China Economic Perspectives

The path to policy easing ahead

Economics

China

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Unlikely to be another September 2024

Current economic conditions share several similarities with September 2024, but important differences remain. Exports are stronger, GDP deflator has turned positive, industrial profits and fiscal revenue are more resilient. Equity market also has come a long way since 2024, and US-China relations are more stable. We therefore do not expect an abrupt policy pivot like September 2024 as a baseline. Instead, we believe easing is likely to proceed in stages, with implementation the immediate priority.

A de facto fiscal tightening in 2Q 2026

A mild fiscal expansion in 1Q turned into a tightening bias in 2Q. We estimate that the broad fiscal stance tightened by 0.4% of GDP in 2Q 2026 relative to a year earlier. Despite strong fiscal revenue growth, spending lagged and land sales remained deeply depressed. We believe this slower pace of fiscal spending reflects more cautious government behaviour in 2Q amid greater emphasis on limiting excessive borrowing and over investment. Together with the continued property downturn and subdued household consumption demand, this tightening was an important drag on 2Q growth. We think there is a material risk that growth could fall short of the lower bound of the 4.5-5% GDP target if the growth momentum since 2Q sustains.

More support is coming through; investment over household consumption

Following a tightening bias since 2Q, we expect the government to deliver the remaining planned broad fiscal expansion in the rest of the year, equivalent to 0.7% of GDP (relative to H225). Faster fiscal disbursement and policy bank financing tools should support infrastructure, AI-related investment and industrial production. Consumption support is likely to remain relatively mild, while a LPR or RRR cut would be a positive surprise. We think an additional fiscal package is probable, but any expansion beyond the existing budget will likely be data-dependent and come later in the year. We expect some September data to improve. Growth recovery is expected to continue in 4Q as policy support feeds through.

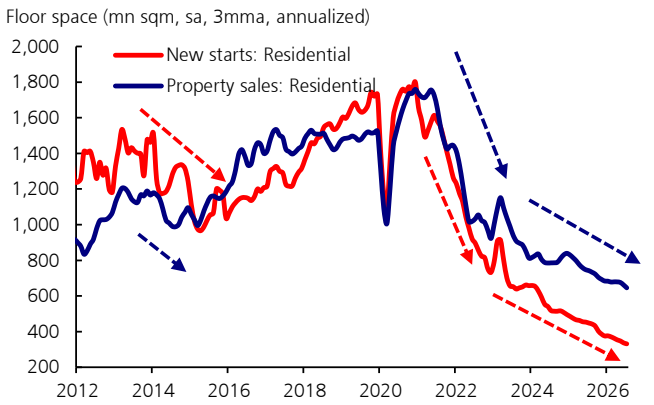
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It's not exactly September 2024

Policy has been behind the curve. July activity data were weak (see here), while high-frequency indicators point to little improvement in August (see here). If the soft momentum persists through the rest of the year, we think there is a material risk that growth could fall short of the lower bound of the 4.5-5% GDP target. The policy tone has turned more supportive since the July Politburo meeting (see here), with recent state media commentary reinforcing the shift (see here). Yet, aside from property easing in some tier-1 cities, concrete measures remain unclear. Investors are increasingly wondering whether China is approaching another policy pivot like the one in September 2024.

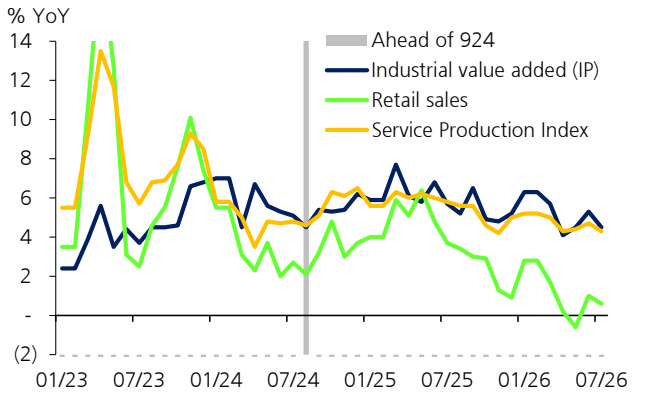
The similarities are clear. The property downturn has yet to run its course, despite early signs of price stabilization in top tier cities. Retail sales were weak then but weaker now, and headline FAI fell into outright YoY contraction since 2H2025. Industrial production growth was slowing visibly both now and then. CPI inflation was struggling to stay positive in 2024 and dipped below 1% YoY in July-August 2026. Youth unemployment rate is hovering above 2024 levels. GDP growth was even weaker in 2Q26, at 4.3% YoY and 3.6% QoQ SAAR (UBSe), than in 2Q24, when growth was 4.7% YoY and 4.1% QoQ SAAR.

