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Three challenges

China enters 2026 weighed down by three major challenges: a prolonged property correction, a lack of local fiscal support, and persistently weak consumer sentiment.

While new home sales appear to have bottomed, household expectations for further price declines remain elevated, increasing the risk of an overcorrection without stronger policy intervention. At the same time, local governments' top priority to address implicit debt is creating a notable drag by diverting fiscal resources away from spending and investment. The expiration of earlier trade-in subsidies has also exposed the fragility of consumer sentiment, weakened by negative wealth effects and a soft job market.

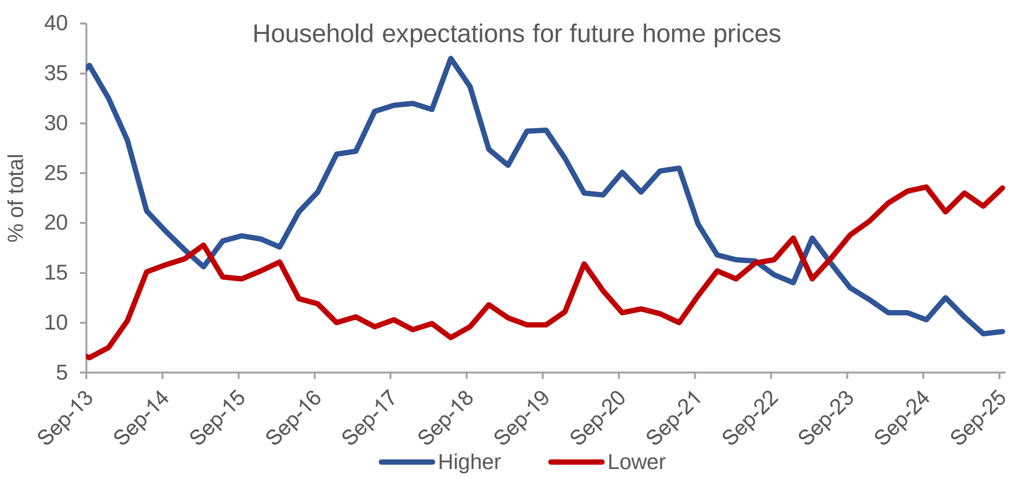
Together, these pressures point to a subdued domestic demand environment this year. Although Beijing faces growing pressure to shore up domestic demand, it is unlikely to tackle all three challenges simultaneously. Policy support is expected to build gradually, beginning with measures aimed at stabilizing the property sector. As a result, we project GDP growth to moderate to 4.6% in 2026, with momentum remaining weak in the first half before seeing modest improvement later in the year.

This soft macro backdrop is likely to temper optimism around the renminbi and introduce periods of volatility in the coming months, barring a sharper deterioration in global markets. Further PBoC easing, including policy rate and RRR cuts, is anticipated in both Q1 and Q2, pushing front-end CGB yields lower, while long-end yields should remain capped with PBoC's CGB purchases from the secondary market.

THE THREE CHALLENGES

Excessive property correction. The correction in China's property market appears to have hit the bottom. New home sales reached 733 million sqm in 2025, less than half of the sales recorded in 2021. This latest level broadly aligns with the estimated annual demand of around 700 million sqm, assuming a 50-year linear depreciation of the existing housing stock. However, PBoC surveys indicate that household expectations for further price declines remain at record highs (Fig 1), raising the risk of excessive market correction in the absence of stronger policy support.

