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Asia Economics | Asia Pacific

The Viewpoint: China's Deleveraging: Deflation Risks Re-emerge

Policymakers are working towards debt deleveraging yet again, given a better exports backdrop. But with a sluggish property market and aggressive pace of household deleveraging, this may instead risk the re-emergence of deflationary pressures.

Key Takeaways

- Since July 2025, policymakers have utilized their usual playbook of tightening fiscal policy as exports growth strengthens.
- But the tightening this time around has been pro-cyclical instead of being countercyclical.
- This is because the property market has remained a substantial drag on activity and household deleveraging has intensified.
- In our base case, we expect the GDP deflator to moderate but to stay in positive territory.
- If households continue to delever aggressively and fiscal tightening is maintained, the risk is that deflationary pressures may re-emerge.

In this report, we take stock of where China is in its deleveraging journey and implications for the road ahead.

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Details

China is deleveraging again…

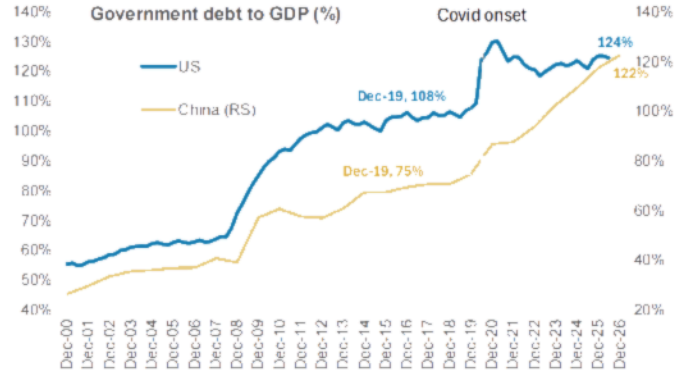
Many large economies have experienced a rise in the levels of government debt to GDP ratio post-Covid. China is no exception. More recently, bond yields around the world have been rising as investors worry about the continued fiscal deficits, which will keep adding to public debt levels just as demand for capital related to corporate capex is also rising sharply. There is no specific level of debt or a particular debt to GDP ratio that would be a natural trigger for policymakers to delever – but in China's case, policymakers appear to be getting concerned about the pace of leveraging and public debt sustainability. Based on our China team's forecasts, China's public debt to GDP ratio will have risen 48ppt from its pre-Covid level, to 122% of GDP by end-2026. But in the past the timing of fiscal tightening has tended to be countercyclical and linked to signs of external demand improving. Hence, just as exports started to improve modestly in 2H2025, policymakers took up fiscal tightening. The augmented fiscal deficit has narrowed 2.5ppt since July 2025.

Exhibit 1: China is tightening fiscal policy while theUS fiscal deficit is widening at the margin



Source: CEIC, Haver, Morgan Stanley Research

Exhibit 2: Ratio of government debt to GDP in both the US and China have risen sharply post-Covid

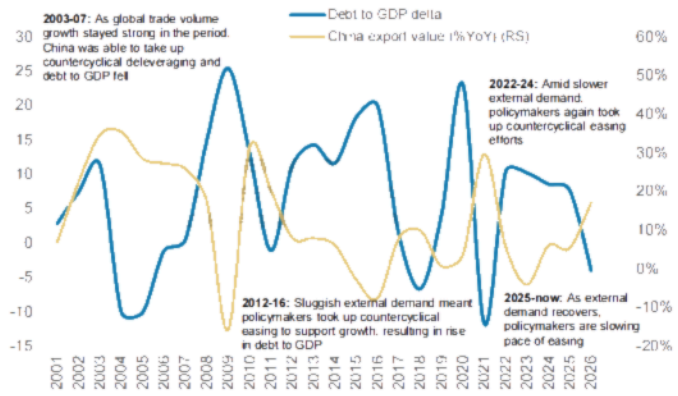


Source: CEIC, Haver, Morgan Stanley Research; Note for China Dec-26 is an estimate

