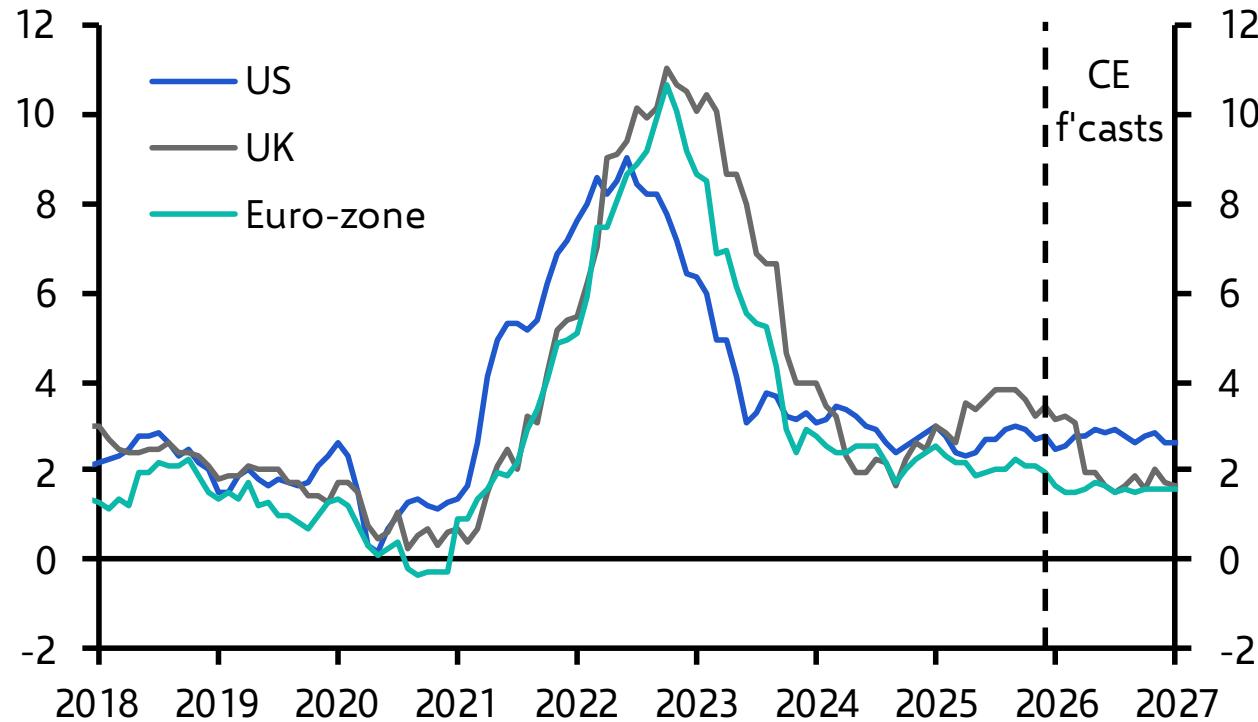
Sources: LSEG, Capital Economics

US Core PCE Inflation (%)



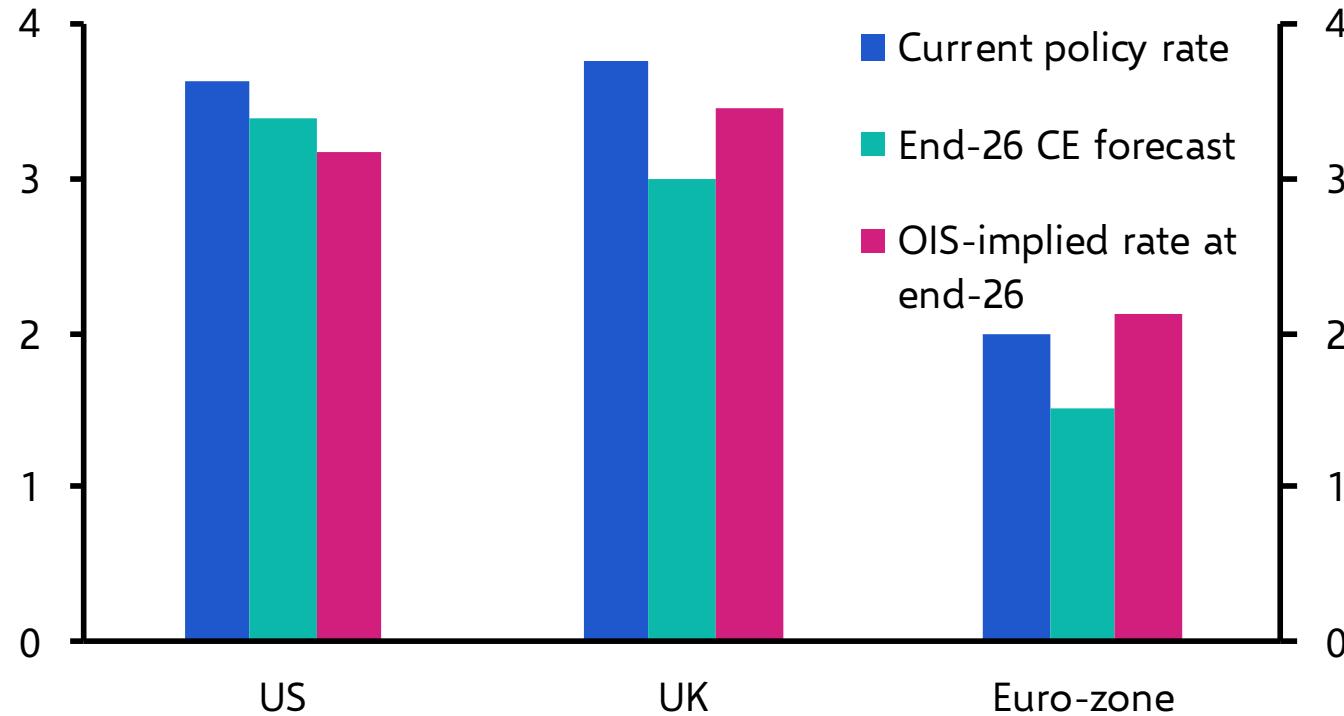
Sources: LSEG, Capital Economics

Advanced Economy Headline Inflation (%)



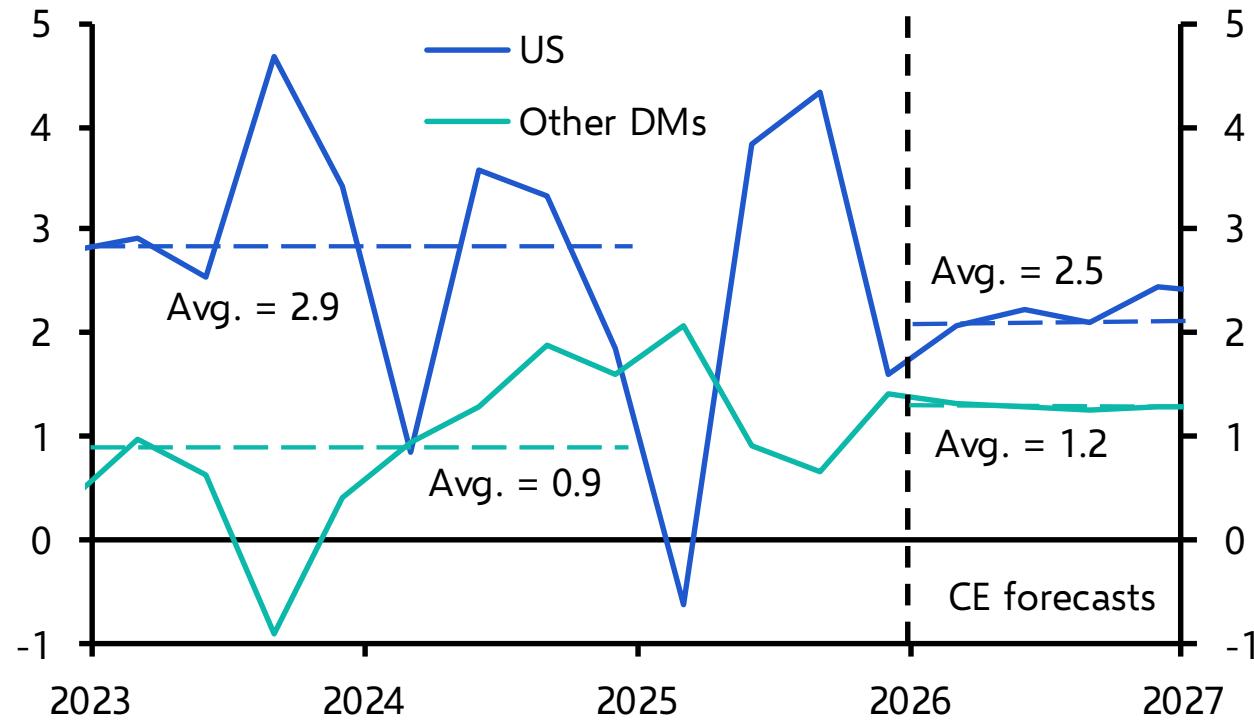
Sources: LSEG, Capital Economics

Policy Interest Rates (%)



Sources: LSEG, Capital Economics

US & other Developed Economy GDP (% q/q annualised)



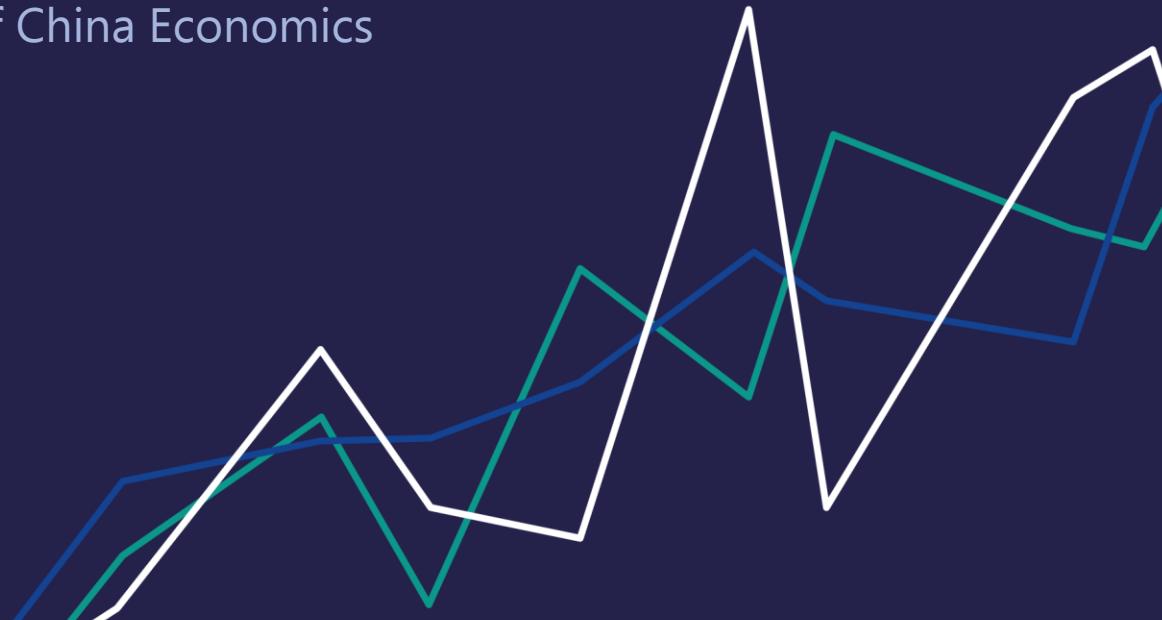
Sources: LSEG, Capital Economics

Conclusions

- Global growth will be a little slow and uneven, but no recessions.
- The US will continue to outperform other DMs – underpinned by a continuation of the boom in AI investment.
- The US labour market is cooling but unemployment won't surge.
- Most central banks will loosen policy further but Trump won't get the major cuts that he wants.