Fig 1 Household expectations for further home price declines at record highs



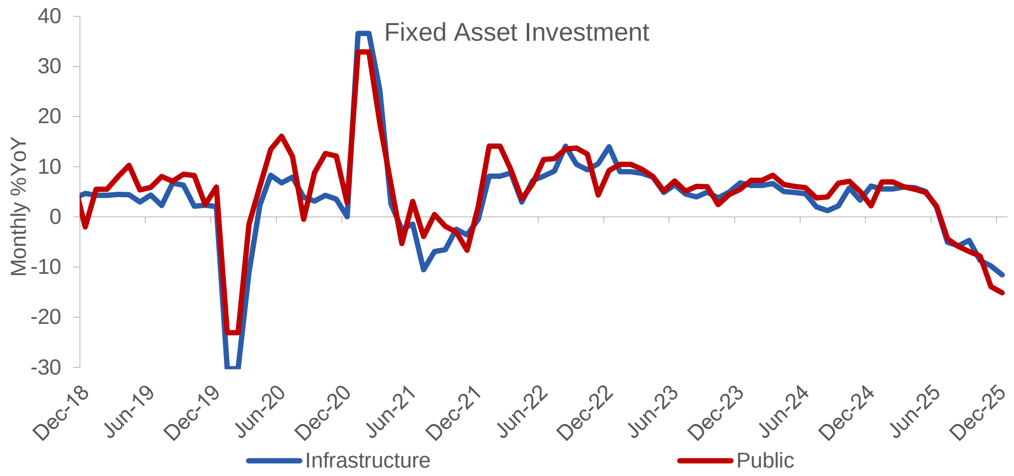
Source: Wind, Mizuho

On the first day of 2026, an article published in *Qiushi*, the official theoretical journal of the Chinese Communist Party, called for more forceful government action to stabilize the property sector, citing its large economic footprint and its implications for consumption, investment, employment, and financial stability. We believe this signals a clear policy pivot at the start of 2026. Authorities are probably mulling over a series of supportive measures to prevent an overcorrection in the property market and to avert a broader economic downturn.

Local deleveraging. Local governments are expected to prioritize resolving their implicit debt in 2026, even though the official deadline for cleaning up local government financing vehicles (LGFVs) is by mid-2027. The Ministry of Finance's creation of a new Debt Management Bureau in November underscores the high priority Beijing places on this task. Given local government's key role in driving China's growth, this deleveraging focus is likely to notably weigh on the 2026 outlook.

In fact, this deleveraging push has already led to the sharp slowdown in public fixed asset investment (FAI) in the second half of 2025. Public FAI fell 2.5% for the full year, marking its first annual decline on record, with the steepest monthly drop seen in December (Fig 2). This contrasts sharply with continued robust local government bond issuance over the same period.

Fig 2 The decline in public FAI became increasingly steeper in 2H25



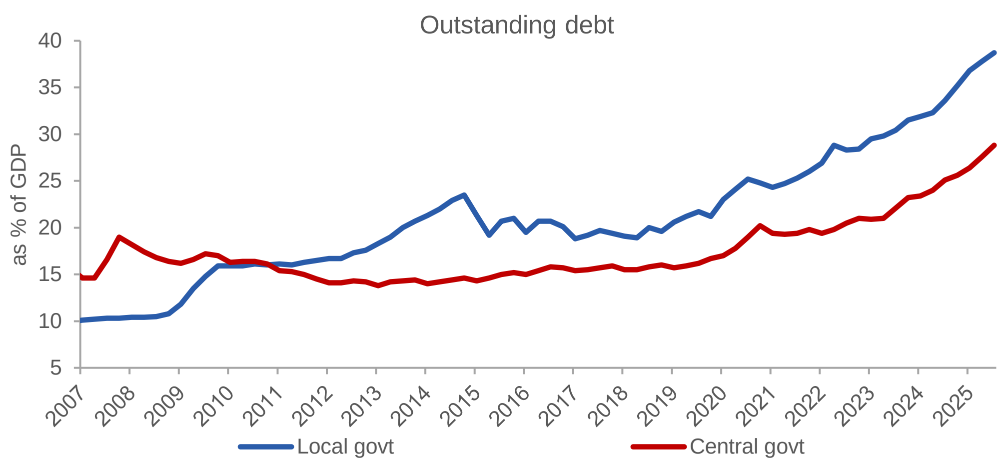
Source: CEIC, Mizuho

While local governments will receive another RMB 2.8 trillion in 2026 to repay hidden debt, as part of Beijing's "10 trillion" solution, the amount is likely far from sufficient. Market estimates of total LGFV debt typically range from RMB 30 to 50 trillion, though part of this may be operational rather than implicit debt. Despite official reports that local governments had exited roughly 60% of their LGFVs by end-June, the remaining portion will be more challenging to address, as the "low-hanging fruit" has already been collected after over a year of debt cleanup.

More fundamentally, the goal of achieving zero implicit local government debt may be structurally unattainable. Local governments' reliance on land sales and LGFVs stems from a persistent mismatch between their revenue sources and expenditure responsibilities. In this context, eliminating LGFVs without broader fiscal reforms is unrealistic.