Figure 1: Property downturn has not bottomed yet



Source: CEIC, UBS estimates

Figure 2: IP was slowing notably both now and then; retail sales were weak then and weaker now

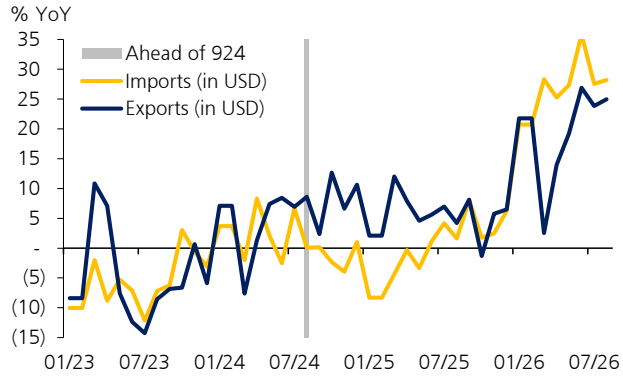


Source: CEIC, UBS estimates

There are, however, important distinctions that may help explain the less decisive policy response. Both exports and imports have rebounded strongly in 2026, supported by the AI cycle and higher prices (see more). Although real export growth has been more modest than 2024 and net exports' contribution to GDP has been broadly similar to 1H 2024, policymakers tend to pay a lot of attention to nominal readings (i.e. 25% YoY in August 2026).

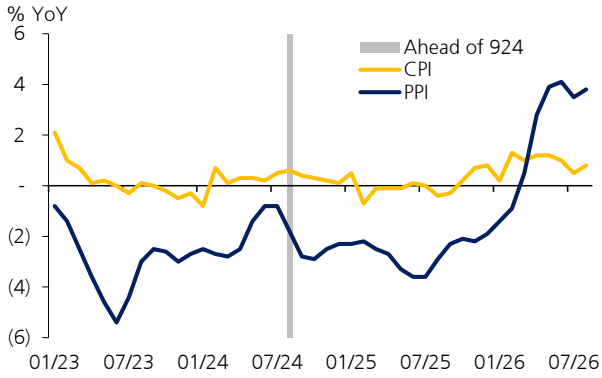
GDP deflator has turned positive YoY and both PPI and CPI picked up in August 2026. This has supported the YTD rebound in **industrial profits** and **fiscal revenue**. The latter is particularly important, as stronger revenue helps finance relatively rigid government spending commitments.

Figure 3: Nominal export growth is much stronger than in 2024



Source: CEIC, UBS estimates

Figure 4: PPI has emerged out of deflation; CPI remains below 1%



Source: CEIC, UBS estimates

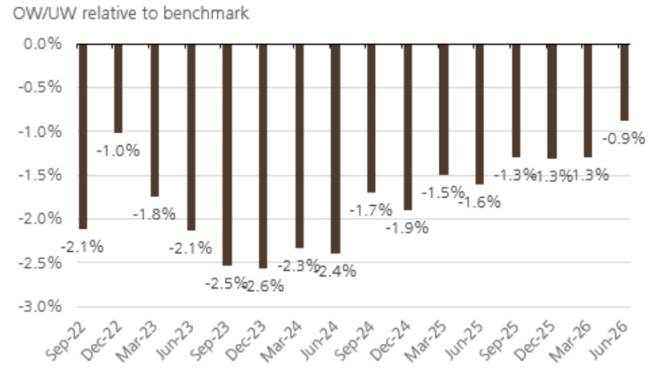
In addition, although the **equity market** has corrected in recent months, the rally since 2024 and the "DeepSeek moment" in 2025 helped rebuild investor confidence. Foreign institutional investors' positioning in Chinese equities improved to -0.9% underweight in 2Q26, from -2.6% at end-2023 (see here). The government also has shown a clearer inclination to support the equity market.