China in transition

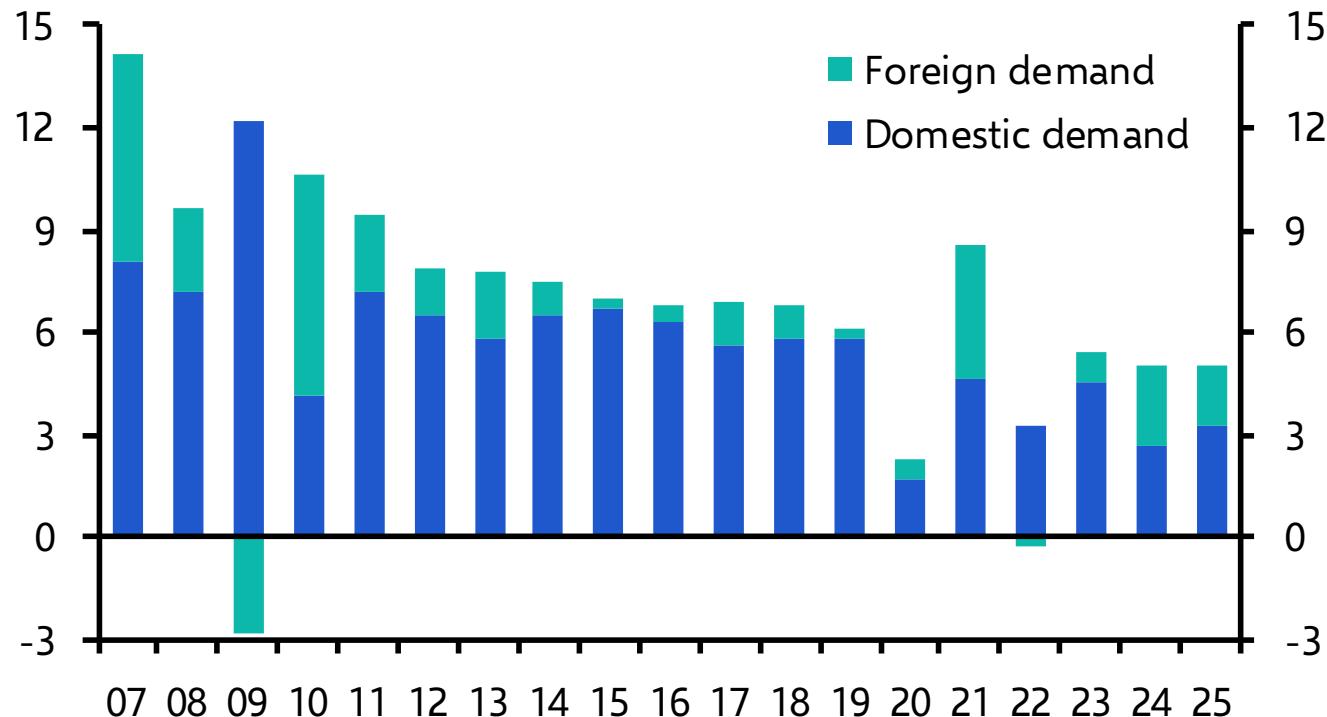
Julian Evans-Pritchard, Head of China Economics



Agenda

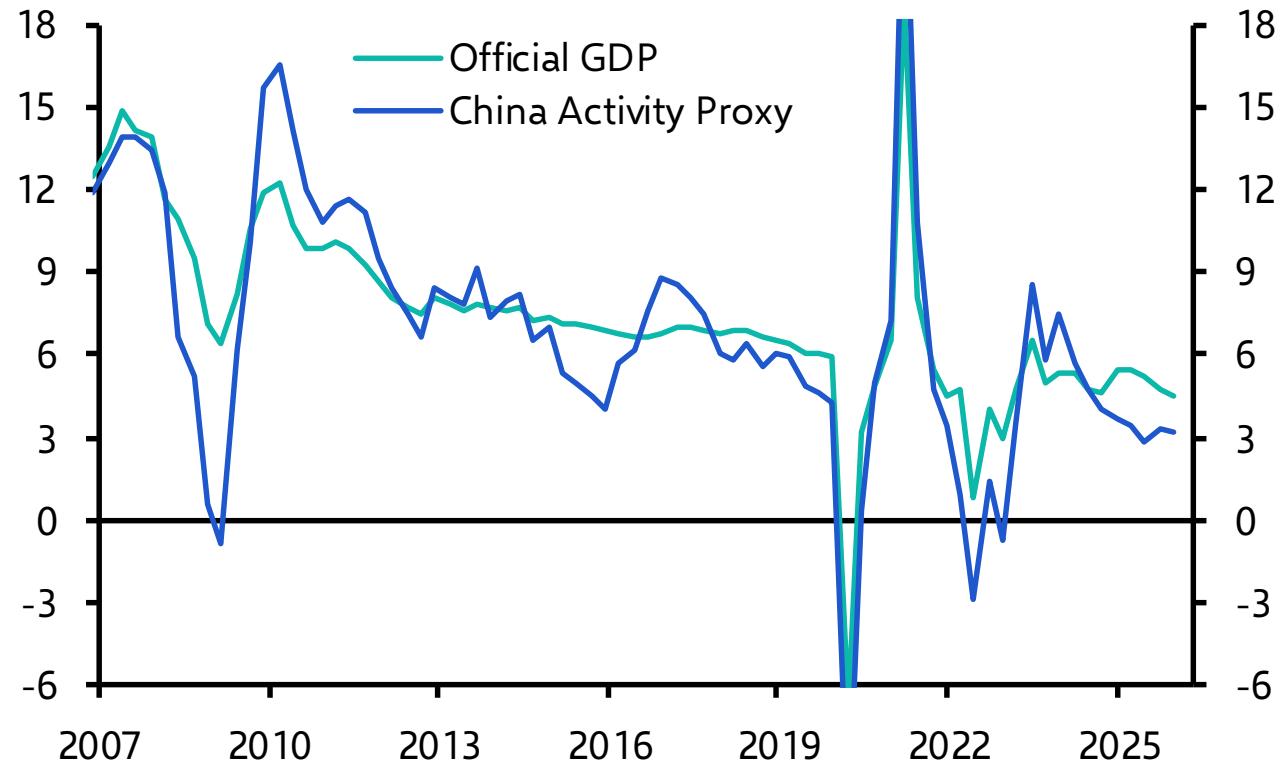
- China's AI catch-up and diffusion
- Plans to rebalance toward consumption
- Why overcapacity & deflation will linger
- The implications for China's trade surplus

China GDP Growth by Source of Demand (real, % y/y)



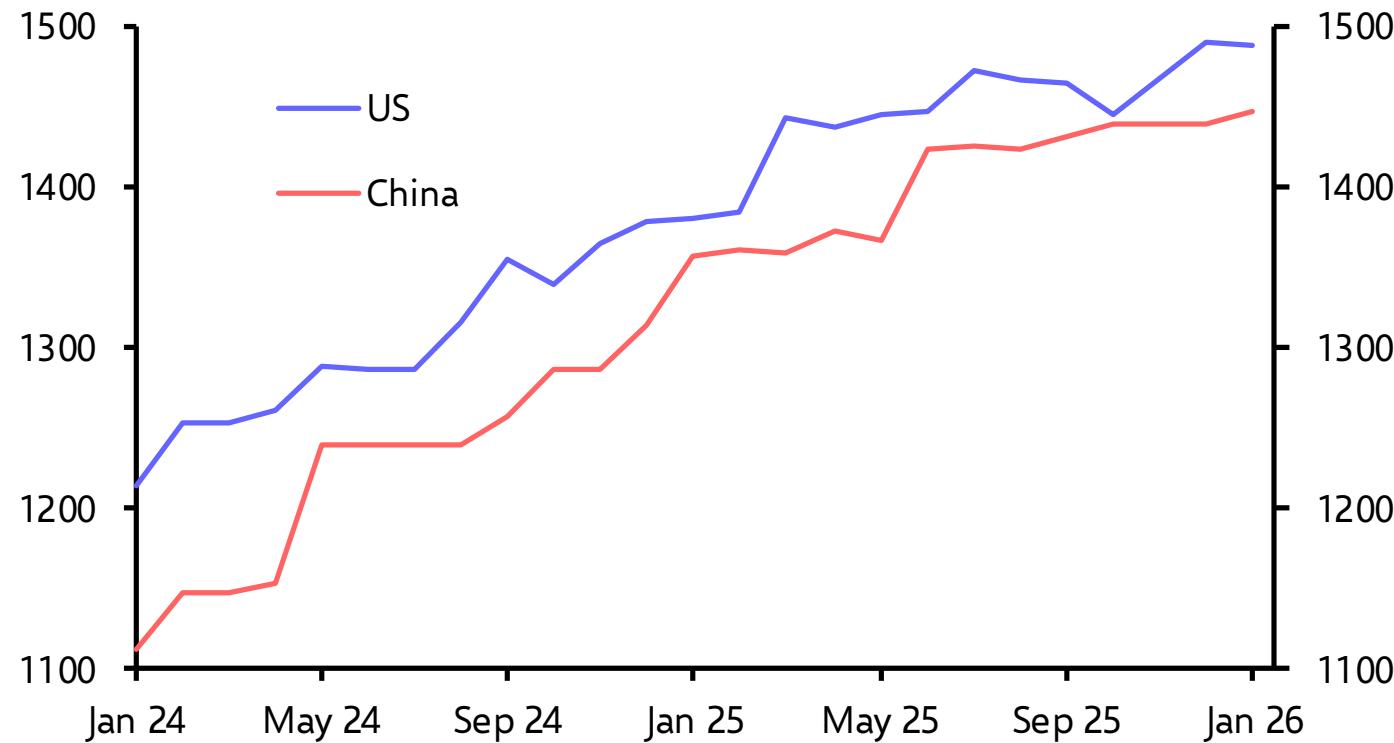
Sources: CEIC, WIND, Capital Economics

CE China Activity Proxy (CAP) & Official GDP (real, % y/y)



Sources: CEIC, WIND, Capital Economics

Performance of Top Large Language Models*



*Chatbot Arena Elo points

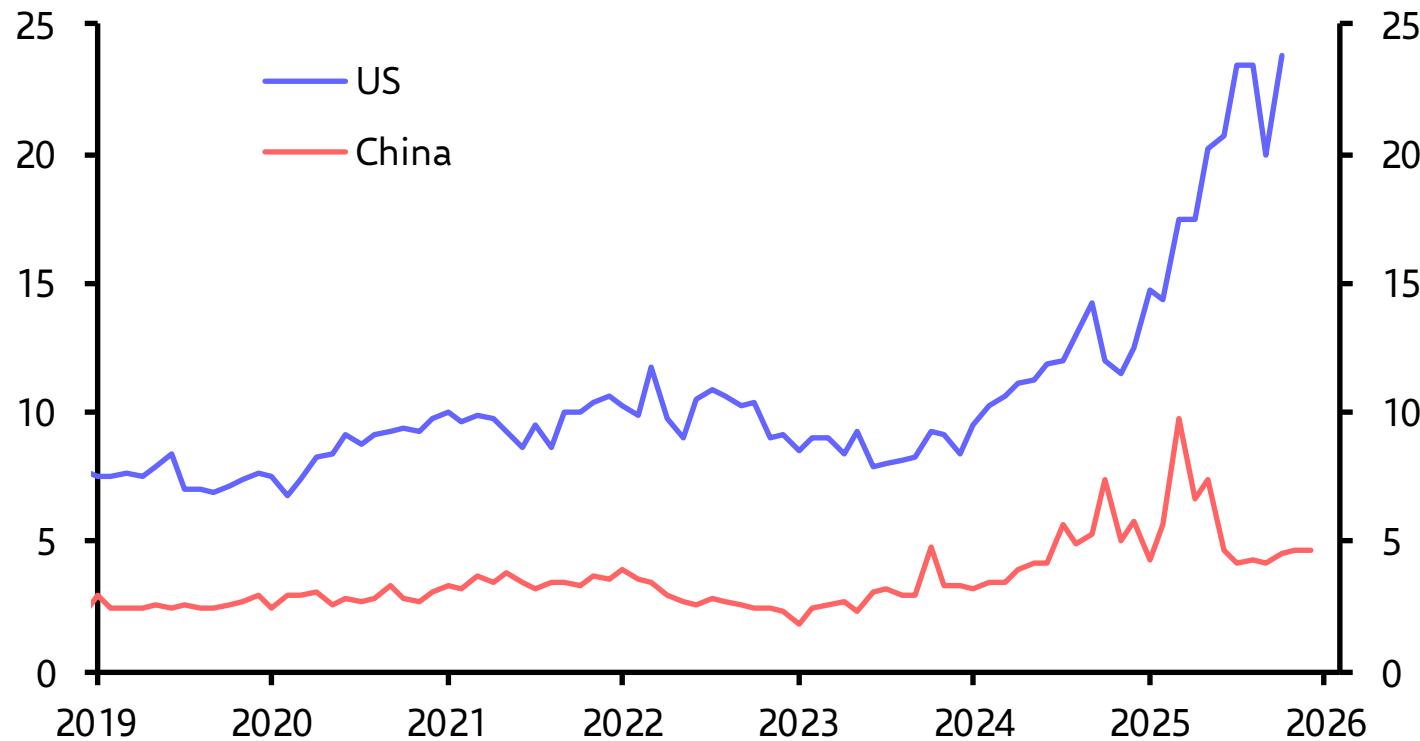
Sources: Stanford AI Index 2025 Annual Report, Internet Archive, OpenLM AI, Capital Economics

ICT Contributions to Real GDP Growth (annualised % pt)



