

China's Next Phase

Yuan's Necessary Internal Devaluation

China is entering the next stage of a prolonged balance-sheet adjustment. The challenge is no longer simply weak economic growth, a troubled property market and indebted local governments. It is the interaction between **a large stock of debt, insufficient liquidity and persistent deflationary pressures**.

This report makes three key arguments:

First, Chinese liquidity matters globally—but through different channels from US liquidity. Federal Reserve liquidity has its strongest influence on financial markets, particularly equities, credit and overall portfolio beta. People's Bank of China (PBoC) liquidity appears to exert a disproportionate influence on the real economy: commodities, energy, gold and world industrial activity. For investors, monitoring the PBoC is therefore at least as important as monitoring the Fed when assessing the outlook for hard assets and the world business cycle.

Second, currently the Chinese and US liquidity cycles are substantially out of phase. When US liquidity is contracting, China has lately been expanding, and vice versa. Because developed financial markets remain closely tied to the US liquidity cycle, this creates an important portfolio distinction: **use US equities to manage beta and use China to seek alpha**. A renewed Chinese liquidity upswing could generate a reflationary impulse largely independent of the US cycle, benefiting commodities and gold first and, ultimately, Chinese risk assets.

Third, China increasingly displays the characteristics of debt deflation. Weak nominal growth, falling prices, depressed property values, low bond yields and strained private-sector balance sheets all increase the real burden of outstanding debt. This leads to a controversial but important conclusion: **China's real exchange rate is too high**. Adjustment can occur either through lower domestic prices and wages or through a weaker nominal Yuan. Since domestic deflation would intensify the debt problem, China has a strong economic incentive to pursue monetary expansion and tolerate—or engineer—a weaker domestic currency, even if that conflicts with external pressure for Yuan appreciation.

The scale of the required adjustment is significant but not unprecedented. China's debt-to-liquidity ratio (the key metric) is currently around **1.0x**, roughly one-third above its estimated long-run equilibrium of approximately **0.75x**. Holding the debt stock constant, restoring the historical relationship would require Chinese liquidity to increase by roughly one-third. For comparison, Japan required a larger increase of around 60% to return its debt-to-liquidity ratio towards historical norms.

The PBoC has already begun this process. Liquidity expanded substantially from early 2022 and is now roughly twice its 2019 level, representing an increase equivalent to approximately US\$3 trillion. The pace has recently become less consistent, but the underlying policy requirement has not disappeared.

The key question, therefore, is shifting from **whether China will create more liquidity to how much, how quickly and through which channels.**

A gradual expansion would support a measured recovery in domestic activity and commodity demand. A more aggressive monetary response could generate a much stronger global reflationary impulse, with potentially significant consequences for gold, industrial commodities, energy and eventually Chinese equities.

China's next phase will consequently be determined less by conventional interest-rate policy than by the **quantity, composition and velocity of PBoC liquidity creation.**

The investment conclusion is simple: use US equities to manage portfolio beta and use Chinese stocks for alpha.

Main Points

- **China faces a debt–liquidity adjustment.** With its debt-to-liquidity ratio roughly one-third above its historical norm, China likely requires a meaningful expansion in liquidity to ease refinancing pressures, counter debt deflation and stabilise property and private-sector balance sheets
- **The PBoC has already started—but more may be required.** Liquidity expanded significantly from early 2022, although injections have recently become less consistent. The question is increasingly not whether China will provide additional liquidity, but **how much, how quickly and through which channels**
- **Chinese liquidity has different global consequences from US liquidity.** Fed liquidity primarily influences financial assets and portfolio beta, whereas PBoC liquidity appears to exert a disproportionate influence on commodities, gold, oil and global economic activity
- **China increasingly exhibits the characteristics of debt deflation.** Weak nominal growth, falling prices, depressed property values and indebted balance sheets threaten to become self-reinforcing as deflation raises the real value of outstanding debt
- **The real Yuan appears overvalued.** China ultimately faces a choice between downward adjustment in domestic prices and wages or depreciation of the nominal exchange rate. Because deeper domestic deflation would aggravate the debt burden, monetary expansion accompanied by some form of 'internal' currency adjustment looks increasingly likely
- **The investment implication is “US for beta, China for alpha.”** Because the Chinese and US liquidity cycles are substantially out of phase, stronger Chinese liquidity could provide an independent reflationary impulse benefiting gold, commodities, global economic activity and, eventually, Chinese risk assets

The Debt–Liquidity Constraint

Credit-based economies carrying large debt burdens cannot easily tolerate widespread debt defaults. In practice, there are two broad ways to reduce an excessive debt burden.

