China’s Deflation Trap and the Limits of Supply-Side Stimulus

Why Beijing’s Playbook Isn’t Working — and What It Means for Asia

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Abstract

China enters 2026 mired in a deflationary spiral that policymakers have acknowledged but remain unwilling to address with the scale of demand-side intervention required. With PPI negative for over three years, a property downturn that has destroyed household wealth on par with the 2008 American housing crisis, and a leadership prioritizing technological supremacy over consumption stimulus ahead of the 2027 Party Congress, we argue that China’s deflation is structural, self-reinforcing, and likely to deepen before it improves. The record $1.2 trillion trade surplus in 2025 masks profound domestic weakness. The implications for regional trade, ASEAN industrial policy, and global commodity markets are profound. This paper examines the mechanics of China’s deflationary trap, evaluates the policy response, and maps the transmission channels through which China’s domestic malaise reshapes the Asian economic landscape.

1. The State of Play: Deflation as Structural Feature

China's deflationary challenge is not a cyclical anomaly. It is the predictable outcome of two decades of investment-led growth colliding with a property bust, demographic headwinds, and a leadership that views consumption stimulus as ideologically suspect.

The Producer Price Index has now been in negative territory for over three years. January 2026 data from the National Bureau of Statistics showed PPI at -1.4% year-on-year, narrowing from -1.9% in December 2025 but still firmly in deflationary territory. On a month-on-month basis, PPI rose 0.4% in January — the highest sequential move since September 2023 — driven primarily by surging non-ferrous metals prices (input prices up 16.1%) linked to the global AI-driven semiconductor materials boom. But this bright spot obscures the broader picture: factory-gate deflation continues to weigh on industrial profits across most sectors.

Consumer prices offer little comfort. CPI eased sharply to 0.2% year-on-year in January 2026, down from 0.8% in December and well below the 0.4% consensus forecast. Food prices fell for the first time in three months (-0.7%), dragged down by pork, eggs, and cooking oils. Core CPI, which strips out food and energy, fell to 0.8% — the weakest reading in six months. The GDP deflator — the broadest measure of economy-wide pricing power — has been negative since mid-2023, meaning nominal GDP growth has consistently undershot real GDP growth.

This is not subtle. It represents a sustained destruction of corporate pricing power, household wealth, and government revenue capacity. The Central Economic Work Conference in December 2025 acknowledged the problem by upgrading the official diagnosis from "insufficient demand" to a "prominent contradiction between strong supply and weak demand." That language is remarkably candid by Chinese policy standards. It is also an admission that the existing playbook is failing.

ING's Lynn Song projects full-year 2026 CPI at 0.9%, noting a "solid case" for further monetary easing but cautioning that risks remain from both domestic policy rollout and international price developments. MUFG describes the underlying reflation trend as "gradual" and notes that anti-involution measures are unlikely to accelerate the pace.

Our view: China's deflation is self-reinforcing through three channels — the property wealth destruction loop, the overcapacity-price compression loop, and the fiscal revenue erosion loop — and the current policy mix is insufficient to break any of them. The probability of a meaningful demand-side pivot before the 2027 Party Congress is low. Investors and regional policymakers should plan for at least two more years of Chinese deflationary pressure.

2. The Property Wealth Destruction Loop

The housing sector sits at the center of China's economic malaise. Home prices have been falling for four and a half years. This is household wealth destruction on par with America's 2008 crash, except it is still accelerating. Approximately 70% of Chinese household wealth is held in real estate, making the price decline a direct and persistent drag on consumer confidence and spending.

The numbers tell a grim story. New home sales declined approximately 14% in 2024, following drops of 17% in 2022 and 26% in 2021. Reuters forecasts suggest prices will fall another 3.8% in 2025 and 0.5% in 2026 before stabilizing. But these consensus estimates may be optimistic. Goldman Sachs reported in late 2025 that November new home sales fell 20–30% year-on-year, and landmark developer China Vanke reported a record 49.5 billion yuan ($6.8 billion) annual loss for 2024, followed by Evergrande's formal delisting from the Hong Kong exchange in August 2025.