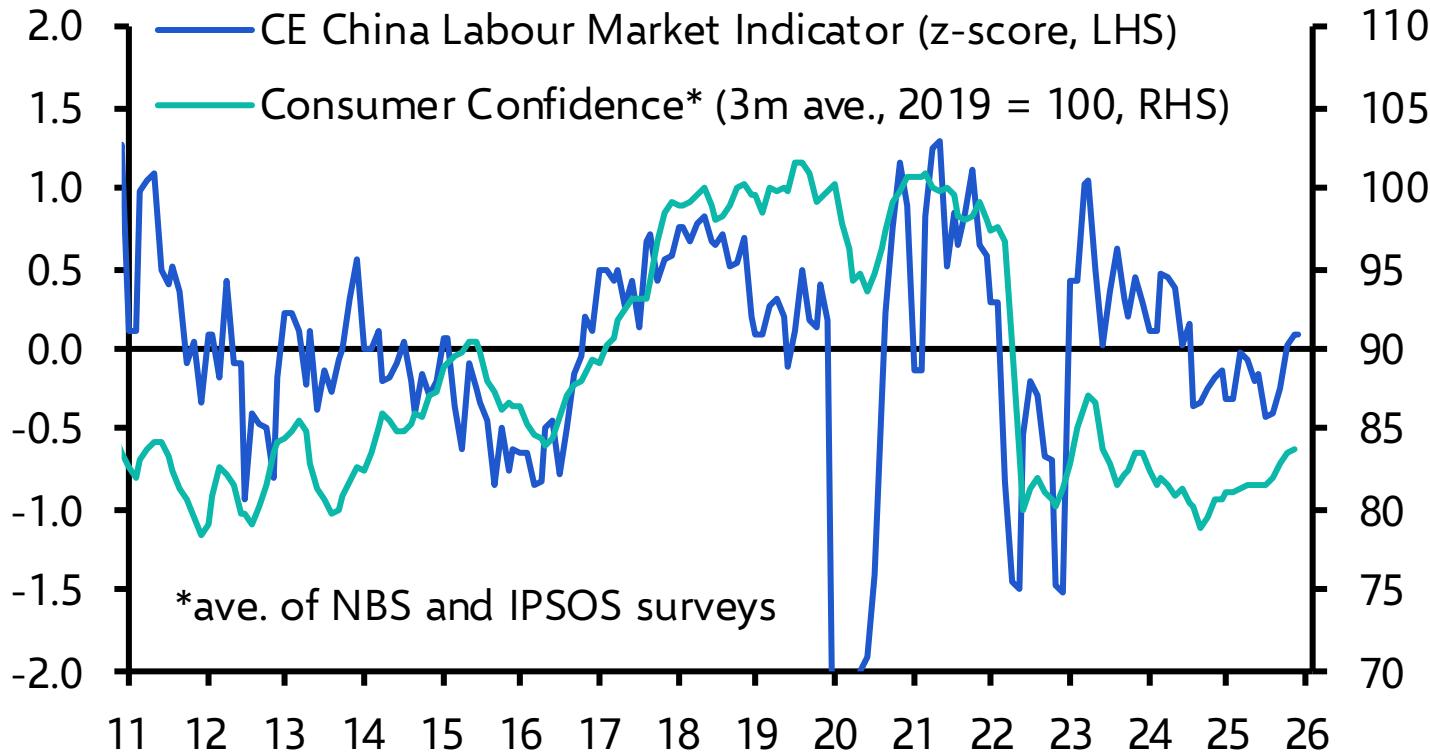
Sources: CEIC, BEA, Capital Economics

Imports of Computing Equipment & Parts (\$bn, seas. adj.)



Sources: CEIC, Comtrade, Capital Economics

China Labour Market Indicator & Consumer Confidence

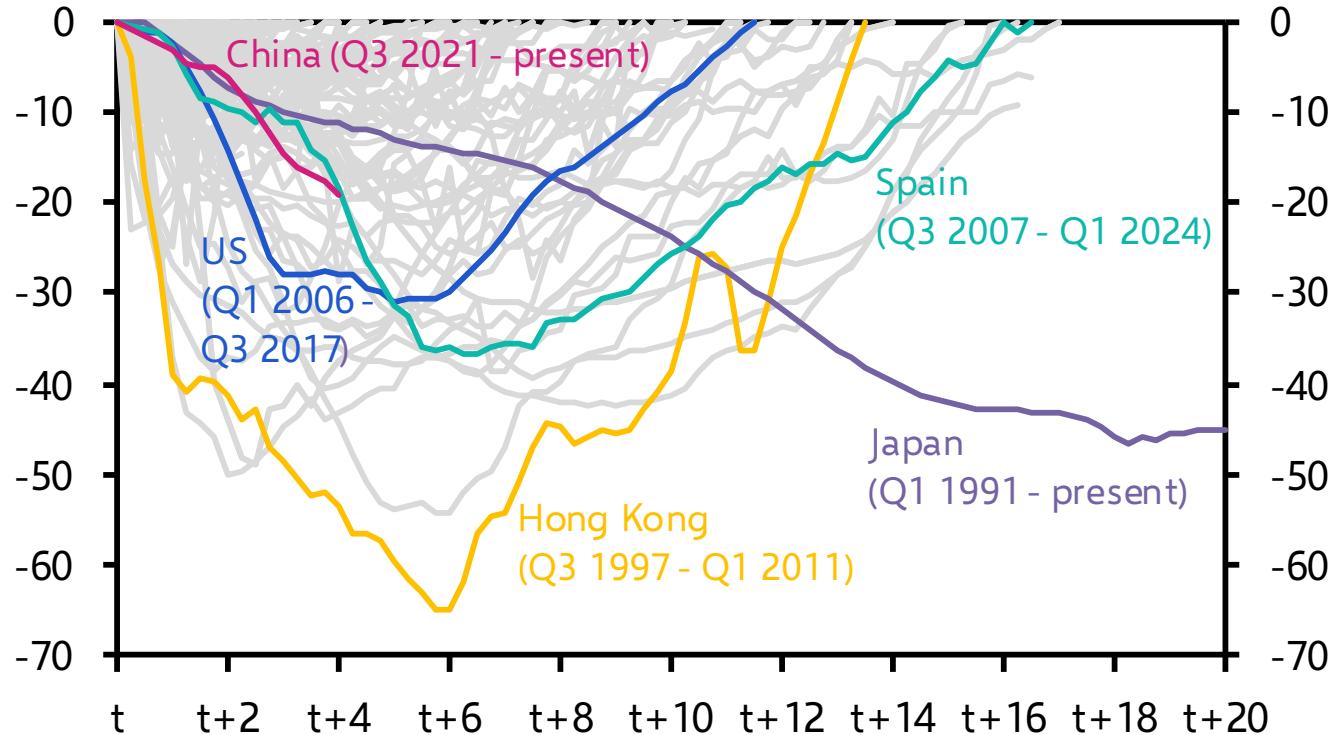


Sources: CEIC, LSEG, Capital Economics

China's Five-Year Plan Proposals

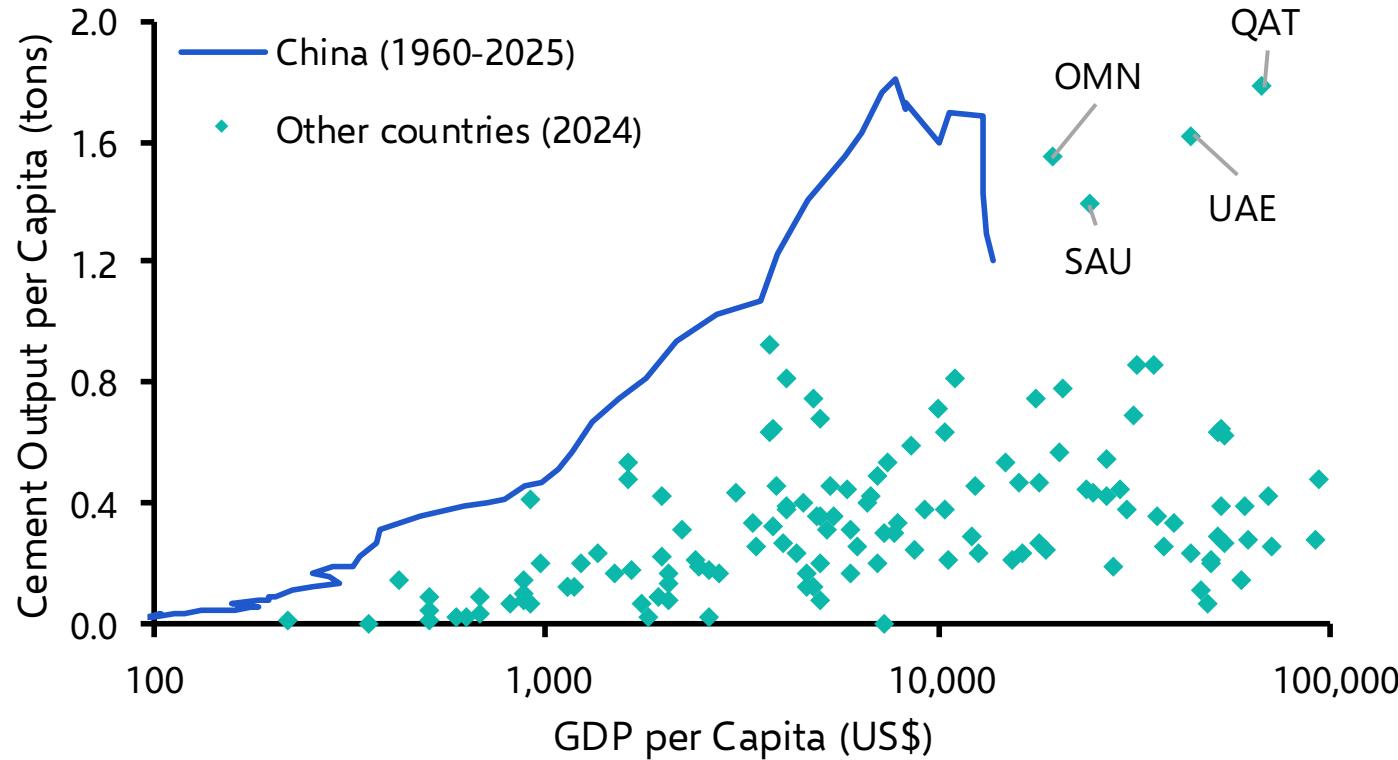
- Floated a goal of increasing the consumption share of GDP.
- Pledged to allocate a higher share of fiscal spending to social welfare.
- Proposed an expansion of free education, public healthcare, and a gradual increase in pensions and unemployment support.
- But rebalancing away from investment to be gradual.
- Economic security agenda means government will continue to support high-tech manufacturing.

Global House Price Drawdowns (%, nominal)



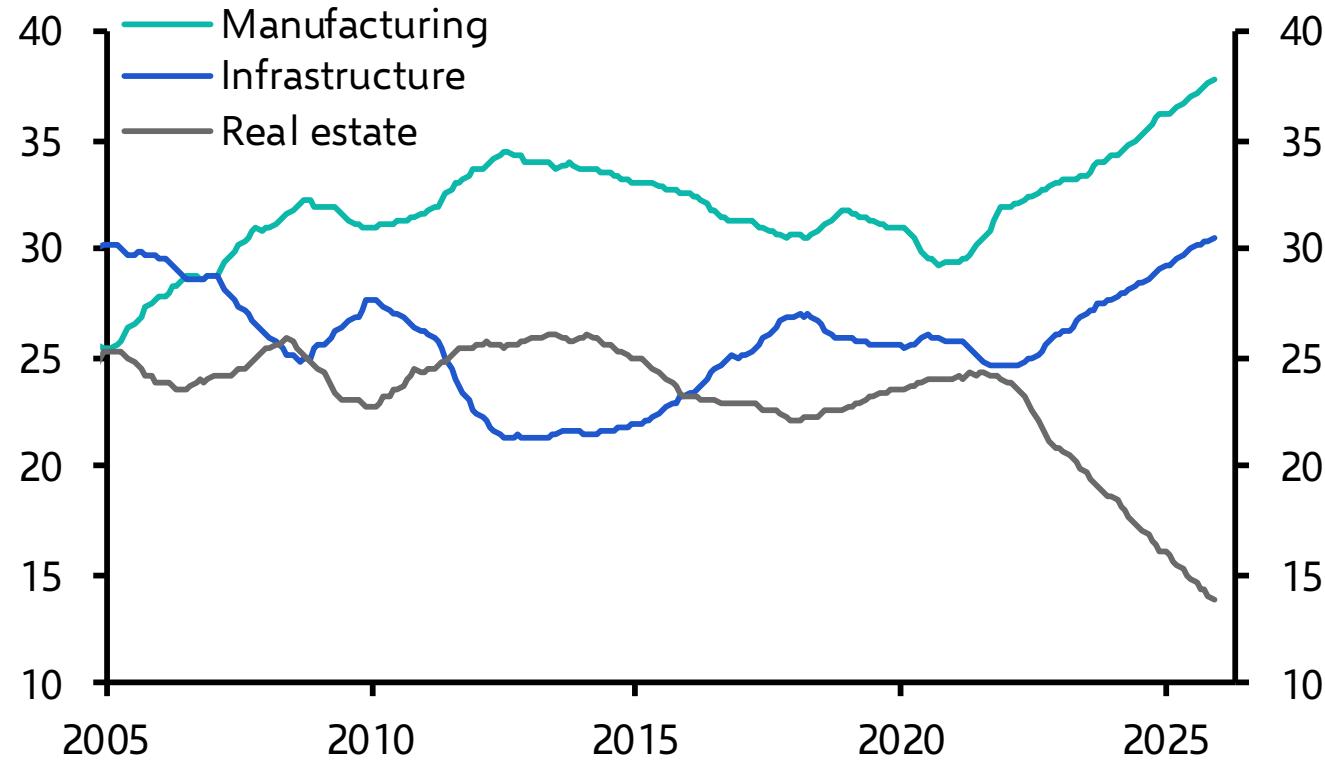
Note: t+2 indicates 2 years since prices started falling
Sources: CEIC, BIS, Capital Economics