Figure 5: Top 40 global investors' positioning in Chinese equities dropped in 2026 due to stronger performances in other regions



Source: FactSet, UBS

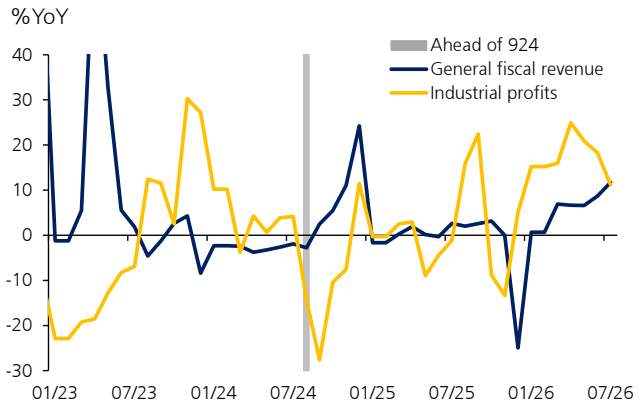
Figure 6: Meanwhile, in relative terms, foreign funds are much less underweight in China now compared to late 2023



Source: FactSet, UBS. Note: data based on c.800 funds that disclose their stockholdings and benchmarks up to 2Q26

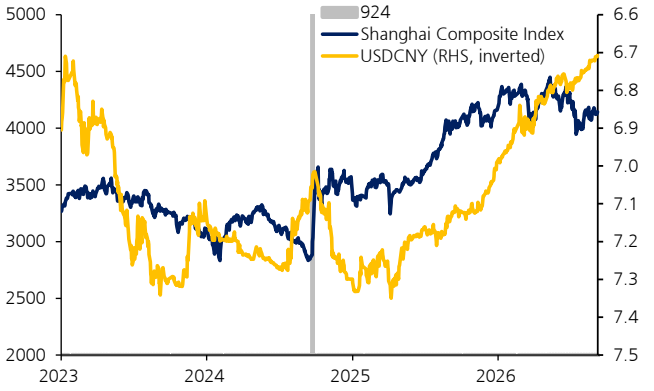
The external backdrop is also more benign. US-China relations have entered a period of broad stability following the Madrid talks in September 2025 and President Trump's visit in May (see here), and President Xi is scheduled to visit the US later this month (see here). By contrast, ahead of the September 2024 policy pivot, then-candidate Trump was threatening more sanctions including 60% tariffs on Chinese imports, which intensified the pressure on supply chains' reallocation out of China. Partly reflecting reduced external risks, **USDCNY** has strengthened against the dollar since May 2025.

Figure 7: A solid 18% YoY YTD increase in industrial profits and 6% YoY fiscal revenue growth (vs 0.5%/-3% YoY in Jan-Aug 2024)



Source: CEIC, UBS estimates

Figure 8: Equity market and USDCNY have come a long way since September 2024



Source: CEIC, UBS estimates

Overall, we think strong growth in nominal variables, lack of obvious near-term deflation threats, solid fiscal revenue, recovery in A-share market and a relatively stable external environment may have reduced the perceived need for aggressive pro-growth policies.

We therefore do not expect a binary or abrupt policy pivot as a baseline. Instead, we believe policy easing is likely to unfold in stages. The July Politburo meeting marked the first stage by signalling a more supportive tone. We have likely now entered a second stage, with stronger signals and faster implementation, focusing on spending existing fiscal funds that should have been spent in 2Q. A further round of support could follow later in the year with additional new measures. At the core of the easing cycle is fiscal policy.

A de facto fiscal tightening in 2Q

Strong fiscal revenue, weak spending. Buoyant capital markets, higher inflation and stronger tax collection re-enforcement has supported fiscal revenue in 2026. General fiscal budget revenue rose 5.8% YoY in Jan-Jul, a sharp improvement from -3% YoY in Jan-Aug 2024. Growth accelerated to 7.3% YoY in 2Q 26 from 2.4% in 1Q.