Ultimately, resolving LGFV debt hinges on deeper fiscal reform, including expanding stable revenue channels for local governments and reallocating more spending responsibilities to the central government. Notably, the central government's leverage increase over the past two decades has been much milder compared to local governments (Fig 3), suggesting room for increasing fiscal support at the central level.

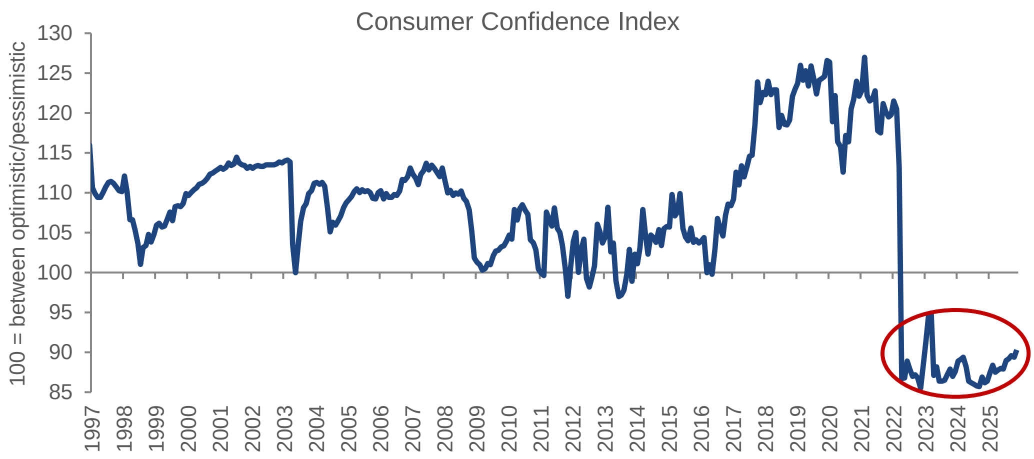
Fig 3 The buildup in central government debt is much milder compared to that of local governments



Source: Wind, Mizuho

Subdued consumer sentiment. China's consumer sentiment index published by the PBoC has remained roughly 10% below the neutral level of 100 since 2022 (Fig 4). Weakness in property prices and a soft employment outlook are the two main drags. With property accounting for about 60% of urban household assets, the decline of over 30% in home prices since the late-2021 peak suggests significant negative wealth effects for households.

Fig 4 Consumer sentiment has been notably below the neutral level for almost three years



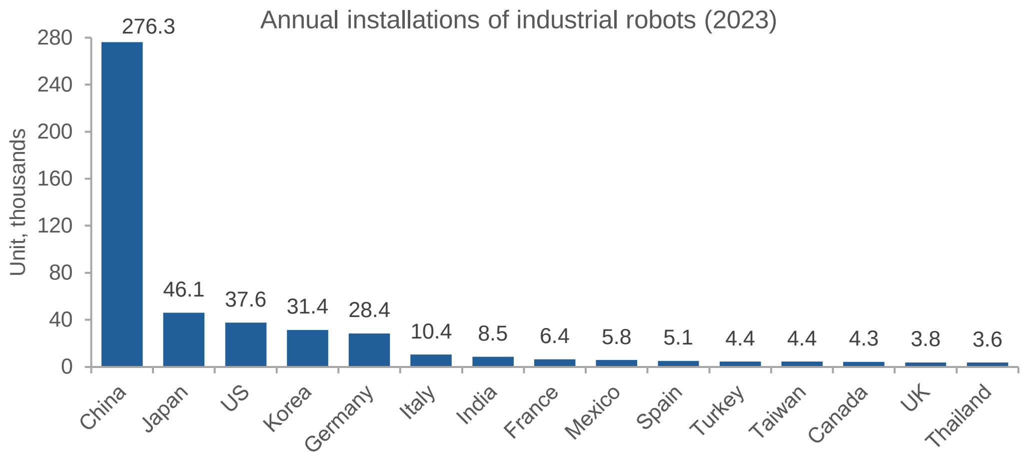
Source: CEIC, Mizuho

To support spending, the government introduced trade-in subsidies in late 2024 for selected durable goods such as home appliances and mobile phones. These measures boosted retail sales and pushed up prices in the subsidized categories. For example, home appliance prices rose 5.9% YoY in December, compared with a 3.3% decline at the end of 2024, and YoY price changes for communication equipment remained positive for most of 2025.

