The Yuan's Managed Descent

PBoC Easing, the Deflation Void, and China's Export Machine

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Abstract

China enters mid-2026 growing near 4.4 to 4.5%, a number that flatters a domestic economy in the grip of persistent deflation. The property overhang is now four years old, households are deleveraging, and the GDP deflator has been negative for the better part of two years. Beijing's response has been a supply-side and external-facing one: the PBoC eases into a liquidity trap while the export machine, restructured around geographic diversification, still cleared a record 1.2 trillion USD trade surplus in 2025 despite a 47.5% effective US tariff wall. The policy tool absorbing the strain is the currency. We read the yuan's path as a managed, administratively throttled descent rather than a free float, designed to preserve export competitiveness without triggering capital flight. This paper maps the deflation void, the transmission of Chinese overcapacity into the rest of Asia, and the single catalyst that would change our call: a demand-side fiscal pivot at scale. Absent that pivot, we stay Underweight China domestic demand.

1. The Growth Number and the Economy It Conceals

China will likely print 2026 real GDP growth of 4.4 to 4.5%, comfortably inside the informal target band and above the global average. Taken alone the figure suggests an economy that has stabilized. It has not. The headline is carried by net exports and by state-directed investment in advanced manufacturing, while the parts of the economy that touch the household, namely property, consumption, and private services, remain in a deflationary contraction that the real growth rate deliberately obscures.

The clearest signal is the price level, not the volume level. China's GDP deflator has been negative across most quarters since 2023, the longest stretch of economy-wide price decline since the late 1990s. Nominal GDP growth, the number that actually services debt, pays wages, and funds local governments, has been running roughly a full percentage point or more below real growth. When an economy grows 4.5% in real terms but closer to 3.5% in nominal terms, the arithmetic of deleveraging becomes punishing: debt is fixed in nominal terms while the income to service it deflates. Consumer prices have hovered around zero, dipping negative in several months of 2025, and producer prices have been in outright deflation for more than three years. This is not disinflation converging on a comfortable target. It is a self-reinforcing loop in which falling prices raise real debt burdens and push households to defer purchases in anticipation of lower prices later.

> **Our view:** The 4.4 to 4.5% real growth print is real but misleading. We anchor our China call to the GDP deflator and to nominal growth, not to the headline. On that basis China is in a balance-sheet deflation, and we treat the volume number as a supply-side achievement, not evidence of demand repair.

2. Anatomy of the Deflation Void

We call it a void because monetary easing is flowing into a space where it neither lifts prices nor durably lifts demand. Three structural forces keep the void open.

2.1 The property overhang

Property, at its peak, was roughly a quarter of Chinese GDP once upstream and downstream linkages are counted. The correction that began in 2021 has removed a vast pool of household wealth and, more importantly, of household confidence. New home starts remain a fraction of their 2020 to 2021 peak, developer balance sheets are still being worked out, and a large inventory of unfinished and unsold units continues to hang over the market. Because roughly 60 to 70% of Chinese household wealth was held in residential property, the price decline is a direct negative wealth shock to the consumer that no rate cut fully offsets.

2.2 Consumer deleveraging

Chinese households responded to the property shock the way balance-sheet-impaired households everywhere do: they are paying down debt and rebuilding precautionary savings rather than spending. Mortgage prepayment has been elevated, the household savings rate remains structurally high, and retail sales growth has been soft in real terms once price effects are stripped out. This is the demand side of the deflation loop, and it is rational at the household level even as it is destructive at the aggregate level. It is the textbook composition problem that monetary policy alone cannot solve.

2.3 Overcapacity and the supply glut

The state's answer to weak demand has been to build supply. Directed credit into electric vehicles, batteries, solar, and other advanced manufacturing has produced world-leading capacity but also chronic overcapacity, price wars, and collapsing producer margins. This is why the PPI cannot lift: the industrial economy is manufacturing deflation domestically and then exporting it. The 2025 official rhetoric against involutionary competition (neijuan) acknowledged the problem, but capacity discipline has proven far harder to enforce than capacity creation.

> **Our view:** The deflation void is not a monetary problem with a monetary fix. It is a demand deficiency created by a wealth shock and a supply glut created by industrial policy. Until one of those two blades is addressed at scale, easing pushes on a string. We are skeptical of any thesis that treats another round of rate or reserve-ratio cuts as a turning point.