…but the deleveraging this time around has been relatively painful

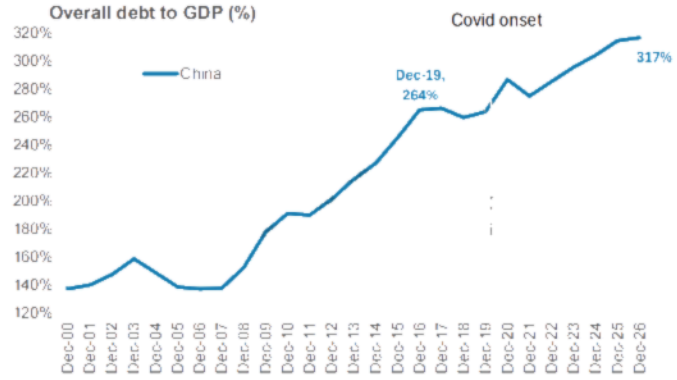
Usually this fiscal tightening happens in a countercyclical manner, as exports provide support to growth. This was indeed the case in 2017, when strong exports growth helped and allowed China to delever. But this time around, the fiscal tightening has resulted in a deceleration in growth – see China Economics: 3Q GDP Missing Target Again Amid Deflation-Fiscal Gridlock (17 Aug 2026).

Exhibit 3: China tends to run a countercyclical growth model when exports are strong



Source: CEIC, Haver, Morgan Stanley Research

Exhibit 4: China's ratio of overall debt to GDP has continued to rise since Covid amid a deflationary environment



Source: CEIC, Haver, Morgan Stanley Research; Note: Dec-25 is an estimate

Why is that the case? We cite the following factors

1) Unlike previous cycles, the property market is a substantial drag on economic activity

For instance, from 1H16 to 1H18, there was a reflation in the property sector at that time; households were leveraging alongside an improvement in exports, which helped to provide support for deleveraging the corporate balance sheet (which was the troubled balance sheet at that time).

2) Households have been deleveraging at a faster pace

Against this backdrop, the fiscal tightening has become pro-cyclical.

3) The initial strength in exports was driven by tech and provided more modest spillovers than previous cycles

Exports growth was not as broad-based then and was concentrated in less labour-intensive sectors.

How We Can Get Back to a Beautiful Deleveraging

1) Manage an appropriate r-g gap

In our earlier work, where we analyzed more than a century of historical data and 76 instances of deleveraging episodes, we found that the debt-reducing economies relied on keeping an adequate buffer (of about 2ppt) between real rates and real GDP growth for debt consolidation. For more details, please see Global and US Economics: Debt Sustainability: r-g Is Key (14 Jul 2021).

In this context, China managed its monetary conditions in a way that this r-g gap has been kept in a reasonable range. This has helped to manage the overall pace of the deleveraging process.

2) Supporting aggregate demand

Our framework has been that if one or both of the private sector balance sheets are deleveraging, then the government balance sheet would have to lever up to provide support to aggregate demand.

In China's context, since the household balance sheet is deleveraging and the economy is already facing deflationary pressures, this means that policymakers should expand the fiscal deficit further to provide support.

3) Growth mix

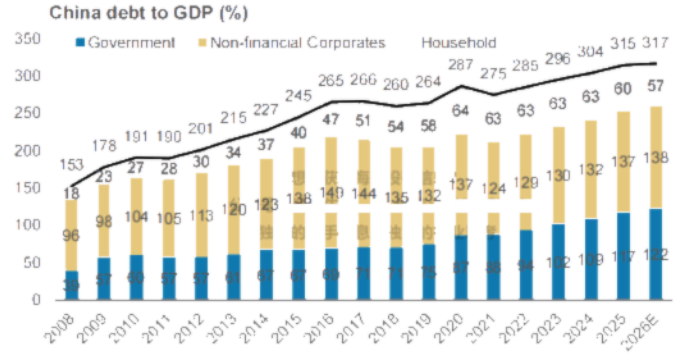
In China's case, this is particularly important. At the current juncture, policymakers are cutting back on all expenditures and though there may be scope for fiscal policy to catch up, policymakers have not announced plans for a significant fiscal expansion. But in order to manage aggregate demand, even as policymakers take up fiscal expansion, it will be important to tilt the mix towards consumption rather than capex. Using fiscal policy or applying incremental debt towards capex at this juncture means that there will be support to aggregate demand today, but with the creation of aggregate supply later on. Policymakers appear to be hesitant in providing support to consumption on the basis that it does not generate sustainable growth, but the challenge arising from persisting with capex is that the economy will not get back to a sustained moderate rate of inflation. Instead, it will keep revisiting the deflation issue as more excess capacity comes onstream.