The government's response has been incremental: mortgage subsidies for new homebuyers, tax rebates for purchases, lower transaction fees. The PBoC's 200-billion-yuan relending facility for whitelist projects saw only 6% take-up by Q3 2024, because banks — already grappling with historically low net interest margins — remain unwilling to extend fresh credit to projects with weak sales prospects. Private estimates suggest completing all unfinished pre-sold homes could require at least 3 trillion yuan, dwarfing the available policy tools.

Morgan Stanley's Chetan Ahya notes that policymakers prefer investments as the key growth driver while viewing consumption stimulus as a "one-time boost" that adds to their debt burden. This philosophical resistance to direct household transfers is the core obstacle to breaking the property-wealth-consumption feedback loop.

The transmission mechanism is straightforward: falling home prices reduce household wealth, depressing consumption. Depressed consumption reduces corporate revenue, compressing wages and employment. Lower wages further depress housing demand. The feedback loop is self-reinforcing and cannot be broken by supply-side measures or targeted production incentives.

3. The Overcapacity-Price Compression Loop

Beijing bet that high-tech manufacturing would fill the gap left by property. Instead, state-driven investment has created overcapacity across solar panels, EVs, steel, chemicals, and an expanding list of industrial goods. Domestic demand cannot absorb the output, and the resulting price competition is destroying margins industry-wide.

The “anti-involution” drive — Beijing’s attempt to crack down on destructive price competition — acknowledges the problem but cannot solve it without addressing the fundamental supply-demand imbalance. As Li Xunlei, chief economist at Zhongtai International, has noted, for the past 15 years supply has consistently exceeded demand, and no amount of targeted industrial policy can reverse that arithmetic when the consumer side remains structurally weak. The NBS confirmed in its January 2026 data release that anti-involution measures had contributed to price stabilization in cement and photovoltaic industries, but these are narrow wins against a broad-based problem.

The export channel has been the release valve — and it worked spectacularly in 2025. China’s trade surplus surged to a record $1.2 trillion, up 20% from $992 billion in 2024. Total exports rose 5.5% to $3.77 trillion while imports flatlined at $2.58 trillion. The surplus is now equivalent to the GDP of a top-20 global economy. But the composition reveals the deflation dynamic: export volumes grew even as unit prices fell — a textbook deflation export.

Critically, the geographic diversification of Chinese exports has been dramatic. Exports to the United States fell 20% in 2025 under tariff pressure, but shipments to Africa surged 26%, to Southeast Asia 13%, to the EU 8%, and to Latin America 7%. Higher-value exports including semiconductors, automobiles, and ships recorded gains of more than 20%. China exported approximately 6.5 million vehicles in 2025, up over one million from the prior year. But this channel is narrowing: the EU, Turkey, Brazil, Mexico, Vietnam, Korea, and India have all imposed anti-dumping duties or countervailing measures on Chinese goods.

The US-China trade truce holds, but at a 47.5% effective tariff rate on Chinese goods — a level experts say is too high for most Chinese exporters to profit from direct US sales. Natixis’s Gary Ng forecasts Chinese exports will grow approximately 3% in 2026, less than half the 2025 rate. BNP Paribas’s Jacqueline Rong expects exports to remain a growth driver but with domestic demand staying “tepid.”

The result is a margin squeeze with no exit. Firms cannot raise prices domestically because demand is weak. They cannot expand exports indefinitely because trade partners are imposing barriers. And they cannot reduce output because state policy incentivizes production growth in “strategic” sectors regardless of profitability.

4. The Fiscal Revenue Erosion Loop

The collapse of land sales has gutted local government revenue. Historically, land-sale proceeds constituted 30–40% of local government fiscal resources. With the property downturn, this revenue stream has cratered, forcing local governments to cut spending, reduce public-sector wages, and defer infrastructure investment — all of which further depress domestic demand.

The deflationary pressure and property slump have driven China's fiscal revenue-to-GDP ratio down by 4.8 percentage points since 2021, to just 17.2%, according to Morgan Stanley. Meanwhile, the public debt-to-GDP ratio has expanded by 40 percentage points since 2019, reaching 116% in 2025 — still below the US federal ratio of 124% but on a trajectory that prompted Fitch to downgrade China's sovereign rating from A+ to A in 2025.

The central government has responded with record borrowing: the official 2025 budget deficit was set at 4% of GDP, with total government borrowing approaching 14.4 trillion yuan when including local government special-purpose bonds and ultra-long treasury bonds. The Big Six state banks are receiving a combined 520+ billion yuan in capital injections from the Ministry of Finance to shore up balance sheets strained by property-related NPLs.