Cement Output vs Income Level



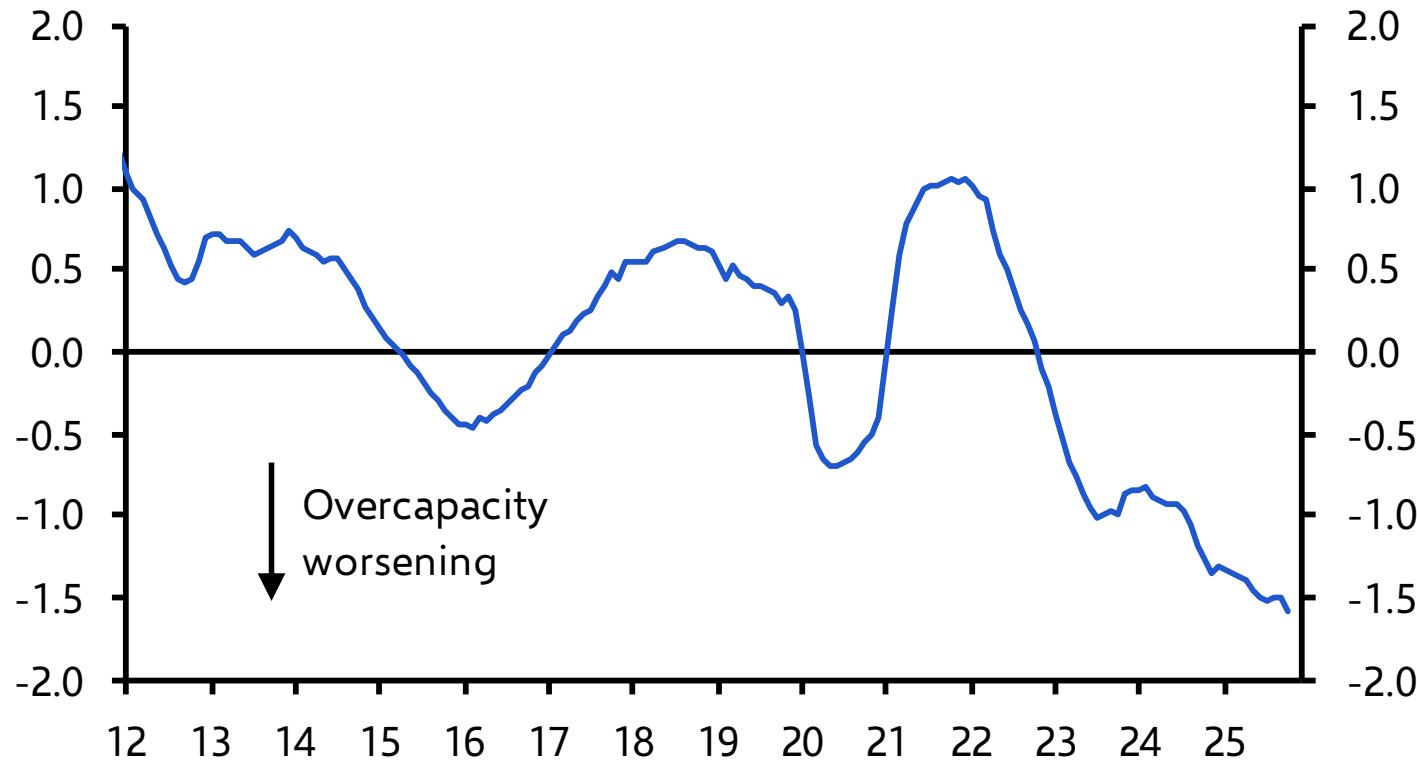
Sources: CEIC, The Global Carbon Project, Capital Economics

Fixed Investment (% of total, 12m ave.)



Sources: CEIC, Capital Economics

CE China Overcapacity Index (z-score, 12m ave.)

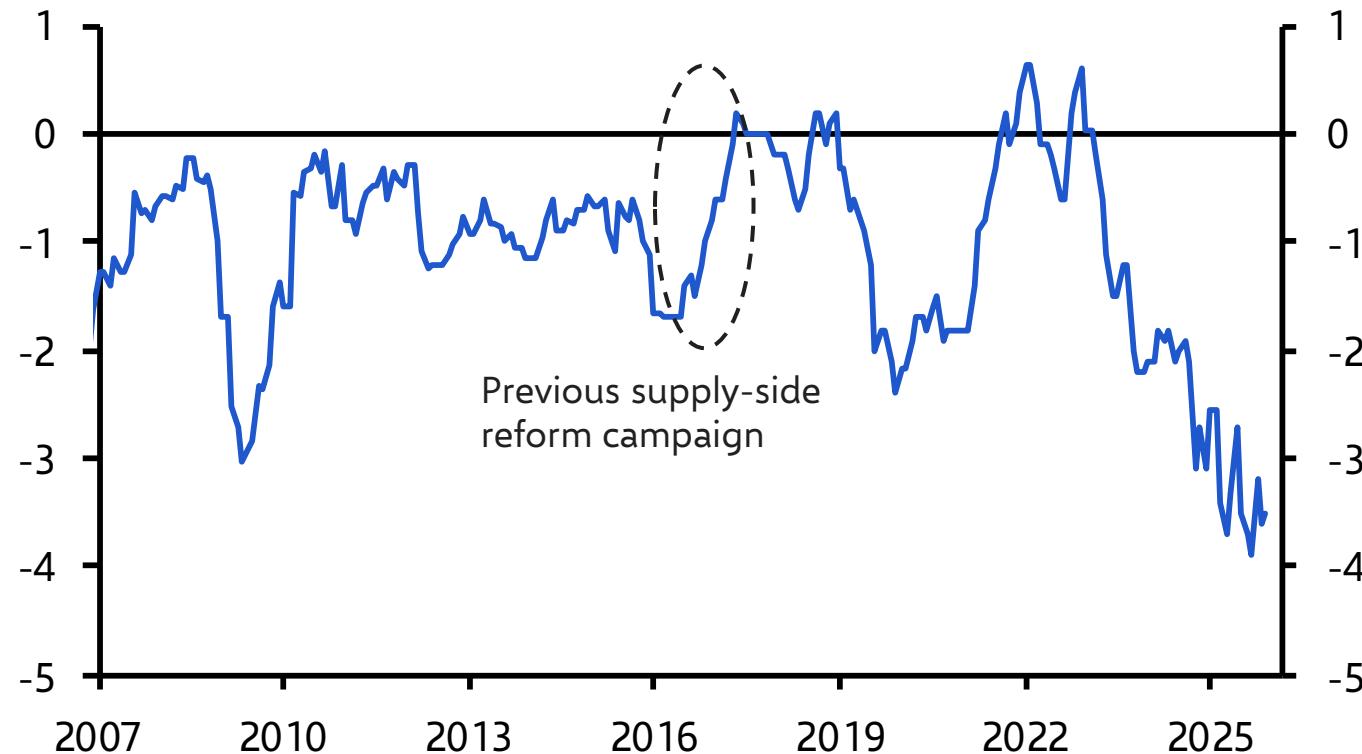


Sources: CEIC, Capital Economics

The Consequences of Rebalancing

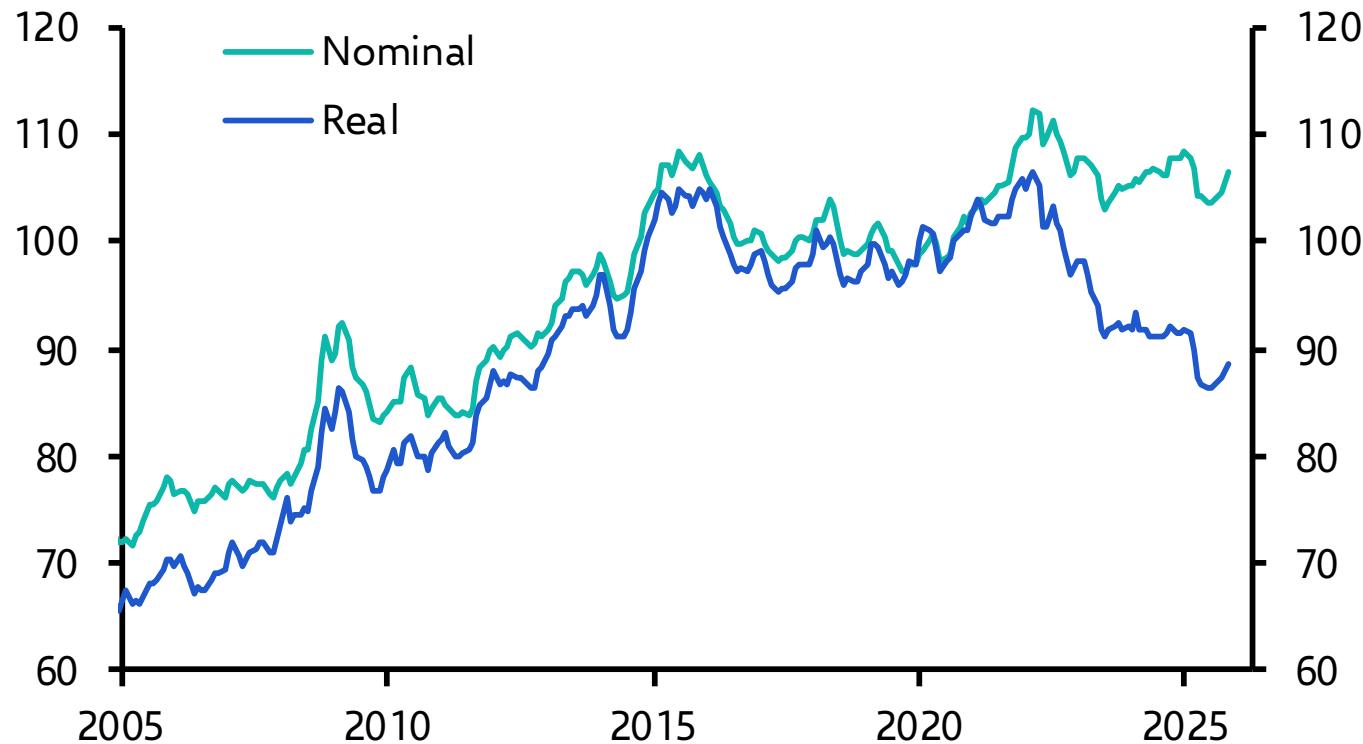
- The consumption share of GDP is set to rise, investment share to fall.
- Will this fix overcapacity and pull China out of deflation?
- Will this reduce external imbalances and rein in China's trade surplus?
- In both cases the answer is yes over the long-run, but probably not in the near-term.

PPI – Consumer Durables (% y/y)



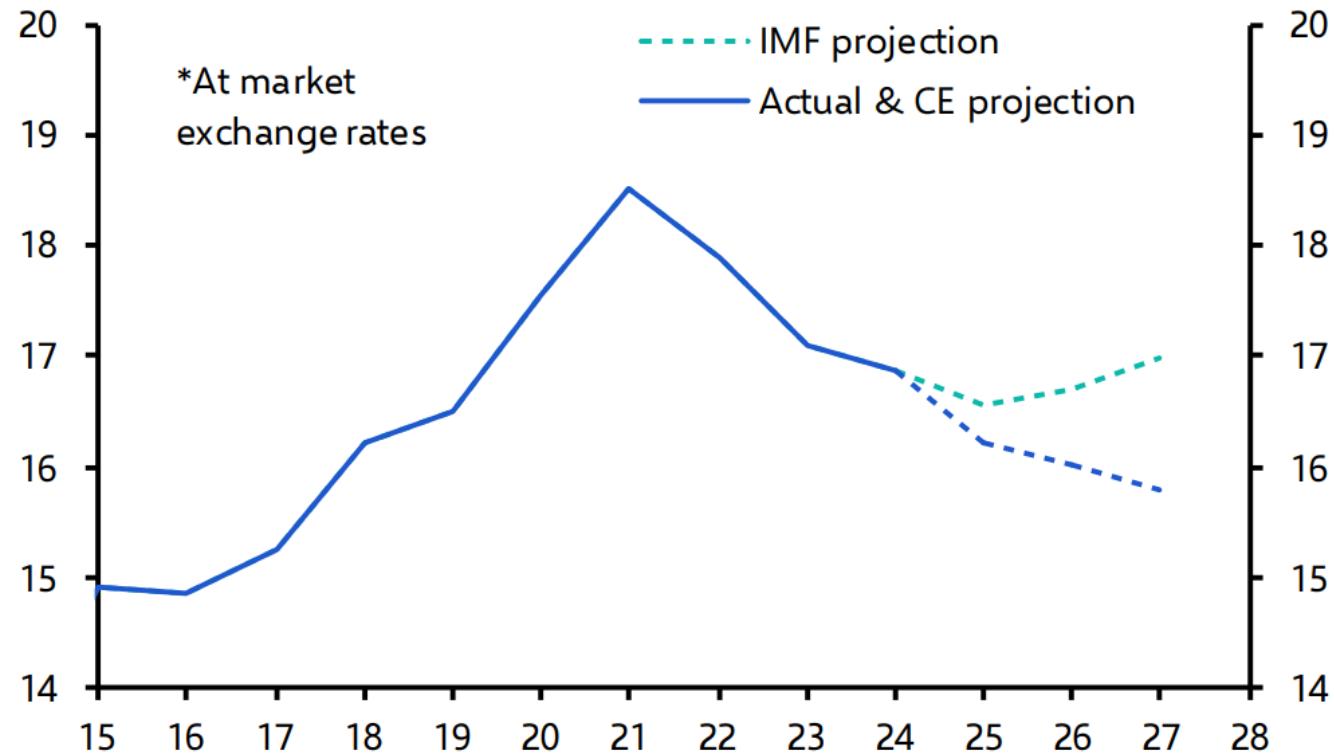
Sources: CEIC, Capital Economics

China's Effective Exchange Rate (2020 = 100)



Sources: CEIC, Capital Economics

China's Share of World GDP* (%)



Sources: LSEG, Capital Economics

Conclusions

- AI rollout and consumption recovery will support activity.
- But will be offset by weaker investment spending.
- Rebalancing should benefit China over the medium-term...
- ...but won't fix overcapacity and deflation in the near-term.
- GDP growth to edge down in 2026, remain weak in nominal terms.
- Domestic weakness will continue to fuel China's trade surplus.