The first is to **grow out of it**: nominal incomes, profits and asset values rise sufficiently rapidly that the existing stock of debt becomes progressively less onerous.

The second is to **inflate out of it**: create sufficient new money and liquidity to reduce the real value of existing liabilities while increasing the balance-sheet capacity available to refinance them.

The difficulty arises from a fundamental tension between the **weak flow of economic activity; the large stock of outstanding debt and the geopolitical fall-out from letting the nominal Yuan fall**

In a conventional economic slowdown, falling prices can help restore equilibrium by encouraging demand and reallocating resources. In a heavily indebted economy, however, falling prices are destabilising. Debt contracts are largely fixed in nominal terms. When incomes, prices and asset values decline but debt does not, the real burden of those liabilities rises.

Weaker balance sheets suppress investment and consumption, falling asset prices generate negative wealth effects, and borrowers become increasingly reluctant—or unable—to assume additional liabilities. Activity weakens again, placing further downward pressure on prices.

This is the classic mechanism of **debt deflation**.

History offers several examples.

The US experienced an extreme debt deflation during the Great Depression of the early 1930s. After the Second World War, substantial wartime debt burdens were initially reduced through a combination of strong real growth and nominal income expansion. Since the 1970s, however, policymakers facing major debt stresses have increasingly relied on some form of **monetary inflation**.

Japan provides a more recent example. Following the excesses of the 1980s and early 1990s, Japan endured decades of weak growth, falling asset prices and slow balance-sheet repair. Ultimately, policymakers adopted a combination of Abenomics, supply-side measures and aggressive Bank of Japan monetary expansion. The substantial recent depreciation of the Yen is an unmistakable consequence.

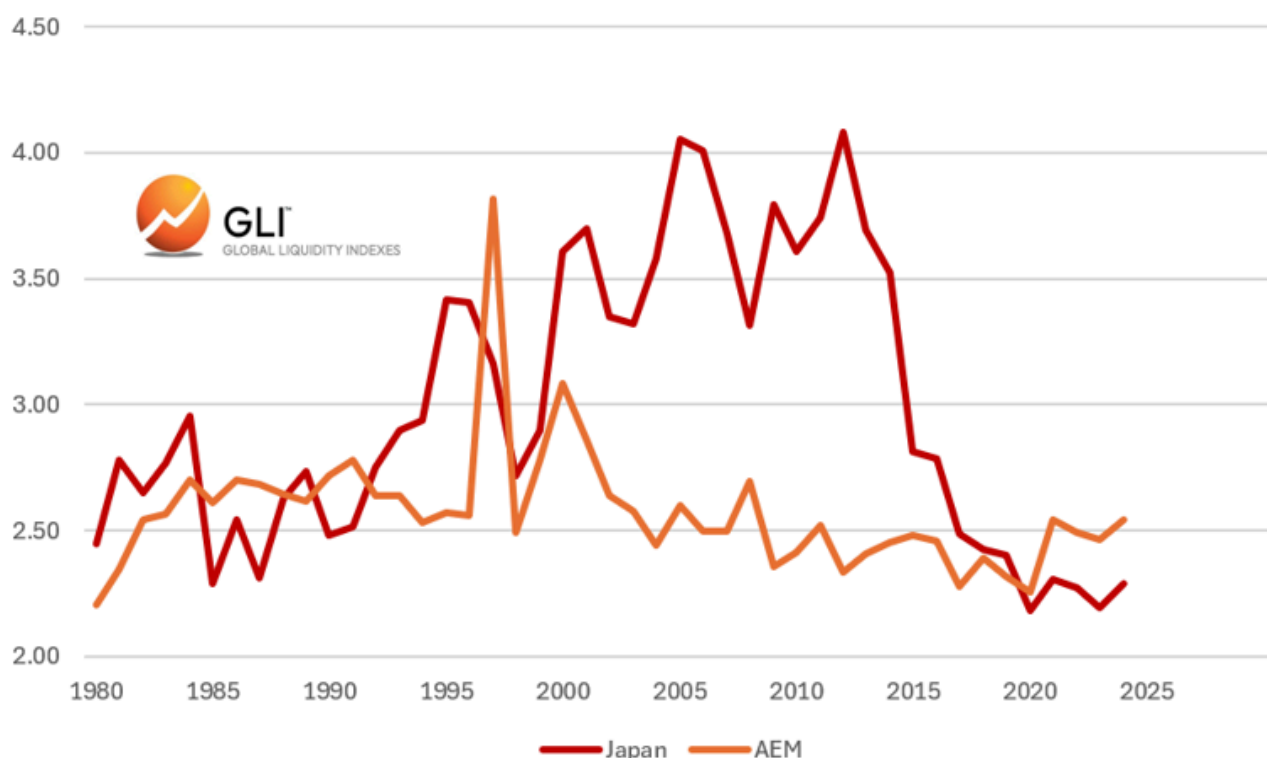
Crucially, this monetary expansion also allowed Japan's **debt-to-liquidity ratio** to fall markedly towards its longer-run norm.