3. The PBoC Eases Into the Void

The PBoC's stance is officially moderately loose, the softest formal characterization in over a decade. In practice this has meant incremental cuts to policy rates and the reserve requirement ratio, structural relending facilities aimed at manufacturing and technology, and targeted support for property inventory absorption. The direction is unambiguously accommodative. The problem is transmission.

In a healthy economy, lower rates pull forward borrowing and spending. In a balance-sheet recession, lower rates mostly reduce the interest income of savers and compress bank net interest margins, which are already thin, without generating the private credit demand that would reflate prices. Chinese aggregate financing growth has increasingly been carried by government bond issuance rather than private borrowing, a tell that the private sector is not taking the bait. This is the domestic manifestation of a liquidity trap: the marginal yuan of easing is not finding a willing private borrower.

The PBoC also faces an external constraint. With the Fed cutting but US rates still well above Chinese rates, aggressive easing widens the yield differential against China, pressuring the yuan and incentivizing capital outflow. The central bank is therefore easing with one hand while managing the currency and capital account with the other. That tension is the hinge of this entire paper, and it is why the currency, not the interest rate, has become the primary adjustment valve.

> **Our view:** We expect further modest PBoC easing through 2026, but we assign low weight to its reflationary impact. The binding constraint on Chinese monetary policy is now the currency and the capital account, not the domestic price level. Easing continues largely to cap real rates and support the fiscal-financing burden, not because policymakers believe it will end deflation.

4. The Managed Descent of the Yuan

Faced with a deflationary domestic economy and a durable interest-rate disadvantage, Beijing wants a weaker yuan to preserve export competitiveness, but it cannot tolerate a disorderly one that would ignite the capital flight it spent a decade learning to fear. The result is what we call a managed descent: a currency guided lower in controlled steps through the daily fixing, defended at the edges of the trading band, and reinforced by an increasingly active toolkit of capital-flow management.

The mechanics matter. The PBoC sets a daily reference rate around which the onshore yuan trades within a band. By setting the fix, adjusting the countercyclical factor, managing the offshore (CNH) liquidity that determines the cost of shorting the currency, and guiding state banks in the spot market, the authorities can slow, pause, or accelerate depreciation almost at will. This is not a free float finding fair value. It is an administered price walked lower deliberately, with the aim of exporting deflation while retaining control of the exit doors. Capital-flow management is the other half: outbound investment quotas, scrutiny of large foreign-currency conversions, and moral suasion over corporates repatriating export proceeds all keep the descent orderly. The record 1.2 trillion USD surplus itself generates an enormous foreign-currency flow that, if fully converted onshore, would push the yuan up; the managed regime steers that surplus into a controlled depreciation instead of an appreciation.

> **Our view:** Our base case is continued, orderly yuan depreciation guided by the fix rather than a one-off devaluation. A sharp, uncontrolled drop is the tail risk we watch most closely, because it would be the signal that capital-flow management is losing the battle with outflow pressure. We view the odds of that tail as low but rising if the Fed pauses its cutting cycle and the yield gap reopens.

5. The Export Machine and Geographic Diversification

The single most underappreciated fact about China in 2026 is that the export machine did not break under tariffs. It rerouted. Despite a 47.5% effective US tariff, China posted a record goods trade surplus of roughly 1.2 trillion USD in 2025. The mechanism was geographic diversification: exports to the United States fell as a share of the total, while exports to ASEAN, the EU, Latin America, Africa, and the rest of the Global South rose to more than compensate. The US is now a minority destination for Chinese goods, and the marginal Chinese export increasingly clears in markets where no tariff wall exists.

Part of this is genuine market diversification and part is rerouting through third countries, which is precisely why transshipment enforcement has become the front line of trade policy across Vietnam, Malaysia, and Mexico. The competitiveness underpinning all of it is the combination of a deflating domestic cost base, world-leading manufacturing scale, and a currency that is being guided lower. Chinese exporters are winning on price in a world where global merchandise trade volumes are barely growing, which means China is taking share, not riding a rising tide.

Metric	2024	2025	2026E
Real GDP growth	5.0%	4.8%	4.4 to 4.5%
GDP deflator (approx)	-0.5%	-0.8%	Negative
CPI (avg)	0.2%	0.0 to 0.3%	Near zero
PPI (avg)	-2.0%	-2.2%	Negative
Goods trade surplus (USD)	0.99tn	1.20tn	~1.15 to 1.25tn
US effective tariff on China	~20%	47.5%	47.5%
PBoC stance	Prudent	Moderately loose	Moderately loose

Figures are Darmine estimates and rounded compilations consistent with PBoC, customs, and IMF sources. 2026E are Darmine projections.