Exhibit 5: China has maintained an appropriate r-g gap



Source: CEIC, Haver, Morgan Stanley Research estimates

Exhibit 6: The government balance sheet needs to lever up to support aggregate demand as households delever



Source: CEIC, Haver E=Morgan Stanley Research estimates

Outlook – Risks of Deflationary Pressures Re-emerging

In our base case, we expect non-tech exports to remain robust, providing some offset to the headwinds from deleveraging. Moreover, we expect a modest fiscal expansion and so we expect the GDP deflator to average 0.8% this year before moderating to a still positive 0.2% in 2027.

But consumers have been deleveraging at a fast pace, to the extent that household debt is now contracting on a YoY basis. Meanwhile, the pace of contraction in property sector investment is still going to be intense, and though there may be scope for fiscal policy to catch up, policymakers have not yet announced a significant fiscal expansion (see China Economics: Politburo: Faster Fiscal Rollout, Not a Pivot Yet (30 Jul 2026)).

This therefore increases the risk that China could dip back into deflation.

Three Reasons Why Deleveraging Is Painful in This Cycle

#1: Property remains a drag

The underlying indicators are soft: A key difference in this cycle compared with past cycles is the persistent drag from the property market. Even though the property market entered into a downturn from 2021 onwards, the high-frequency indicators are pointing towards a continued contraction and decline in activity.

How long will the property market stay in adjustment mode? The adjustment in China's property market has been prolonged and the key question amongst investors is when this adjustment will be done and property stop being a drag on growth. As compared to its own historical trend, real estate fixed asset investment as a percentage of GDP is still declining, even though it has already fallen below its 2004 level. As compared on a relative basis to the US and Japan, which had all experienced substantial adjustments in their property sector, real estate investment in China has also reached 3.4% of GDP, similar to the 2.4% and 3.9% reached in US and Japan at the trough.

A period of below-trend property activity may still be necessary: Our perspective is that the property market will still stay in adjustment mode for an extended period, for a couple of reasons.

1. China's property market previously operated above its long-term trend and so may need to remain below trend for some time.
2. The underlying demand trend is still softening. Demographics represent a structural constraint on property demand. China's total population is declining, creating a natural headwind for long-term demand for housing.

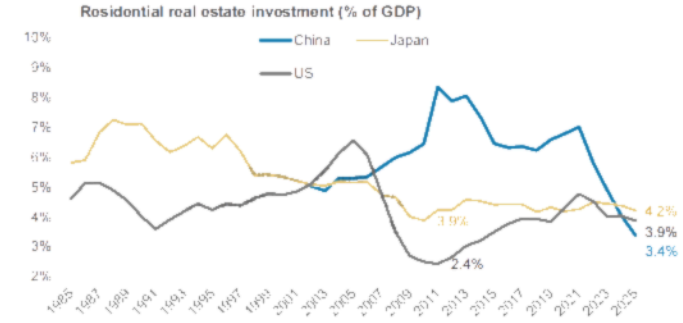
Recent policy measures pose downside risks: Our property analyst for China, Stephen Cheung, lowered his 2026 full-year property market forecasts in view of weak land sales, expecting new home sales to decline 9.8%Y (see China Property: Lowering Full-year Forecasts on Weak Land Sales, 9 Aug 2026).

Since then, policymakers have issued guidelines to accelerate the transition from presales to completed home sales model – see China Property: Quantifying the Impact of a Completed-Sales Model (30 Aug 2026). Stephen believes this could structurally weigh on developers' sales and returns and pose downside risks to his already lowered forecasts.