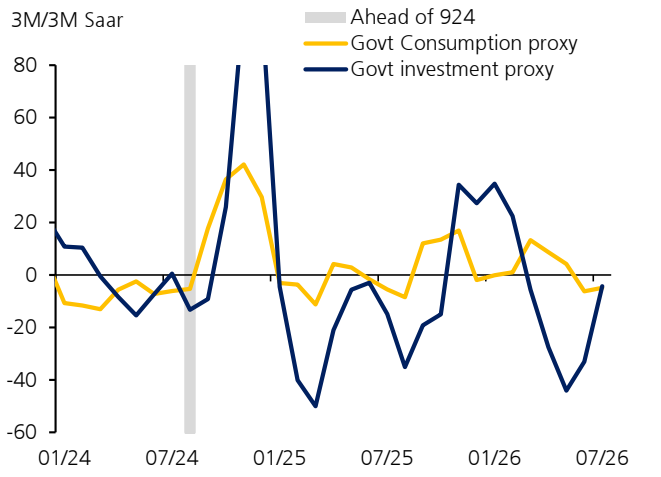
Strong industrial profit growth and higher prices lifted VAT receipts. Individual income tax revenue rose 15% YoY YTD and securities transaction stamp-duty revenue nearly doubled. The two are interlinked - much of the former came from capital income. In addition, according to the Ministry of Finance, enhanced tax-compliance efforts also generated RMB34bn in back-tax payments and late-payment surcharges in 1H26 (equivalent to 0.3% of fiscal revenue in 1H).

Fiscal expenditure failed to keep pace. Despite the rebound in revenue, general fiscal budget expenditure increased by only 1.3% YoY in Jan-Jul, with growth of 2.6% YoY in 1Q slowing to 0.2% YoY in 2Q. Investment-related fiscal spending contracted notably sequentially in 2Q, as did most consumption-related categories. We believe the slow pace primarily reflects a change in public sector behaviour, amid greater emphasis on avoiding excessive borrowing and over investment. As a result, stronger revenue did not translate into a corresponding increase in fiscal demand.

Land revenue remains in deep decline. Local government land sale revenue fell 31% YoY in Jan-Jul 2026. Under the new presale model, the UBS property team expects developers to require higher margins to compensate for lower project IRRs, potentially increasing the risk of failed land auctions (see here). Land sales are therefore likely to remain deeply depressed through the rest of 2026, with weakness potentially extending into 2027. That said, local governments have flexibility in implementation (see here), hence the actual policy outcomes are subject to uncertainty.

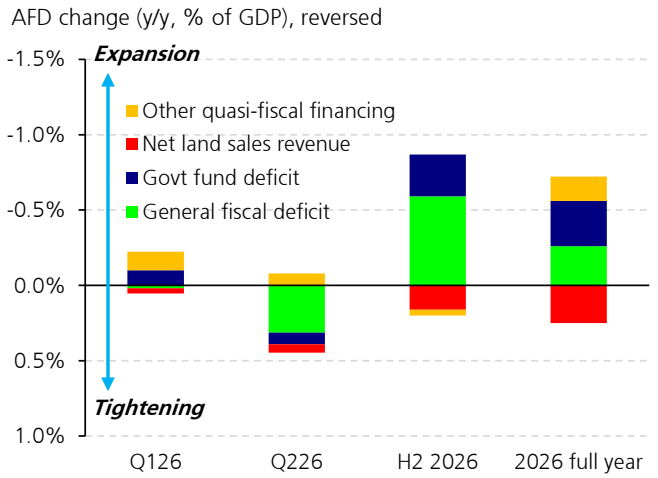
We estimate that China's broad fiscal stance tightened by 0.4% of GDP in 2Q relative to a year earlier, including both on-budget and off-budget activity. Relative to 1Q25, fiscal policy was mildly expansionary in 1Q26 by ~0.2% of GDP, when the government prioritized a strong start to the year and spending expanded sequentially. In 2Q, however, fiscal revenue improved but spending declined sequentially, and land sales slid into deeper contraction. The resulting narrowing of the broad fiscal deficit amounted to a de facto fiscal tightening of 0.4% of GDP relative to a year earlier. Together with the continued property downturn and subdued household demand, this tightening was an important drag on 2Q growth. If government consumption were flat sequentially, 2Q GDP would have been 4.5-4.6% YoY instead of 4.3%.