However, these policies created a high base for 2026 and were inherently unsustainable. As subsidies were exhausted across most provinces, retail sales of home appliances and furniture fell 18.7% and 2.2% YoY in December, in stark contrast to the ~40% growth seen in 2Q25. Without a substantial increase in government support, retail sales growth is likely to slow markedly in 2026.

Moreover, China's rapid advances in high-tech industries may further pressure labor demand. The adoption of "dark factories", which are highly automated facilities capable of operating 24/7 with minimal or no human intervention, had made significant progress. According to the International Federation of Robotics, China's industrial robot density increased nearly sevenfold between 2015 and 2023, with annual installations exceeding the rest of world adding together (Fig 5).

Fig 5 China's annual installations of industrial robots exceed other countries by a wide gap



Source: International Federation of Robotics, Mizuho

In fact, the employment sub-index in the NBS Manufacturing PMI has stayed below the expansion threshold of 50 since 2012 (excluding pandemic distortions), indicating weakening demand for manufacturing labor for more than a decade. Moreover, "jobless growth" is likely to become increasingly evident as AI and humanoid robotics achieve more breakthroughs in the near future.

BASELINE FORECASTS

Our assumptions. While Beijing will likely maintain the growth target of "around 5%" for 2026, it is unlikely to tackle all three challenges simultaneously, especially as policymakers have shown greater tolerance for slower growth. Policy support is expected to build gradually over the year, beginning with measures aimed at stabilizing the property sector.

Local fiscal spending and investment will likely remain constrained during implementation through mid-2026, as local governments prioritize resolving hidden debt risks over stimulus. Finally, we do not expect any meaningful improvement in consumer sentiment in the foreseeable future.

Our forecasts. Based on these assumptions, China's growth momentum is set to remain relatively soft in the first half of 2026. A meaningful shift in local fiscal conditions is unlikely before the late-July Politburo meeting, implying that the growth outlook may deteriorate further before policymakers decide to take further actions.

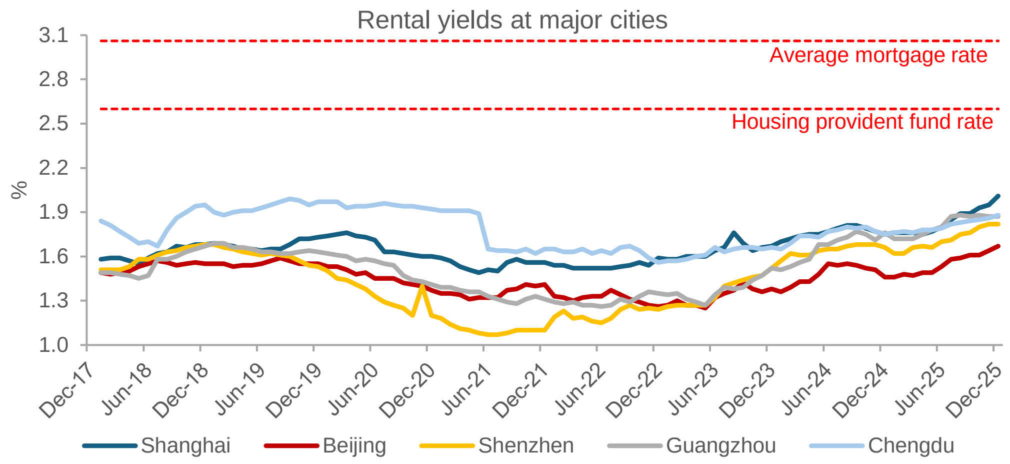
We forecast full-year GDP growth to slow to 4.6% in 2026, down from 5.0% in 2025. Within the year, growth is expected to pick up from 4.5% YoY in the first half to 4.8% in the second half. We anticipate only two rate cuts in 2026, with 10bp each in the first and second quarters, amid squeezed bank interest margins.