Under a strict implementation scenario, he expects property sales to contract at a compound annual rate of 24% over 2026-28.

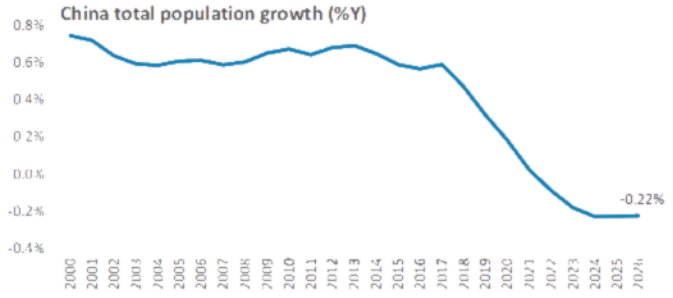


Exhibit 7: China's residential real estate investment has fallen sharply



Source: CEIC, Haver, Morgan Stanley Research

Exhibit 8: Population growth is still declining



Source: CEIC, Haver, Morgan Stanley Research

#2: Accelerated household deleveraging

The evolution of debt trends across the three balance sheets: After 2021, initially household debt to GDP ratios held steady between 2022 and 2024, while corporate and government balance sheets were levering up. This dynamic shifted when households started to reduce their ratio of debt to GDP in 2025 but aggregate demand was still supported by a rise in corporate and government leverage. In 2026, even as households have become more aggressive in their deleveraging, policymakers have also taken up fiscal tightening, which is therefore complicating the deleveraging process.

Households are deleveraging at a faster pace: Tied to the property market downturn, households were initially deleveraging at a very gradual pace and they did so by bringing household debt growth in line with nominal GDP growth.

But from 2025 onwards, households started to delever at a faster pace than in previous years – household debt growth slowed more than nominal GDP growth. In 2026, we estimate that the ratio of household debt to GDP will decline another 3ppt, after having declined 3ppt last year. In fact, 2026 will be the first year in which household debt will contract on a YoY basis.

The picture looks the same when viewed from the other side of the household balance sheet. Household saving rate has risen in 2Q26 and has reached a new high in the post-2022 period once you look past the usual seasonal patterns.

The lack of policy support is accelerating the adjustment in household balance sheets: Households are already facing a starting point where the deflationary backdrop is weighing on incomes. Since 2Q23, when China's GDP deflator turned negative, household wage growth has also slowed significantly. Against this backdrop, households are cutting back on consumption to the point that saving rate is going up.

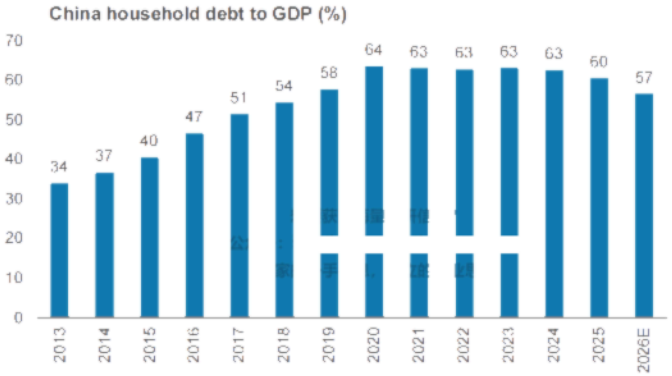
What's more, policy support for consumption has been less forthcoming. The lack of social security has meant that households have continued to hold on to high rates of precautionary saving. As a result, retail sales has softened to average just 1.2%Y on a year-to-date basis vs. an average of 3.8%Y in 2025. This reduction in household expenditures contributes to a broader weakening in domestic demand and intensifies the downside pressures on growth.