The paradox: Beijing is ramping up government borrowing, but the fiscal multiplier is declining. Falling tax revenue and collapsed land sales mean that even record deficits are barely offsetting the contractionary forces elsewhere in the economy. The PBoC's expected rate and RRR cuts for 2026 are insufficient when real interest rates remain elevated due to deflation.

5. Why the Policy Response Is Insufficient

5.1 The Political Constraint

Eurasia Group ranks China's deflation trap as a top-7 global risk for 2026, arguing that with the 21st Party Congress looming in 2027, Xi Jinping will prioritize political control and technological supremacy over the consumption stimulus and structural reforms that could break the cycle. The 15th Five-Year Plan (2026–2030) emphasizes technology self-sufficiency, security, and supply-side modernization, with comparatively little operational detail on demand-side reform.

The IMF has recommended a comprehensive demand-side package: strengthening social protection systems, accelerating Hukou reforms to give migrant workers access to social benefits, and raising social spending especially in rural areas. The IMF estimates such measures could boost consumption by up to 3 percentage points of GDP in the medium term. Beijing has acknowledged the recommendation but shows no signs of implementing it at scale.

Nomura economists expect Beijing to introduce major stimulus only in Q2 2026, arguing that strong export performance reduces the urgency for domestic demand measures. This is the fundamental tension: external strength masks internal weakness, and policymakers are using the former as justification to delay addressing the latter.

5.2 The Monetary Transmission Problem

The PBoC faces a unique constraint: banks' net interest margins are at historical lows, limiting their ability to pass rate cuts through to borrowers. Credit demand is weak because households and firms are deleveraging, not because borrowing costs are too high. New RMB loan creation has contracted. The monetary policy transmission mechanism is broken in a way that additional rate cuts cannot fix.

The PBoC has signaled an easing bias for 2026, describing policy as "moderately loose." In January 2026, the central bank cut sector-specific interest rates and earmarked cheap loans for small and medium-sized tech and private firms. MUFG expects further easing steps at the February 20 PBoC meeting. But these are targeted measures, not the broad-based demand stimulus that the deflation dynamic requires.

The PBoC has also maintained a tight grip on the yuan, keeping USD/CNY within a 7.00–7.40 band despite market expectations of depreciation. This choice — prioritizing exchange rate stability over monetary expansion — reflects geopolitical logic: allowing significant depreciation would inflame trade tensions and accelerate capital outflows. But it also means the exchange rate cannot serve as an adjustment mechanism.

5.3 The Stimulus Gap: What Would It Actually Take?

To break the deflationary cycle, China would need direct household transfers or social spending on the order of 3–5 trillion yuan — roughly 2–3% of GDP. This is the scale of intervention the IMF has recommended. For context, the entire consumer trade-in subsidy program that policymakers have touted as their demand-side response amounts to a fraction of this figure. BNP Paribas notes that the 2026 fiscal subsidy program for consumer goods actually looks weaker than the 2025 version.

The government has pledged "more proactive" macroeconomic policies for 2026 and will unveil economic targets at the Two Sessions parliamentary meeting in March 2026. ING expects the inflation target to remain at approximately 2%, unchanged from 2025's goal that was missed by a wide margin (full-year 2025 CPI was essentially flat). The gap between the stated target and actual inflation outcome is itself a measure of the policy insufficiency.

6. Regional Transmission: How China's Deflation Reshapes Asia

6.1 The Export Price Channel

China's deflation is not contained within its borders. When Chinese manufacturers sell below cost to maintain market share, they export deflation to competitors. ASEAN steel producers face anti-dumping duties originally imposed on Chinese steel. Vietnamese solar manufacturers have seen Chinese firms halt production lines locally in response to US tariff arbitrage. The yuan's trade-weighted depreciation compounds the price pressure, making Chinese exports even more competitive against ASEAN producers.

The geographic shift in Chinese exports is reshaping competitive dynamics across the region. The 13% surge in Chinese exports to Southeast Asia in 2025 means ASEAN manufacturers face intensified competition in their home markets, even as they benefit from supply chain diversification FDI. This dual dynamic — simultaneously receiving Chinese investment and competing against Chinese exports — is the defining challenge for ASEAN industrial policy.