The implications for the rest of Asia

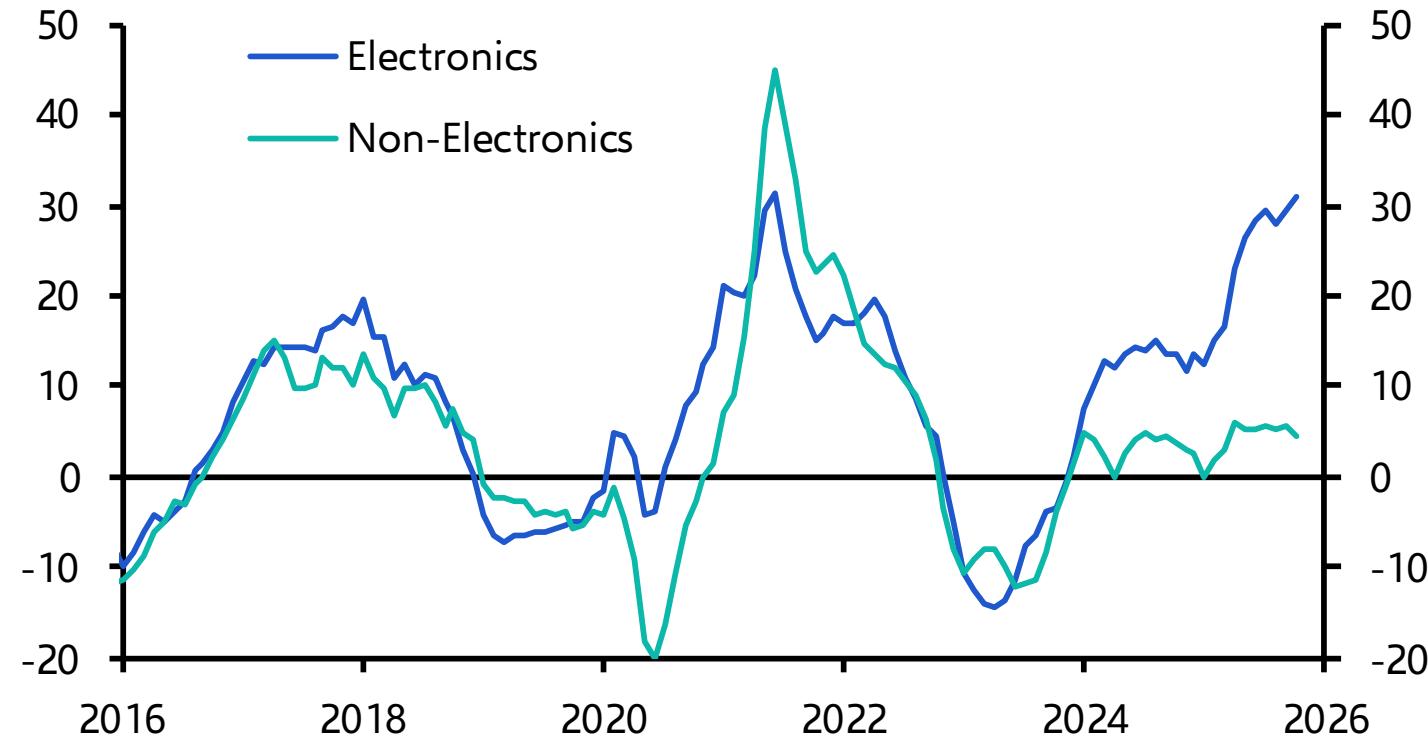
Marcel Thieliant, Head of Asia-Pacific



Agenda

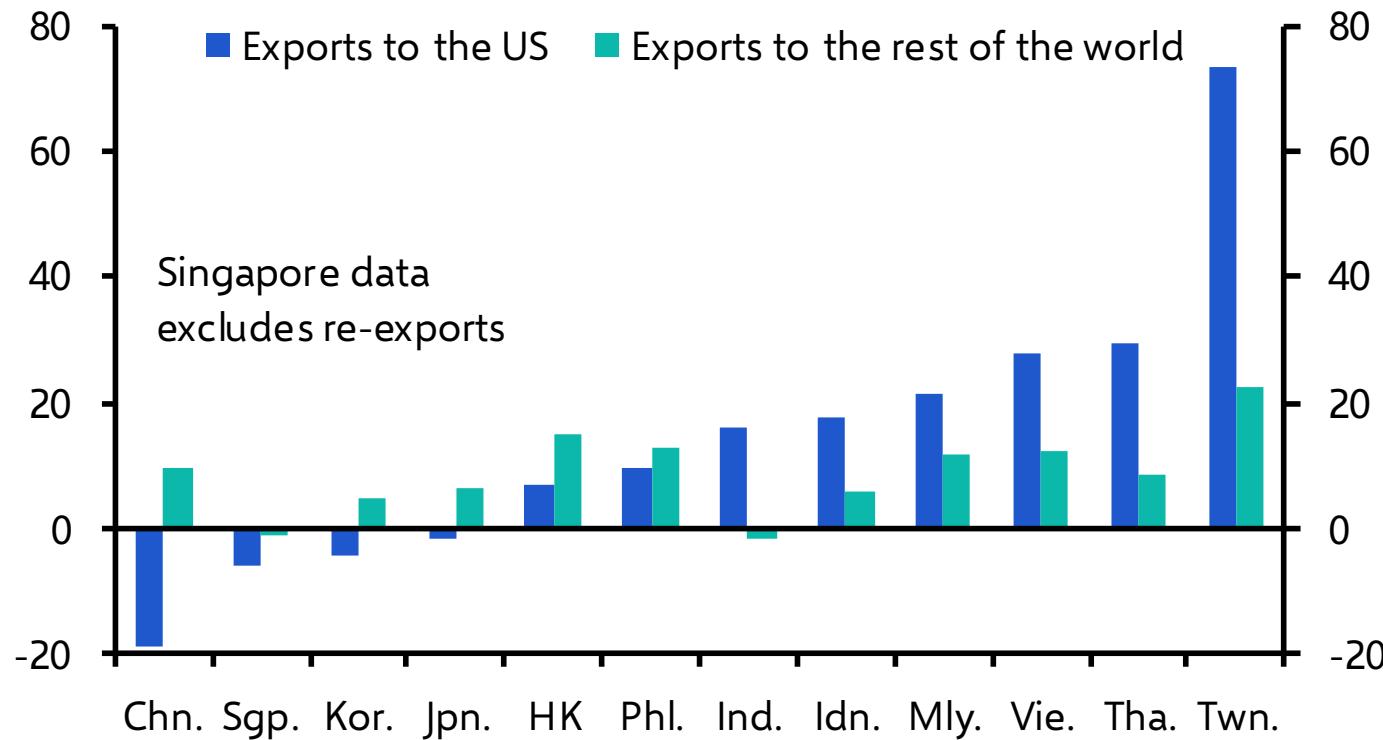
- How are the AI investment boom and US tariffs affecting Asian economies?
- Is China's export dominance harming the rest of the region?
- Is Japan facing a fiscal crisis?

Exports from Asia Excluding China (\$, % y/y)



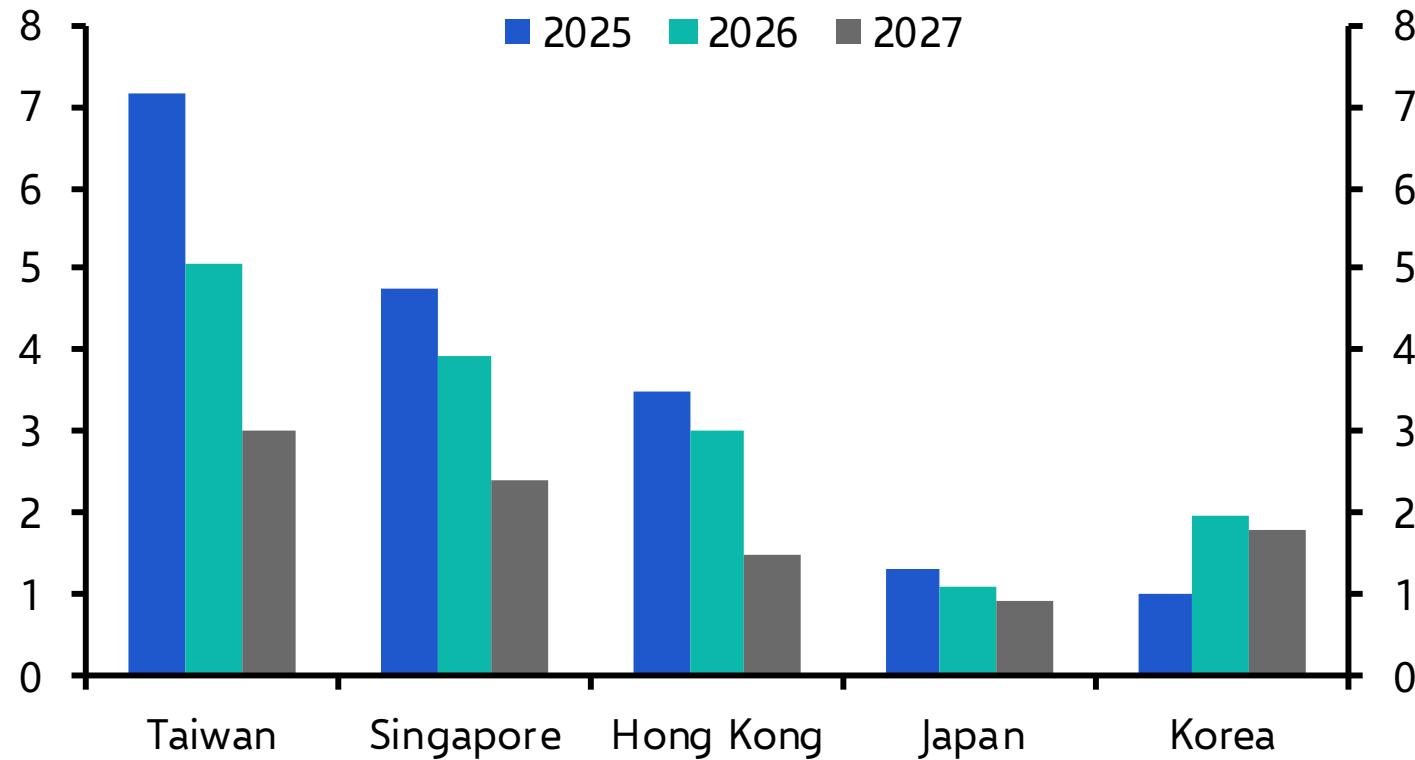
Sources: LSEG, Capital Economics

Exports from Asia (Jan. – Nov. 2025, \$, % y/y)