Figure 9: Government spending contracted sequentially in 2Q



Source: CEIC, UBS estimates

Figure 10: A mild fiscal expansion in 1Q turned to a tightening bias in 2Q



Source: CEIC, UBS estimates

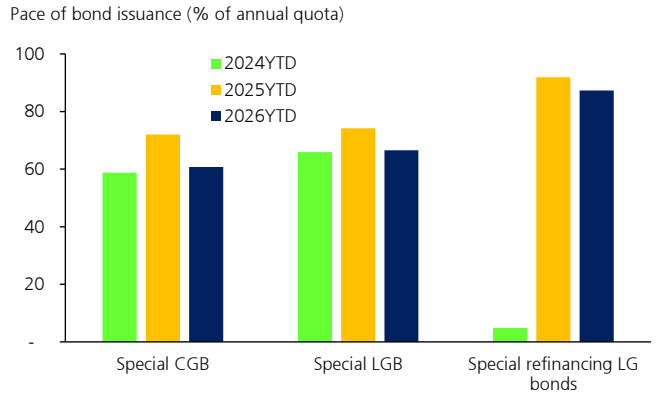
More policy support on the way

The fiscal stance is expected to turn more supportive. At the March NPC, the government set a supportive policy tone and planned a broad fiscal expansion of around 0.5% of GDP. Following the tightening in 1H, we expect the remaining expansion to be delivered in 2H26, equivalent to ~0.7% of GDP relative to 2H25. By end-August, issuance of special central and local government bonds was at 61% and 67% of their full-year targets, respectively, both lagging last year's pace. This leaves around RMB1.8trn in proceeds from planned special central and local government bond issuance, excluding RMB300bn earmarked for capital injections, to support spending. **Faster bond issuance is not a prerequisite for faster fiscal spending:** the Treasury already holds ample cash that can be deployed, and we expect spending to accelerate in the coming months. In addition, an RMB800bn policy-financing facility was launched in September, up from RMB500bn in 2025, to provide equity capital for local projects.

Actual policy support will likely favour investment over household consumption. Faster disbursement of fiscal funds should provide near-term support to infrastructure and related manufacturing. We expect FAI growth to improve somewhat through the rest of the year. While China's FAI data remain among the least reliable of its major activity indicators, the relative performance across sectors is still informative. Sectors that have outperformed YTD are likely to continue outperforming, particularly the "six-network" infrastructure sectors (modernized power grid, computing power network, next-generation communications network, water network, urban underground utility network, and logistics network); the AI supply chain; and major projects under the 15th Five-Year Plan (see Figure 13). Investment in intellectual-property, an intangible component of FAI, rose 9.1% YoY in Jan-Jul and accounted for 15% of total FAI, which likely benefited from the AI drive. **Policy-supported and intangible investment may continue to outgrow traditional construction activity.**

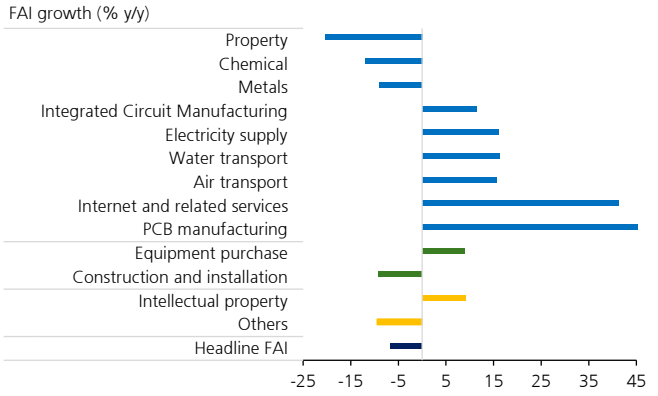
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Figure 11: RMB 1.8trn in special CGB and special LGB to be issued and deployed in Sep-Dec (excluding special CGB for capital injection)



Source: CEIC, UBS estimates. Data till end August

Figure 12: FAI in intellectual property, equipment purchase, and sectors related to six-networks/AI supply chain may outperform



Source: CEIC, UBS estimates

On consumption, the government has recognized the diminishing returns from consumer-goods subsidies, as parts of the durable-goods market have become saturated. The policy focus is instead shifting towards service consumption by easing administrative restrictions and increasing supply. We think this is directionally appropriate, but the near-term growth impact is likely to be limited without a meaningful boost to household income. Household income gains from the AI supply chain remain narrowly concentrated and the equity-market wealth effect is skewed towards higher-income households with a relatively low marginal propensity to consume.