6.2 The Commodity Demand Channel

China consumes roughly 50% of global copper, steel, and cement production. Sustained domestic weakness depresses commodity prices, benefiting commodity importers (Japan, Korea, ASEAN manufacturers) but devastating commodity exporters (Australia, Indonesia's mining sector). The bifurcated impact creates winners and losers within Asia that do not neatly align with traditional economic groupings.

6.3 The Capital Flow Channel

Chinese firms and high-net-worth individuals are increasing capital outflows, benefiting Singapore and Hong Kong as wealth management hubs but draining domestic investment. Singapore's position as a family office destination and regional headquarters for firms diversifying away from China exposure is a direct beneficiary of China's domestic malaise.

6.4 The Disinflationary Transmission to Global Markets

China's deflation has direct implications for global bond markets, commodity pricing, and central bank decision-making. Chinese deflation is inherently disinflationary for the world — lower export prices, subdued commodity demand, and capital outflows that seek yield in developed market bonds. This creates a paradox: the Fed may find it easier to cut rates in a world where Chinese deflation is suppressing global inflationary pressure, benefiting US bond markets and equities at the expense of emerging market commodity producers.

For commodity markets specifically, the consensus assumption that Chinese demand for copper, iron ore, and energy will return to trend growth is increasingly questionable. If the property sector stabilizes at structurally lower activity levels — which is the most likely outcome — commodity demand will reset permanently lower.

7. The 15th Five-Year Plan: Hopes and Limits

China's 15th Five-Year Plan (2026–2030) will set the economic agenda for the Xi era's final chapter before the 2027 Party Congress. Early signals suggest the plan will emphasize technology self-sufficiency, new quality productive forces, and supply-side modernization — consistent with the industrial policy approach that has dominated since 2015. Domestic consumption features as a stated priority, but operational mechanisms for boosting it remain vague.

The central challenge is that China's growth model for the past two decades has systematically suppressed household income share in favor of corporate and government investment. Household consumption as a share of GDP remains around 38–40%, compared to 55–65% in most advanced economies. Reversing this requires not incremental adjustments but a fundamental rebalancing of income distribution — higher wages, stronger social safety nets, portable benefits for migrant workers, and reduced reliance on land sales as a fiscal mechanism. Each of these is politically sensitive.

The result is likely to be a Five-Year Plan that articulates the right goals but lacks the execution mechanisms to achieve them within the politically relevant timeframe.

8. Investment Implications

What we are watching: The GDP deflator. CPI can be manipulated through selective subsidy programs and base effects. The GDP deflator captures the full breadth of pricing power across the economy. Until it turns sustainably positive, China's deflationary trap persists. We assign less than 20% probability to a sustained positive GDP deflator before H2 2027.

Positioning: We are structurally cautious on Chinese domestic demand exposure and constructive on the beneficiaries of China's deflation export — particularly ASEAN manufacturers gaining market share through supply chain diversification, and Singapore's financial services sector capturing wealth management flows. We view commodity-linked Asian economies as facing asymmetric downside risk from Chinese demand weakness.

Key risk to our view: A genuine fiscal pivot toward demand-side stimulus at scale — on the order of 3–5 trillion yuan in direct household transfers or social spending — would materially change the outlook. We view this as low probability before the 2027 Party Congress but would reassess immediately if signals emerge from the March 2026 NPC session.

9. Conclusion

China's deflation is not a temporary dip. It is the consequence of structural imbalances — an investment-heavy growth model, a collapsing property sector, industrial overcapacity, and a political system that views consumption stimulus as secondary to supply-side modernization. The feedback loops are self-reinforcing, and the policy response remains insufficient in scale and design.

The January 2026 data confirms the pattern: PPI deflation narrowing marginally while CPI disappoints, with the underlying domestic demand picture unchanged. The $1.2 trillion trade surplus is a symptom, not a solution — it demonstrates that Chinese production capacity far exceeds what domestic consumers can absorb, and that the excess is being pushed onto global markets at deflationary prices.

For Asia, this means planning for a prolonged period of Chinese deflationary pressure: compressed export margins, subdued commodity demand, and continued capital reallocation away from China toward ASEAN and India. The firms and economies that understand this structural shift will be positioned to benefit. Those

that wait for a V-shaped Chinese recovery may be waiting a very long time.

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