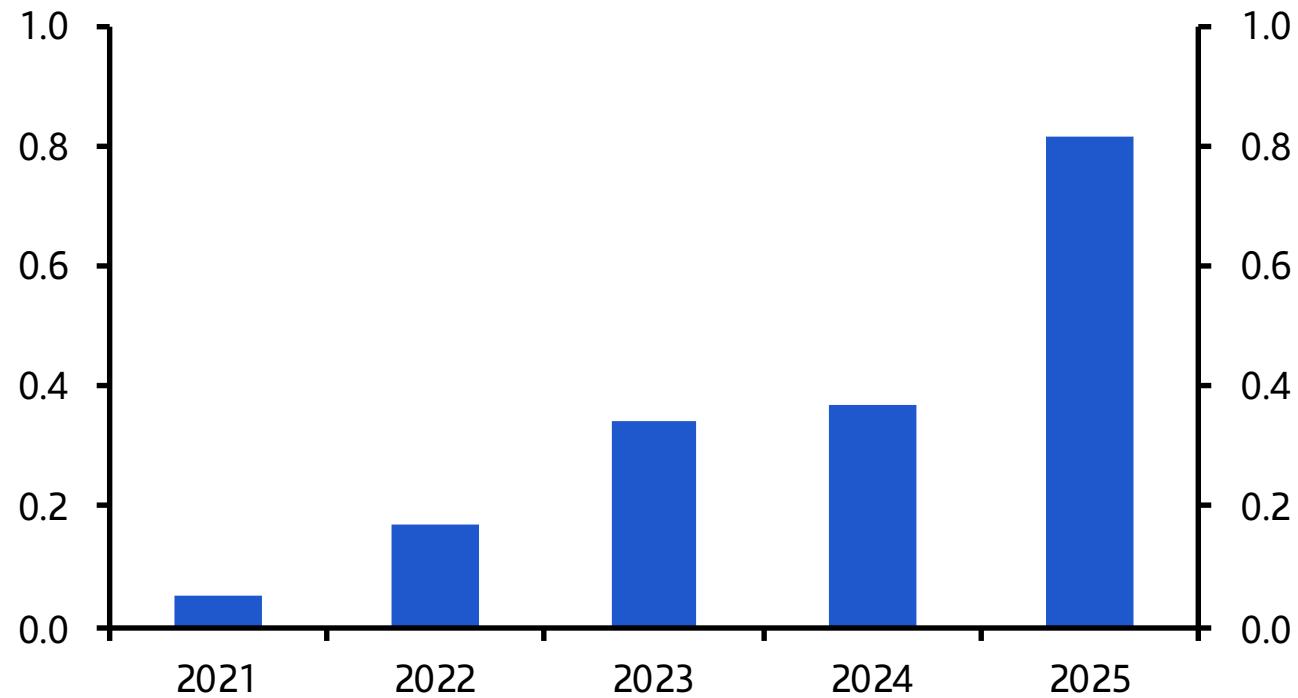
Sources: LSEG, CEIC, Capital Economics

Real GDP (% y/y)



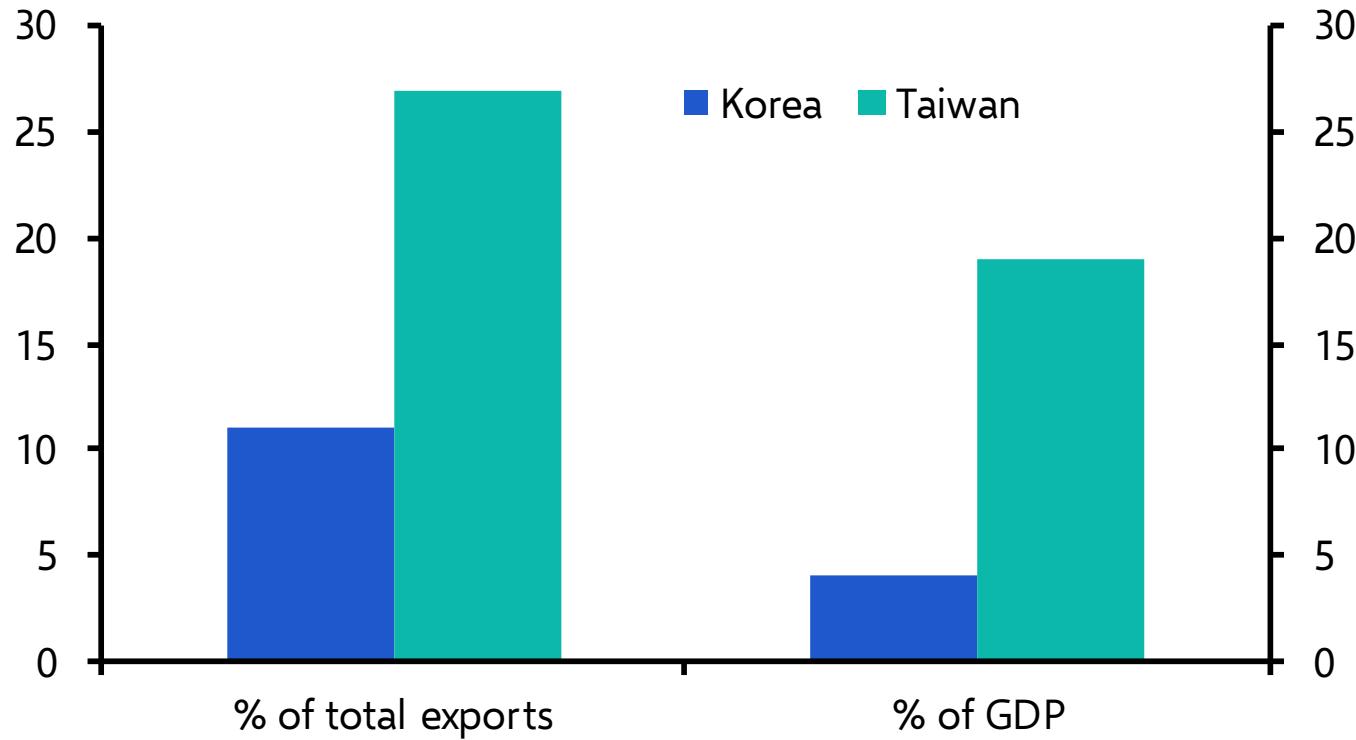
Sources: LSEG, Capital Economics

Malaysia Data Centre Construction (% of Real GDP)



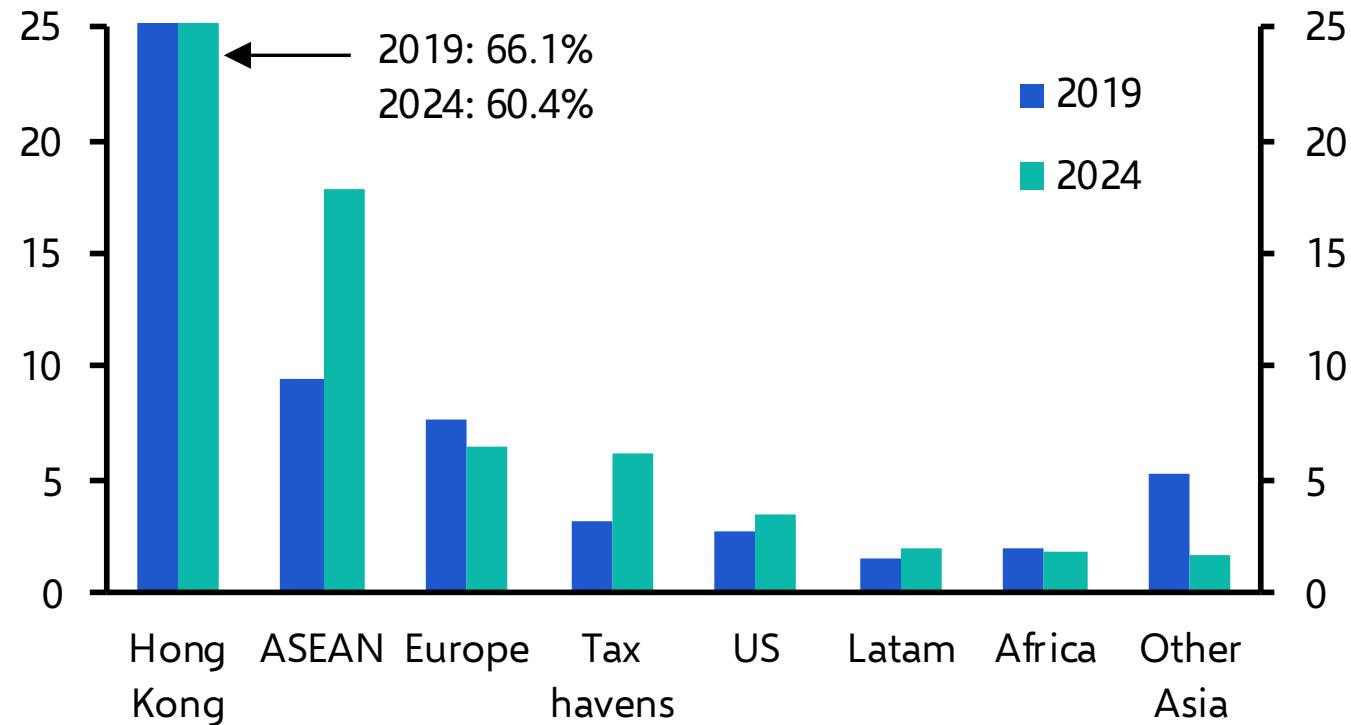
Sources: Bank Negara, LSEG, Capital Economics

Exports of AI Products



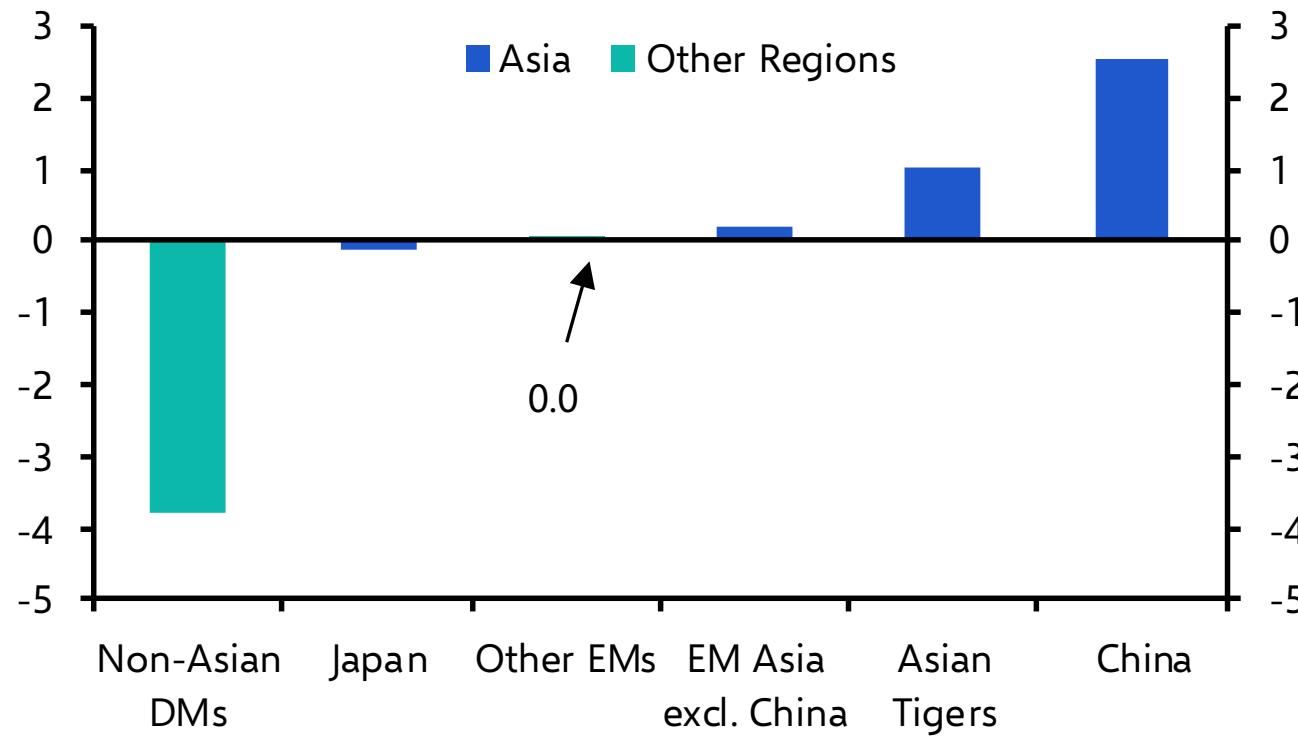
Sources: LSEG, Capital Economics

China's Outbound Direct Investment by Region (% of total)



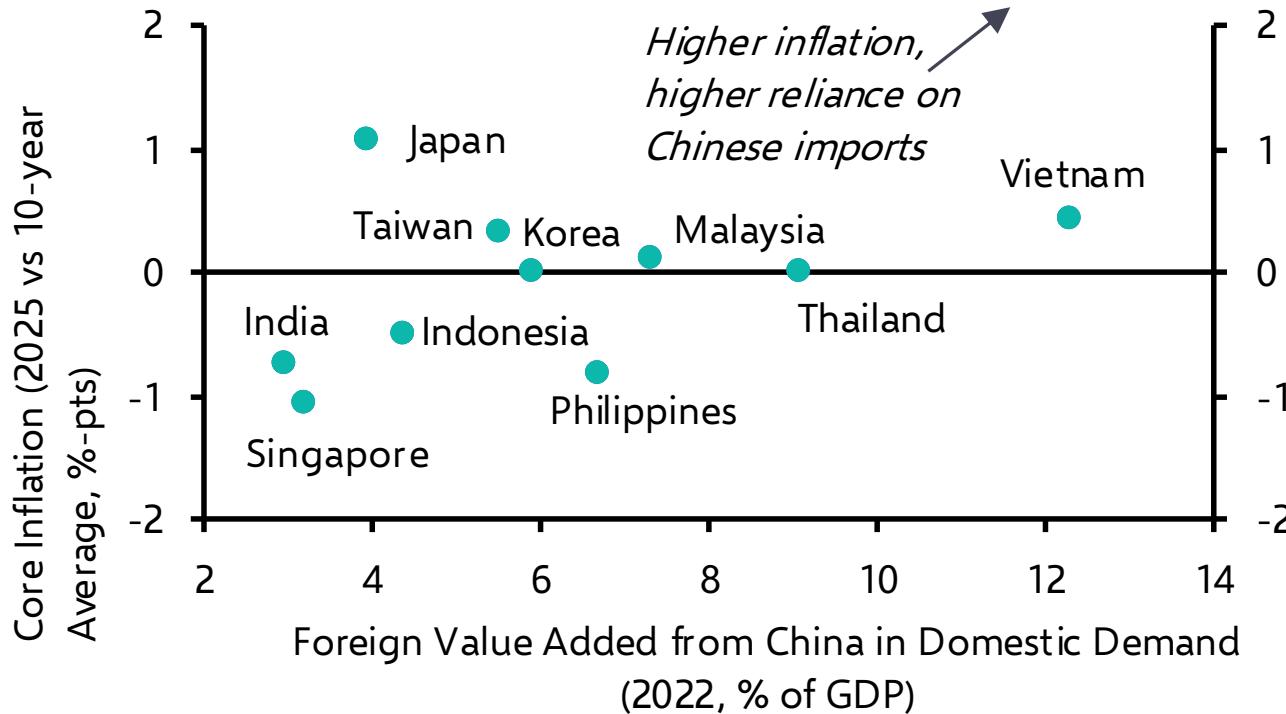
Sources: CEIC, Capital Economics

Global Export Market Share (Volumes, %-pt change since 2022)