The strategic vulnerability is that this model relies on the willingness of other markets to keep absorbing Chinese goods. As the deflationary export wave hits domestic producers in Europe, ASEAN, and Latin America, the political tolerance for open markets erodes. The EU's ongoing measures on Chinese EVs and the wave of antidumping and safeguard investigations across emerging Asia are early evidence that the diversification runway is not infinite.

> **Our view:** We treat the export machine as structurally resilient in the near term but politically fragile in the medium term. The 1.2 trillion USD surplus is a source of strength for China's external accounts and a source of rising protectionist backlash everywhere else. The surplus is the reason we are not outright bearish on Chinese external stability, and the backlash is the reason we do not extrapolate it forward indefinitely.

6. Transmission: How China Exports Its Deflation to Asia

China's deflation does not stay in China. It is transmitted to the rest of Asia through three channels, and this transmission is central to our regional views.

6.1 The price channel

Cheap Chinese manufactured goods, priced off a deflating domestic cost base and a weakening yuan, undercut local producers across ASEAN. This suppresses regional producer prices and industrial margins. It is disinflationary for consumers, which gives regional central banks room to cut, but it is a direct competitive threat to domestic manufacturing in Thailand, Indonesia, Malaysia, and Vietnam.

6.2 The currency channel

A managed-lower yuan drags on the currencies of economies that compete with China in third markets. Central banks that let their currencies appreciate against the yuan lose export competitiveness; those that follow the yuan down import the deflation more directly. This is why MAS's gradual S NEER appreciation stands out as a deliberate quality-defense posture, and why higher-beta, China-competing exporters face the sharper squeeze.

6.3 The demand channel

Weak Chinese domestic demand means weaker Chinese outbound tourism and softer Chinese import appetite for the region's commodities and intermediate goods. Thailand is the clearest casualty, with weak China tourism a direct drag on a regional laggard already carrying high household debt. Commodity exporters see the demand channel most in prices; downstreaming stories such as Indonesian nickel and batteries are more insulated because they are tied to the global EV supply chain rather than to Chinese final demand alone.

> **Our view:** Chinese deflation is a regional force, not just a domestic one. It reinforces our Underweight on Thailand and our caution on China-competing manufacturers, while leaving domestic-demand-driven economies (India, the Philippines, Indonesia) comparatively insulated. The cleanest way to be long Asia and short Chinese deflation is to own the domestic-demand compounders and avoid the goods-exporters caught in the price channel.

7. Central-Bank Divergence and the APAC Backdrop

China's managed descent does not happen in isolation. It sits inside the defining macro feature of Asia in 2026: central-bank divergence. The BOJ is normalizing, with its policy rate heading toward 0.75 to 1.0% by mid-2026 and the 10-year JGB yield above 2.3%, the highest since 1998, on the back of roughly 5.5% Shunto wage settlements and PM Takaichi's expansionary fiscal stance. The Fed is cutting. MAS is appreciating its currency gradually. And the PBoC is easing into deflation. Four major central banks are moving in four different directions.

This divergence is the single most important cross-current for the yuan. BOJ normalization and a firmer yen alter the funding calculus of the carry trade and change relative competitiveness in the goods where Japan and China overlap. Fed cuts narrow the yield gap that pressures the yuan, which is the one external development that most helps Beijing manage the descent; a Fed pause would do the opposite. Against this backdrop, Asia-Pacific still grows around 4.4% in 2026 and contributes roughly 60% of world GDP growth, even as WTO global merchandise trade volume growth slows to only about 0.5%, down from above 2% in 2024 to 2025.

The AI capex cycle is the offsetting engine. Taiwan and Korea together account for roughly 30% of global AI capex by J.P. Morgan's estimate, driving 12 to 13% EPS growth for Asia ex-Japan. This is the reason a China deflation deep dive does not translate into a bearish view on Asian equities as an asset class: the region's earnings are increasingly powered by the semiconductor and AI-hardware complex, which is largely orthogonal to Chinese domestic demand.

> **Our view:** We frame the yuan's descent as one leg of a four-way central-bank divergence. The variable that most determines whether the descent stays orderly is not Chinese policy but the Fed: continued cuts keep

> the exit orderly, a Fed pause reopens the yield gap and stresses the capital account. We position for orderly divergence while hedging the Fed-pause tail.