We regard this ratio as a crucial indicator of financial stress.

Debt must ultimately be serviced, refinanced or repaid. Refinancing requires sufficient balance-sheet capacity within the financial system. Put differently, **debt requires liquidity**.

A similar, though far more abrupt and violent, adjustment confronted Emerging Asia during the 1997/98 Asian Financial Crisis. See chart below. Regional exchange rates collapsed, financial conditions tightened dramatically and equity markets fell sharply as the region was forced through a rapid debt and liquidity adjustment.

Debt/ Liquidity Ratios: Asian EM & Japan



China's Debt Problem

China now faces its own version of this problem.

The country's debt accumulation accelerated dramatically following the 2008/09 Global Financial Crisis. An enormous expansion of credit—much of it intermediated through shadow banking and local-government financing structures—supported a correspondingly large wave of property and infrastructure investment.

Japan's investment excesses were once caricatured as building “bridges to nowhere.” China's equivalent has been “homes for no one” – the accumulation of under occupied apartment developments, highly leveraged property companies and infrastructure whose economic returns are often insufficient to justify its financing costs.

The difficulty today is that China has limited scope simply to grow out of the resulting debt burden.

Domestic capital expenditure remains heavily dependent on infrastructure spending, particularly by financially constrained local governments. Household consumption remains structurally weak relative to the size of the economy, while attempts to compensate through manufacturing and export growth are generating increasing international trade tensions.

Nor would it be straightforward to recreate the extraordinary credit boom of 2010–15. Shadow banking played an important role in that expansion, but policymakers subsequently curtailed the sector because of the resulting jump in leverage, speculation and financial instability.

This creates a simple policy constraint:

Excessive debt eventually demands additional liquidity.

Japan initially resisted aggressive monetary expansion. It eventually capitulated.

Emerging Asia was forced into monetary and currency adjustment after 1997.

Our contention is that **China will ultimately have to do the same.**

The puzzle is not the direction of that adjustment, but its scale and timing.

How Much Liquidity Does China Need?

The debt-to-liquidity ratios of Emerging Asia and Japan have historically averaged around **2.5x**, whereas China's current ratio is only around **1.0x**.

At first sight, China therefore looks considerably less vulnerable.

But absolute international comparisons can be misleading. Financial structures, debt maturities, banking systems and refinancing mechanisms differ significantly between countries. What matters more is an economy's position relative to **its own historical equilibrium**.