Sources: LSEG, CPB, Capital Economics

Asian Countries' Reliance on Imports from China & Inflation

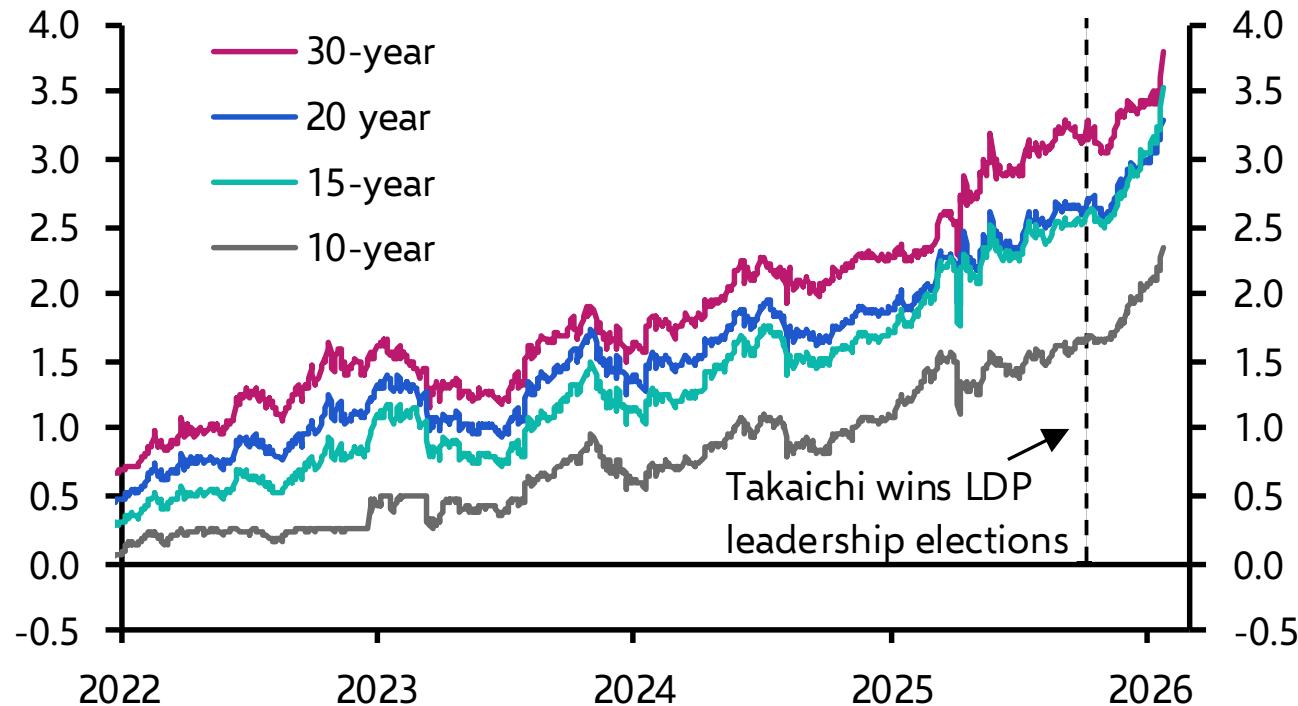


Sources: LSEG, OECD, Capital Economics

Conclusions

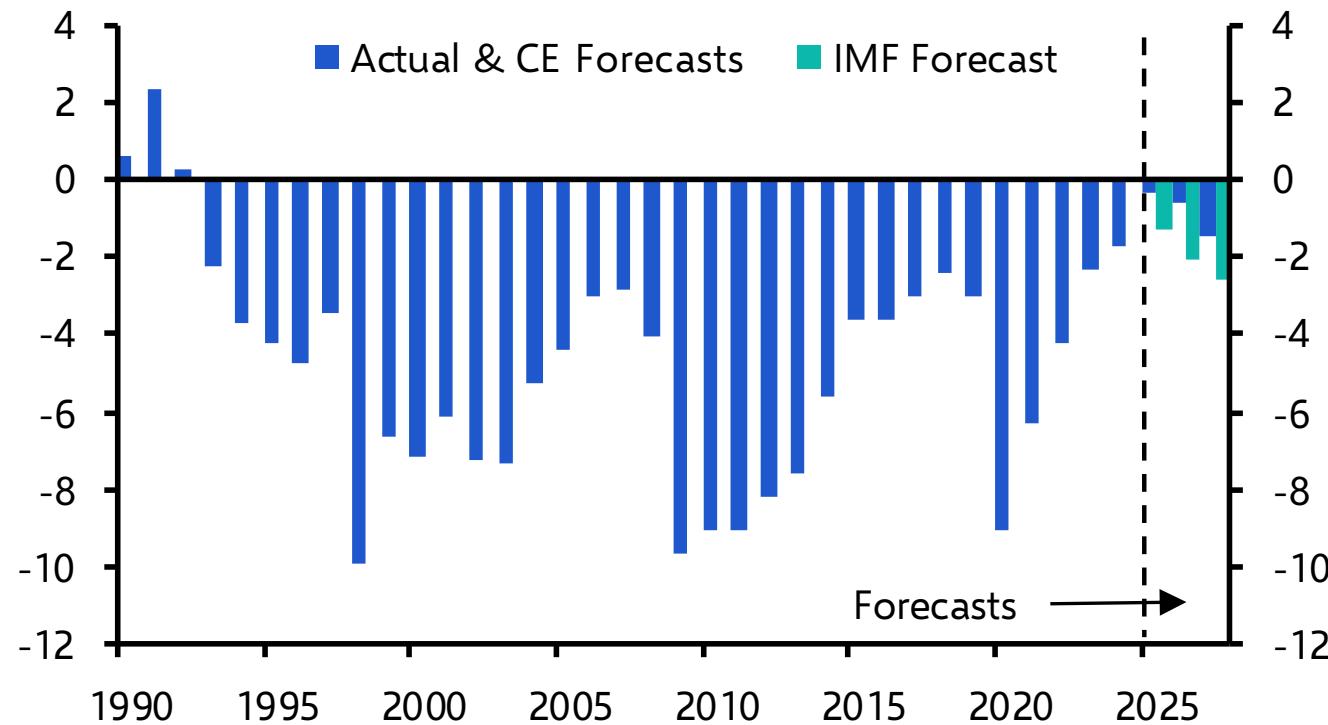
- Taiwan is benefitting from the AI investment boom, but electronics exports rising across the region.
- Lower-income countries are benefitting from US demand shifting away from China.
- China's mounting export dominance isn't doing much harm elsewhere in the region.

Japan Government Bond Yields (%)



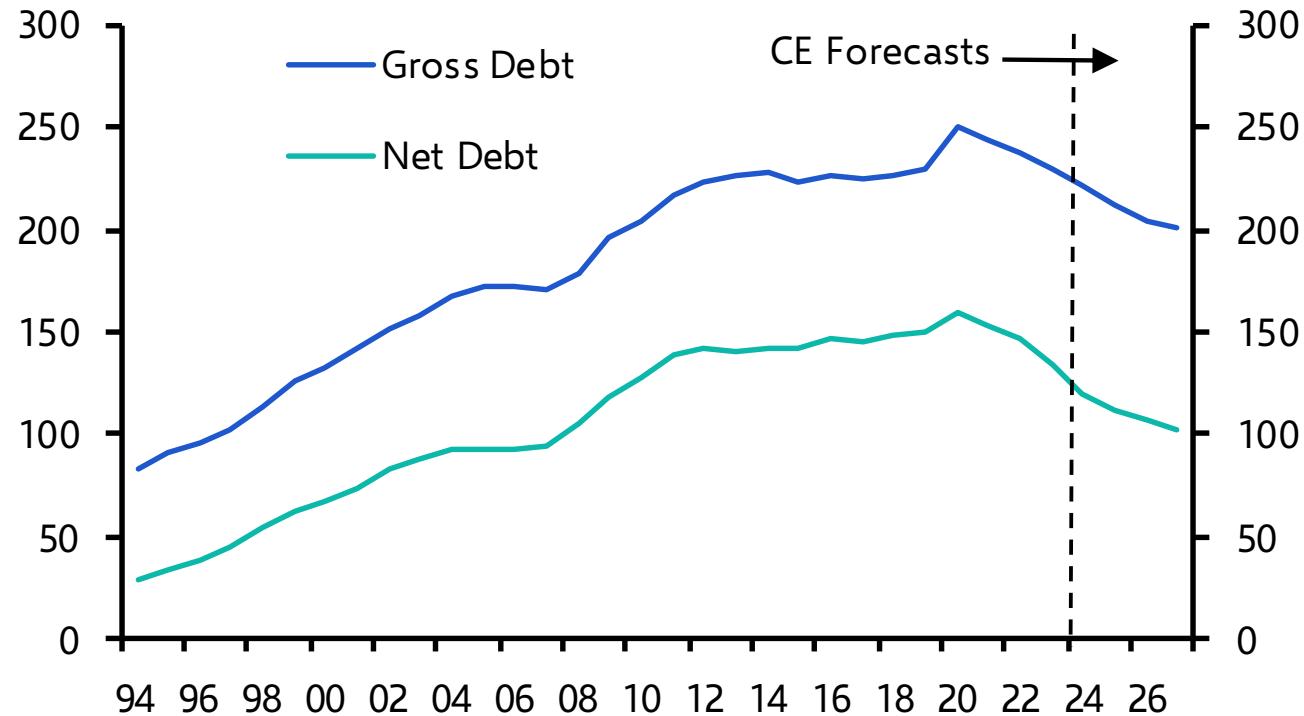
Sources: LSEG, Capital Economics

Japan General Government Budget Balance (% of GDP)



Sources: Cabinet Office, LSEG, Capital Economics

Japan General Government Debt (% of GDP)



Sources: Cabinet Office, LSEG, Capital Economics

Policy options should yields continue to surge

- Offset tax cuts with tightening elsewhere.
- Shorten maturity of bond issuance.
- BoJ could tilt purchases towards long-end or increase purchases.

Source: Capital Economics

China and the rest of the world

Mark Williams, Chief Asia Economist

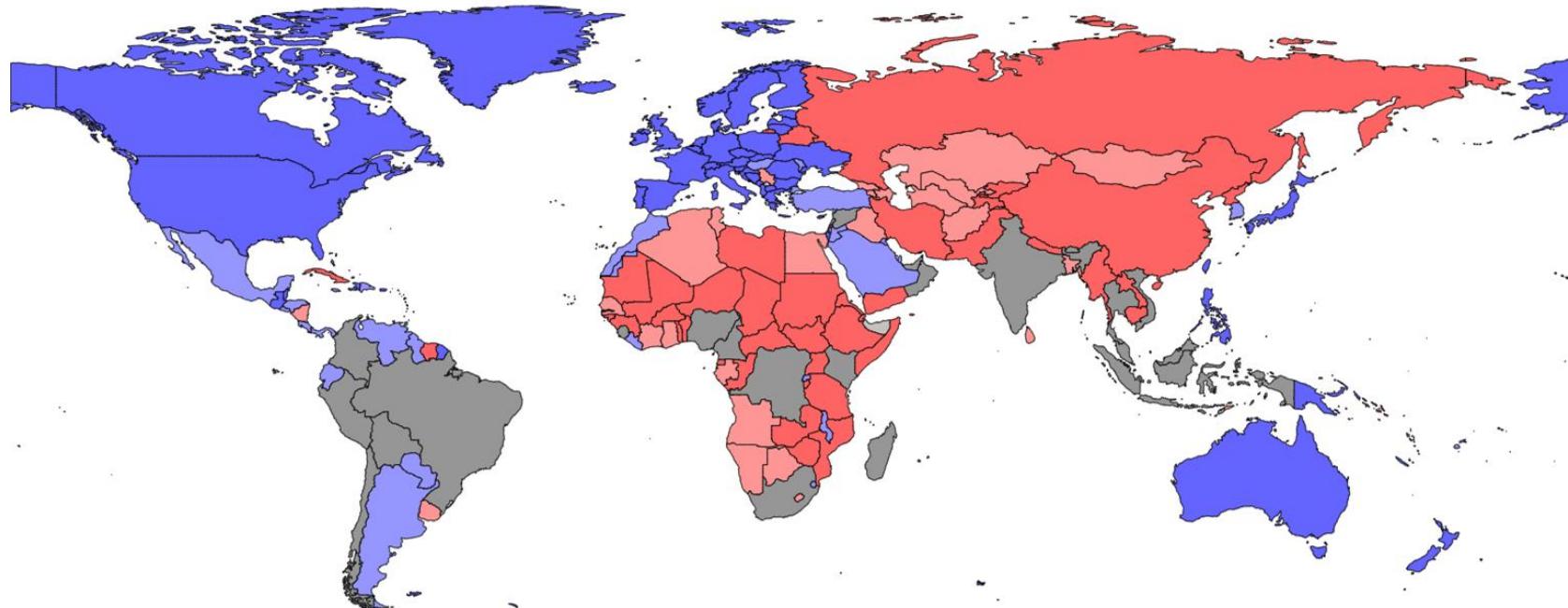


Key points

- China is running the biggest trade surplus of any economy in modern times.
- It will probably get bigger. Deflation will persist too.
- China will face mounting pressure from trade partners to adjust – and more countries will try to protect their markets.
- The flipside of a large trade surplus is large outward investment. The major beneficiary now is SE Asia.