POTENTIAL POLICY SUPPORT

Even with the current cap on China–US trade tension, resistance from non-US trading partners is increasing. This trend could weaken the growth-supporting role of China's trade sector in 2026. In last December's Central Economic Work Conference, Beijing emphasized the need to "better coordinate domestic economic management with international trade frictions." Soon after, China decided to scrap export tax rebates for solar products and batteries in phrases. In our view, these moves highlight the urgency for China to boost its domestic demand to meet the full-year growth target.

For property weakness. Lower mortgage interest rates will be essential to stabilizing property demand. China's average mortgage rate is currently standing at 3.06%, significantly higher than rental yields in major cities (Fig 6) and the 3-year deposit rate of 1.3% at major national banks. Even the national housing provident fund, which is intended to provide employee with limited amount of lower-cost financing for home purchases, offers loans at an interest rate of 2.6%. Without appreciation in property value, buying a home has become far less attractive than renting these days.

Fig 6 Rental yields remained below 2% in major Chinese cities despite the drop in home prices



Source: Wind, Mizuho

If policymakers are concerned that broad-based rate cuts could compress bank margins and heighten systemic financial risks, a targeted cut in the housing provident fund rate could be a more balanced option. Additional option could be the government directly subsidizing households on mortgage interest payments.

Moreover, Beijing could encourage local governments to launch renovation programs for aging residential complexes, funded by low-cost loans from policy banks. Many urban homes built before 2000 are outdated and no longer meet modern living standards. Such projects would not improve residents' quality of life but also raise the resale value of these properties, making it easier for households to upgrade.

The article in *Qiushi* also calls for expanding targeted property supply to address China's structural housing imbalances. While overall housing demand has peaked, given negative population growth since 2022 and relatively ample per-capita living space, shortages persist in key segments. These include affordable housing for young people and new urban residents, as well as high-quality units for households looking to upgrade.

For local deleveraging. The deleveraging campaign was initiated through a notice issued by Beijing. Therefore, it can always be suspended or altered later in theory. However, doing so would come at a cost. As the old Chinese saying goes, "morale is highest at the first attempt, weakens at the second, and is exhausted by the third". A delay or abortion of the task would make it harder for Beijing to enforce fiscal discipline the next time around, adding to potential fiscal burden over the medium to long-term. It may also weaken central authority by signaling that short-term economic pressure can easily force a retreat.

For these reasons, we believe a reversal of the local deleveraging initiative is unlikely unless the economy flashes a series of clear and severe warning signs. The Politburo meeting expected at the end of July will likely be the first key opportunity for Beijing to reassess the pace and direction of this policy.

For subdued consumer sentiment. As noted earlier, slashed property prices and a sluggish labor outlook remain the two key factors weighing on consumer sentiment. Without meaningful improvement on either front, a broad-based recovery in household confidence this year will be difficult to achieve.

While the stock market rally, with the Shanghai Composite Index up 18.4% in 2025, may offer some support to household sentiment, it is far from sufficient to offset the negative wealth effects from declining property prices. Surveys in recent years show that real estate and equities account for roughly 60–70% and 10–15% of household assets, respectively, underscoring the dominant role of housing in the balance sheet of Chinese households.

FX AND RATE IMPLICATIONS

FX. While we remain constructive on the renminbi's full-year outlook, near-term resistance or pressure is expected. The three structural challenges, unlikely to be resolved soon, are expected to weigh on growth momentum in the coming months. This softer macro backdrop is likely to temper the optimism currently priced into renminbi-linked assets and introduce periods of volatility in both CNH and CNY.

We expect renminbi appreciation to pause, with CNH trading in a relatively tight range around 6.95 throughout the first half of the year. Nonetheless, we forecast a modest rebound later, with CNH ending 2026 roughly 2% stronger at 6.85 per dollar. That said, a worse deterioration in offshore markets amid heightened geopolitical tensions may contribute to greater renminbi strength. Either way, the PBoC will stick to its familiar playbook: discouraging one-way bets and smoothing excessive currency strength or weakness when necessary.

Rates. Deflationary pressures are also expected to persist in China this year amid the three challenges. We anticipate broad-based PBoC easing in Q1 and Q2, which should drive front-end China government bond (CGB) yields lower, especially in the 1-year tenor. In contrast, long-end and ultra-long-end yields are likely to remain contained near current levels, as the PBoC closely monitors upward moves and stands ready to increase CGB purchases from the secondary market if required.

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