Exhibit 9: Household debt growth has fallen below nominal GDP growth and continues to decelerate



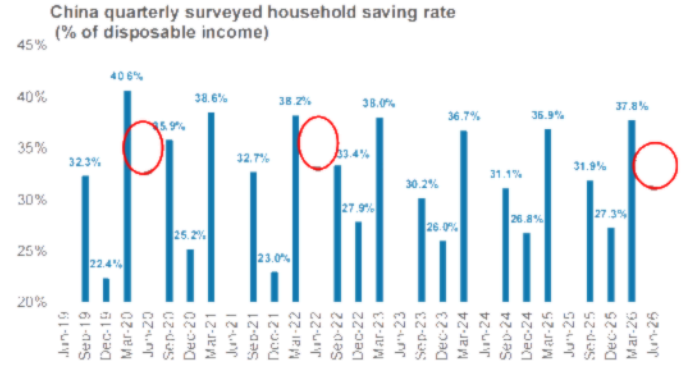
Source: CEIC, Morgan Stanley Research

Exhibit 10: Households are deleveraging



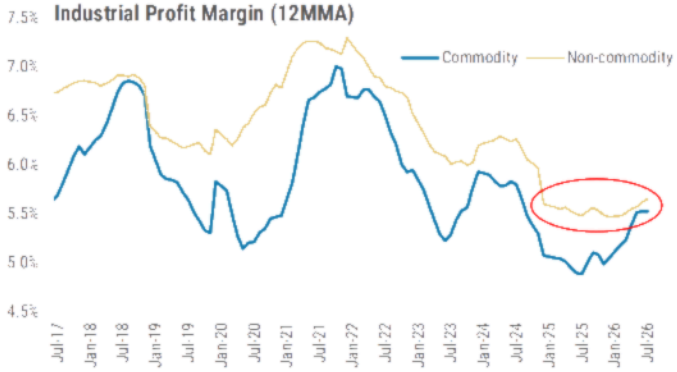
Source: CEIC, Morgan Stanley Research forecasts

Exhibit 11: Household savings rate is at its highest since the Covid peaks in 2020 and 2022



Source: CEIC, Morgan Stanley Research

Exhibit 12: Profit margin for the non-commodity industrial sector has just stabilized, limiting pass-through to wage growth



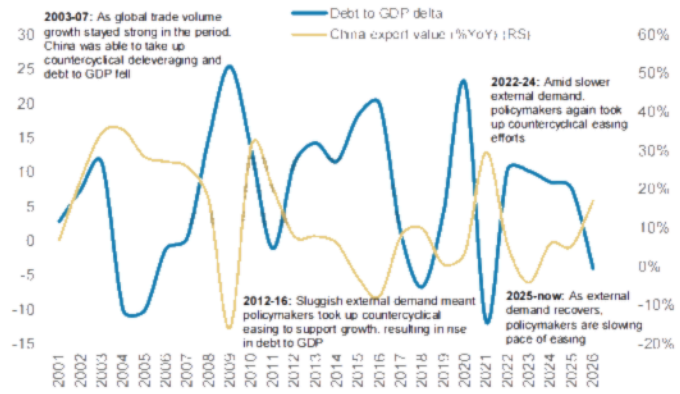
Source: CEIC, Morgan Stanley Research

#3: Pro-cyclical fiscal tightening

A 2.5ppt tightening since July 2025: Fiscal tightening has been underway since July 2025 and has continued to date. Policymakers have utitilised the usual playbook of using exports as a guiding factor to influence when to initiate tightening. This approach has worked in the past, but the issue in this cycle is that the property sector remains very weak and households have been deleveraging at an aggressive pace, which is adding to the challenges.

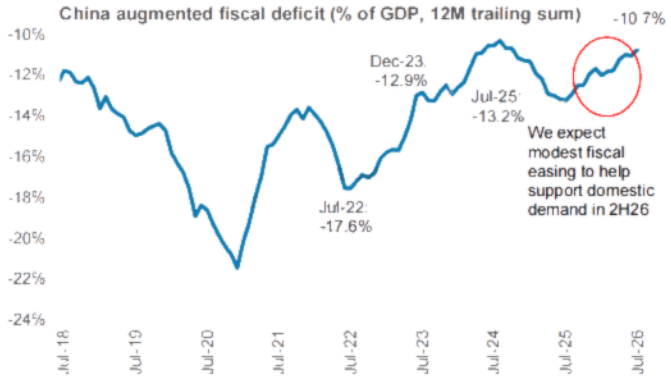
Moreover, the continued decline in ratios of government revenue to GDP would have raised concerns about the fiscal outlook. Past rounds of fiscal expansion have been geared towards supporting investment, which has led to a deflationary environment where pricing power is weak and poor corporate profitability is affecting wage growth. Against this backdrop and combined with weak revenues from land sales, the tax or revenue to GDP ratios have been declining since July 2021. Initially, policymakers maintained a stable expenditure to GDP ratio; however, they have now taken up the reduction in expenditure as a share of GDP in order to narrow the fiscal deficit. For instance, the budget for the consumer trade-in program has been smaller this year as compared to 2025.