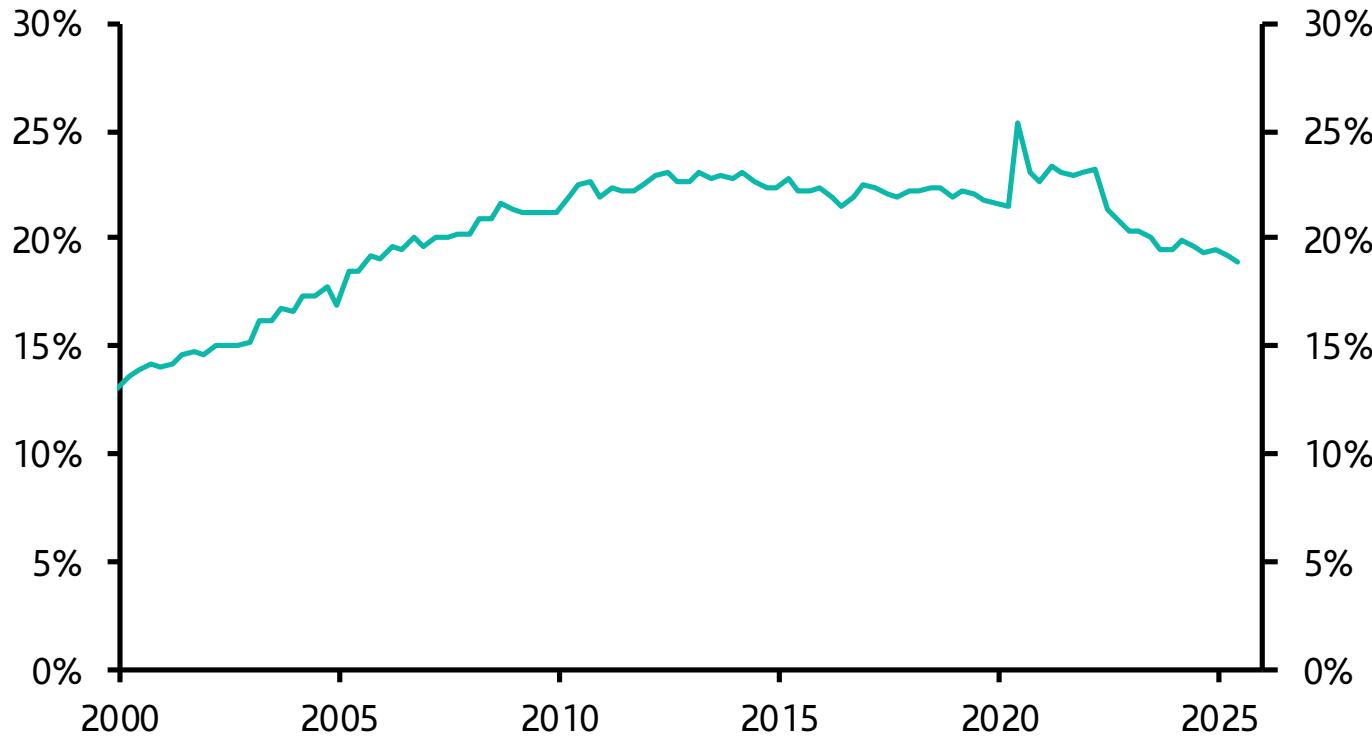
Capital Economics Classification of Global Alignment in 2026

- US & allies
- Leans US
- Unaligned
- Leans China
- China & allies



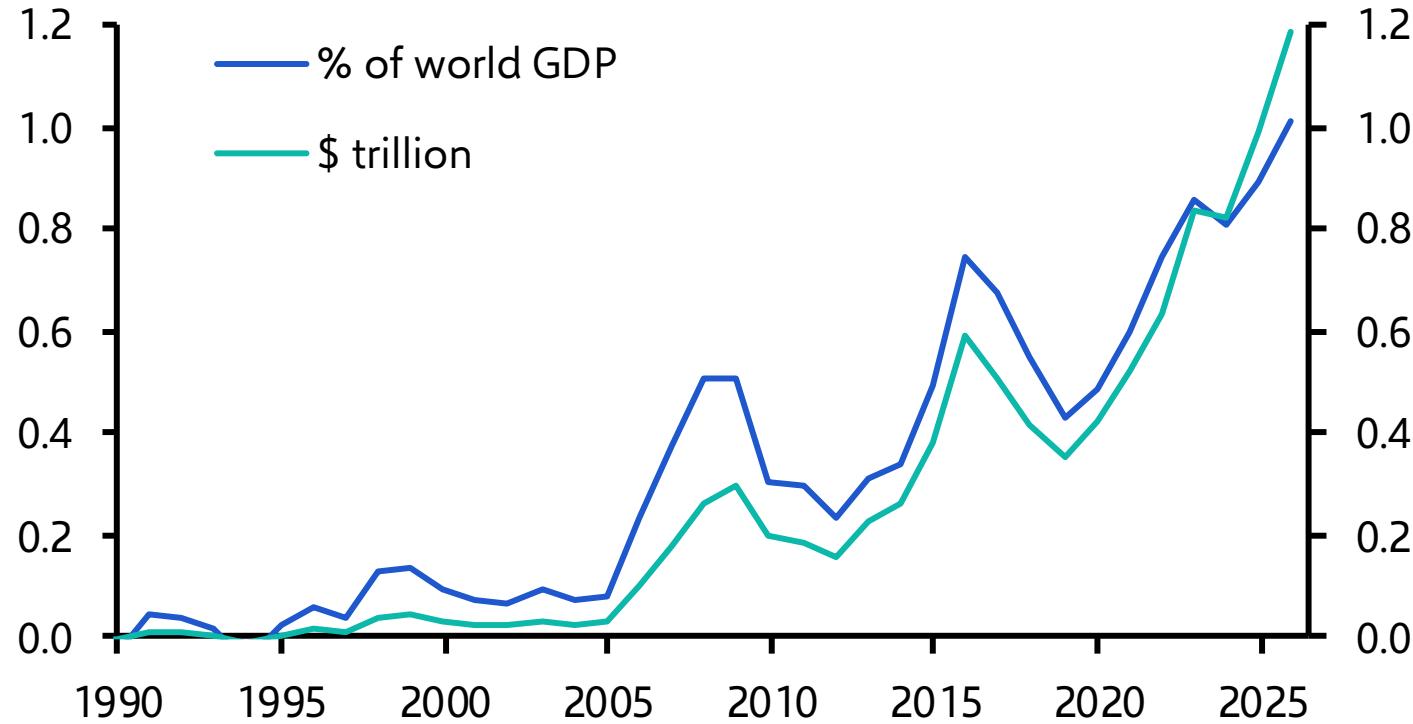
Sources: World Bank, Capital Economics

Share of Global Goods Trade between US & China Blocs



Sources: IMF, Capital Economics

China's Good Trade Surplus



Sources: CEIC, Capital Economics

Conclusions

- No country in modern times has had a goods surplus as large as China's. Goods manufacturers worldwide are under pressure as a result.
- Western governments have additional concerns:
 - About supply chain security
 - And about losing their advanced manufacturing bases
- That points to a more antagonistic economic relationship.
- Despite Trump, other major developed economies will be wary of drawing too close to China.

Key Forecasts

| Geography | Indicator | 2025 | 2026 | 2027 |
|-----------|-----------------|------|------|------|
| US | GDP (% y/y) | 2.2 | 2.5 | 2.5 |
| | Inflation (%) | 2.7 | 2.8 | 2.5 |
| | Policy Rate (%) | 3.63 | 3.38 | 3.38 |
| Euro-zone | GDP (% y/y) | 1.5 | 1.1 | 1.2 |
| | Inflation (%) | 2.1 | 1.5 | 1.5 |
| | Policy Rate (%) | 2.00 | 1.50 | 1.50 |
| UK | GDP (% y/y) | 1.4 | 1.0 | 1.2 |
| | Inflation (%) | 3.4 | 2.1 | 1.8 |
| | Policy Rate (%) | 3.75 | 3.00 | 3.00 |

Sources: Capital Economics

GDP (% y/y)

| Geography | 2023 | 2024 | 2025 | 2026 | 2027 |
|------------------|------------|------------|------------|------------|------------|
| China (Official) | 6.5 | 5.0 | 5.0 | 4.8 | 4.5 |
| China (CAP) | 6.3 | 4.5 | 3.1 | 3.0 | 2.8 |
| Hong Kong | 3.2 | 2.5 | 3.5 | 3.0 | 2.0 |
| South Korea | 1.6 | 2.0 | 1.0 | 2.0 | 1.8 |
| Singapore | 1.8 | 4.4 | 4.7 | 3.8 | 2.1 |
| Taiwan | 1.1 | 2.0 | 7.2 | 5.0 | 3.0 |
| Japan | 0.7 | -0.2 | 1.3 | 1.1 | 0.9 |
| India | 8.8 | 6.7 | 7.5 | 6.5 | 6.5 |
| Indonesia | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Malaysia | 3.7 | 5.1 | 4.9 | 4.9 | 5.0 |
| Philippines | 5.5 | 5.7 | 4.0 | 4.5 | 5.0 |
| Thailand | 2.0 | 2.5 | 2.1 | 1.8 | 2.5 |
| Vietnam | 5.1 | 7.1 | 8.0 | 8.0 | 7.5 |
| Asia | 5.6 | 4.6 | 4.9 | 4.3 | 4.1 |

Sources: LSEG, Capital Economics

Headline CPI (% y/y)

| Geography | 2023 | 2024 | 2025 | 2026 | 2027 |
|-------------|------------|------------|------------|------------|------------|
| China | 0.2 | 0.2 | 0.0 | -0.1 | -0.1 |
| Hong Kong | 2.1 | 1.7 | 1.5 | 1.0 | 1.5 |
| South Korea | 3.6 | 2.3 | 1.8 | 1.5 | 1.9 |
| Singapore | 4.8 | 2.4 | 0.9 | 1.4 | 1.5 |
| Taiwan | 2.5 | 2.2 | 1.8 | 1.3 | 1.5 |
| Japan | 3.3 | 2.7 | 3.2 | 1.4 | 1.6 |
| India | 5.7 | 4.9 | 2.1 | 3.1 | 4.7 |
| Indonesia | 3.7 | 2.3 | 1.9 | 2.5 | 2.8 |
| Malaysia | 2.5 | 1.8 | 1.4 | 1.9 | 2.1 |
| Philippines | 6.0 | 3.2 | 1.6 | 2.3 | 3.0 |
| Thailand | 1.2 | 0.4 | 0.2 | 1.0 | 1.1 |
| Vietnam | 3.3 | 3.6 | 3.3 | 3.3 | 3.5 |
| Asia | 2.9 | 2.1 | 1.0 | 1.3 | 1.7 |

Sources: LSEG, Capital Economics

Policy Interest Rate (%)

| Geography | 2025 | 2026 | 2027 |
|-------------|------|------|------|
| China | 1.40 | 1.20 | 1.00 |
| South Korea | 2.50 | 2.00 | 2.00 |
| Taiwan | 2.00 | 2.00 | 2.00 |
| Japan | 0.75 | 1.25 | 1.75 |
| India | 5.25 | 5.00 | 5.50 |
| Indonesia | 4.75 | 4.00 | 4.50 |
| Malaysia | 2.75 | 2.75 | 4.75 |
| Philippines | 4.50 | 4.00 | 4.00 |
| Thailand | 1.25 | 0.75 | 0.75 |
| Vietnam | 4.50 | 4.50 | 4.50 |

Sources: LSEG, Capital Economics

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