A LPR or RRR cut would be an upside surprise. Our baseline does not assume a cut in either the PBoC's LPR or the reserve requirement ratio (RRR). The Ministry of Finance has provided interest subsidies for SMEs, private enterprises, service-sector businesses and consumer loans, effectively reducing borrowing costs for targeted borrowers. We nevertheless expect the PBoC to maintain ample liquidity through other instruments and keep interbank rates relatively low. The deployment of policy financing tools can leverage additional bank lending. As such, TSF growth may recover modestly from 7.4% YoY in July.

Any incremental fiscal expansion beyond the existing budget will likely be data-dependent and come later in the year. Ministry of Finance officials have confirmed that they will "roll out practical and effective incremental policy measures" in the rest of the year, including new policy measures to enhance fiscal-financial coordination (see here), but the timing and scale will depend on economic conditions. We believe additional support is more likely after the current pipeline of bonds has been issued and the proceeds substantially disbursed. Potential incremental funding channels include additional quota for policy-bank financing tools (off-budget) or additional special CGB (on-budget). We think the proceeds could be used to extend the existing interest-subsidy programs to more sectors or increase the subsidy rate and scale. This would lower effective financing costs without requiring a broad policy-rate cut.

The trigger for incremental fiscal expansion could be a clearer risk of missing the annual growth target, renewed disinflation pressures (for CPI), a loss of momentum in fiscal revenue, and/or a sharper equity-market correction.

Growth should improve sequentially in the rest of the year, but the recovery will remain uneven. We expect growth momentum to improve in September as policy support filters through. The impact should be most visible in infrastructure investment, related manufacturing and industrial production, which are likely to receive the bulk of the support. Consumption may recover more slowly in the absence of stronger household-income support. We expect a more visible rebound in 4Q as the government steps up implementation to secure the full-year growth target.

Figure 13: Area and sectors listed in the 15th FYP, with the six-networks at core

Policy Support Area	Key Beneficiary Sectors
Industrial Capability and Competitiveness Enhancement	Advanced materials, core components and parts, basic software and industrial software, industrial machine tools, high-end instruments and meters, major technical equipment
Emerging Industries	Integrated circuits, embodied AI, biomanufacturing, next-generation batteries, commercial aerospace, domestic large aircraft, low-altitude equipment, green hydrogen, brain-computer interfaces (BCI), high-end medical devices
Integrated Transportation Network	High-speed railways, conventional railway network, highway network, coastal ports, inland high-grade waterways, modern airport system
New Energy System	Major hydropower projects and integrated hydro-wind-solar bases, desert/Gobi renewable energy bases, offshore wind power, coastal nuclear power, power transmission corridors, interregional power balancing projects, natural gas pipeline network
Modern Water Network Development	Flood prevention and disaster mitigation, major water diversion projects, water supply and irrigation systems
New Infrastructure Development	National integrated computing network, satellite internet, information and communication networks, data infrastructure, low-altitude infrastructure
Frontier Technology Breakthroughs	Artificial intelligence, quantum technologies, controllable nuclear fusion, life sciences and biotechnology, brain science and brain-inspired research, major disease prevention and innovative drug development, deep-sea/deep-earth/polar exploration, deep-space exploration
Innovation Capacity Enhancement	National laboratory system, major scientific infrastructure, regional innovation systems, scientific research support platforms
AI Plus Initiative	AI-enabled scientific research, industrial development, consumption upgrading, public welfare, governance modernization and international cooperation
Opening-up Platforms	Hainan Free Trade Port, Pilot Free Trade Zones, border cooperation platforms, border ports, China-Europe Railway Express hubs
Agricultural and Rural Modernization	High-standard farmland, modern seed industry, animal and plant disease prevention and control, agricultural non-point source pollution treatment, rural living condition upgrades
Urban Renewal and Metropolitan Clusters	Underground utility network renovation, livability improvement, redevelopment of old residential/industrial districts, enhancement of metropolitan commuting efficiency

Source: 15th Five Year Plan, UBS

Valuation Method and Risk Statement

N/A