Exhibit 13: China tends to run a countercyclical growth model when exports are strong



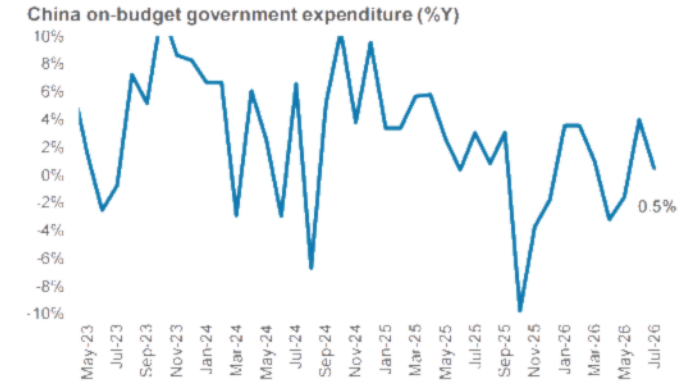
Source: CEIC, Haver, Morgan Stanley Research

Exhibit 14: Augmented fiscal deficit has narrowed over the last 12 months



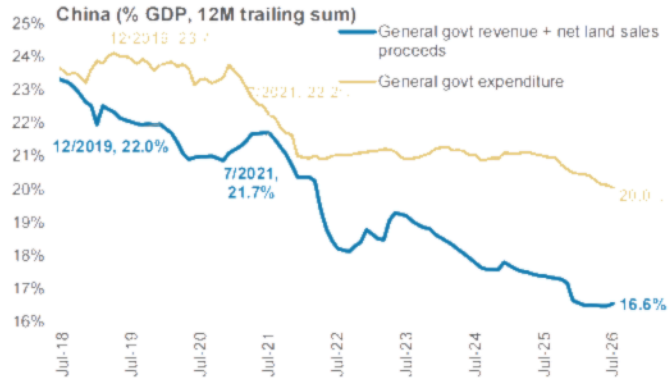
Source: CEIC, WIND, Morgan Stanley Research estimates. Note: For net land sales proceeds, we discount gross land sales proceeds by 0.4x as per IVF to account for cost of acquisition, compensation to farmers, and land development costs.

Exhibit 15: On-budget expenditure growth remains subdued



Source: CEIC, Haver, Morgan Stanley Research

Exhibit 16: Ratio of revenue to GDP continues to decline



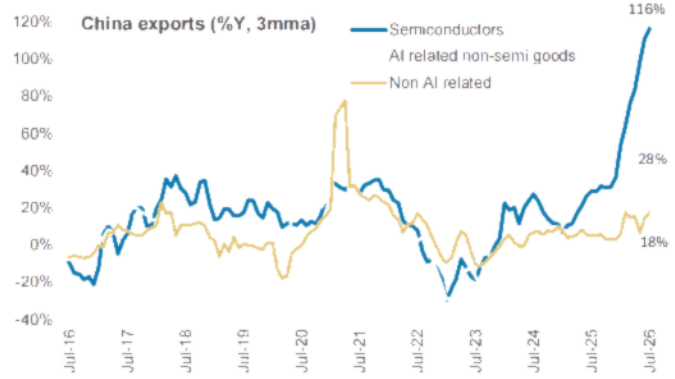
Source: CEIC, WIND, Morgan Stanley Research estimates. Note: For net land sales proceeds, we discount gross land sales proceeds by 0.4x as per IVF to account for cost of acquisition, compensation to farmers, and land development costs.