8. The Catalyst That Would Change Our Call

We are deliberate about naming the one development that would move us off Underweight China domestic demand: a demand-side fiscal pivot at scale. Everything Beijing has done to date has been supply-side, external, or monetary. What the deflation void requires is a large, direct transfer to the household and a genuine backstop for property and local-government balance sheets, financed by the central government's still-substantial fiscal space.

The signature of such a pivot would be concrete and identifiable: a materially larger central-government deficit directed at consumption rather than investment, direct income support or a consumption-voucher program at national scale, a recapitalization or clean resolution of stalled property projects, and a decisive transfer of local-government debt onto the sovereign balance sheet. Piecemeal trade-in subsidies and relending facilities do not qualify; they are the supply-side reflexes that have defined policy so far. The distinguishing feature is whether the marginal fiscal yuan is aimed at demand (households) rather than supply (producers).

We do not forecast this pivot as our base case, because it cuts against a decade of policymaker preference for production over consumption and a deep-seated wariness of welfarism. But we flag it as the highest-conviction upside catalyst: a genuine demand pivot would break the deflation loop, lift nominal growth, reduce pressure on the currency, and re-rate the entire domestic-demand complex from consumer to property to banks.

> **Our view:** Our stance is Underweight China domestic demand, held with conviction but with a clearly defined exit. The trigger to upgrade is a demand-side fiscal pivot at scale, not another rate cut, not another RRR cut, and not another export beat. Until the fiscal composition shifts toward the household, we treat easing and export strength as symptoms of the problem, not solutions to it.

Portfolio Positioning Summary

Overweight: We remain Overweight the Asian domestic-demand compounders that are insulated from Chinese deflation: India (highest structural conviction, ~6.5% growth, S&P upgrade to BBB, median age 28), Singapore (quality defense, MAS S NEER appreciation, MTI 2026 at 2.0 to 4.0%), and Indonesia (nickel and EV-battery downstreaming, 270m consumers). These are levered to structural demand and the AI/semiconductor cycle, not to Chinese final demand.

Market weight: Japan (BOJ normalization, selective financials benefiting from a steeper curve and higher rates, TOPIX target 3,350 to 3,400), Vietnam (manufacturing FDI but transshipment-enforcement risk as the diversification runway narrows), and Malaysia (semiconductor packaging beneficiary but directly exposed to Chinese oversupply in the price channel). Within China itself we are Market weight the external and manufacturing complex that the export machine and managed currency support, while Underweight the domestic side.

Underweight: China domestic demand (deflation void, property overhang, consumer deleveraging, easing that pushes on a string) and Thailand (regional laggard at 1.8 to 2.5%, high household debt, weak China tourism through the demand channel, March 2026 election risk). We are also cautious on China-competing goods exporters most exposed to the yuan's descent through the price channel.

Key catalysts to reassess: Upgrade China domestic demand on evidence of a demand-side fiscal pivot at scale (larger central deficit aimed at households, consumption transfers, property recapitalization, local-debt assumption). Downgrade the region's external stability if the yuan's managed descent turns disorderly, which we would read from an accelerating fixing, a widening CNH-CNY gap, and a reopening yield differential on any Fed pause. Reassess Japan on the pace of BOJ hikes toward 0.75 to 1.0% and the trajectory of the 10-year JGB above 2.3%.

Conclusion

China's 4.4 to 4.5% growth in 2026 is a supply-side achievement layered over a demand-side deflation. The property overhang and consumer deleveraging keep the price level flat to negative, the PBoC eases into a void where the marginal yuan finds no private borrower, and the burden of adjustment has shifted onto the currency. The yuan's managed descent, guided by the fix and defended by capital-flow management, is the mechanism through which Beijing preserves the competitiveness of an export machine that still cleared a record 1.2 trillion USD surplus under a 47.5% US tariff wall. That deflation is then exported to the rest of Asia through the price, currency, and demand channels.

We stay Underweight China domestic demand. The easing is real, the export strength is real, and neither addresses the balance-sheet deflation at the core of the economy. The one development that would change the call is a demand-side fiscal pivot at scale, aimed at the household rather than the factory. We do not forecast it as our base case, but we hold the Underweight with a defined exit and we will move fast if the fiscal composition finally turns toward demand. Until then, the descent continues, managed and deliberate, and Asia's growth story is best owned through the domestic-demand compounders and the AI-hardware complex that sit outside the void.

Sources and Further Reading

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