Strength of Non-tech Exports Is a Positive Offset, but May Not Be Sufficient This Time Around

The composition of exports matters: While headline exports growth have averaged 10.5% since 2025, the composition of that growth presents a more nuanced picture. For much of 2025, technology-related exports accounted for most of the overall increase, but this is also the part of the exports basket which tends to have limited spillover effects across the broader economy. Moreover, price effects also appear to have contributed to the headline export performance, given that overall export volumes had picked up only in the last six months.

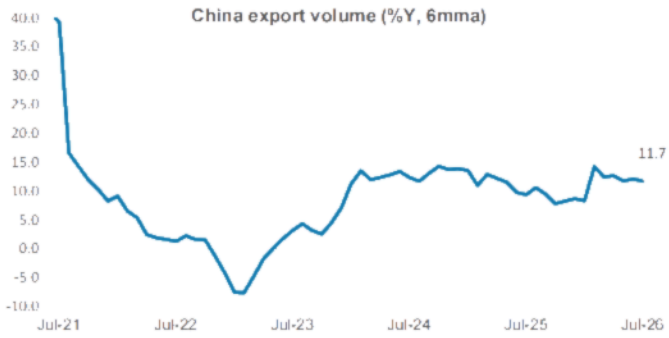
The offset from continued strength in non-tech exports may not be enough: The positive impulse from exports – especially from non-tech, which generates more positive spillovers – is still at an early stage. Indeed, we had thought that the strong exports momentum might help support deleveraging and reflation because it should help lift the profit margins of the non-commodity industrial sector and translate into better wage growth, which then supports consumption. To be sure, we do expect continued strength in exports. But this may not be enough of an offset if households continue to delever at this aggressive pace and if fiscal tightening is maintained.

Exhibit 17: Overall exports have been strong, but the strength has been concentrated in tech goods, which generally have less spillovers to the rest of the economy.



Source: CEIC, Morgan Stanley Research. Note: We identify the AI-related products as semiconductors, computers and storage systems, semiconductor manufacturing/assembly/testing equipment and parts, semiconductor wafers and photomasks, optical fibre components.

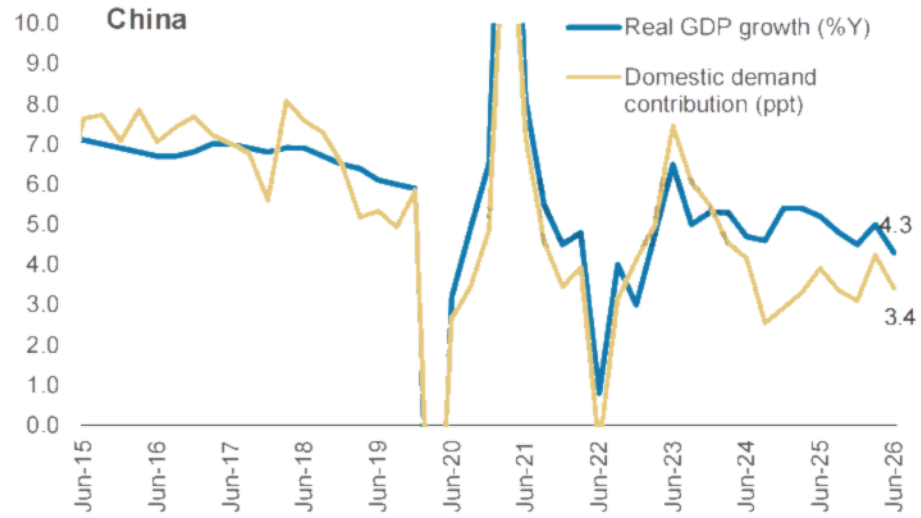
Exhibit 18: Price effects had boosted exports initially, but volume growth has picked up this year



Source: CEIC, Morgan Stanley Research

Exhibit 19:

Domestic demand has contributed less to headline GDP growth



Source: CEIC Morgan Stanley Research