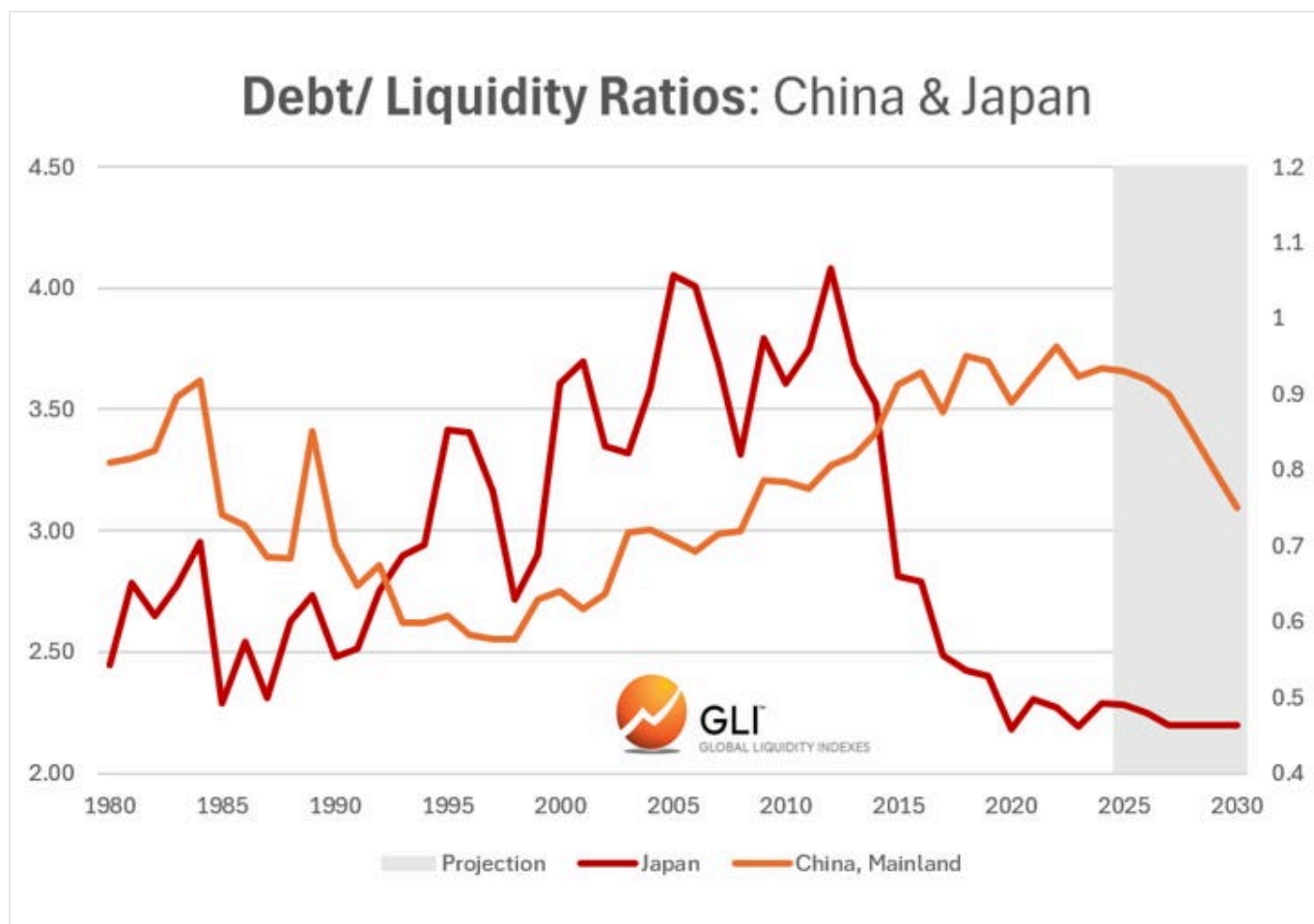
On this basis, China looks considerably more stretched.

China's debt-to-liquidity ratio currently stands at around **1.0x**, compared with a long-run average of approximately **0.75x**—meaning the ratio is roughly one-third above its historical norm.

Mechanically, and assuming an unchanged debt stock, China's liquidity pool would therefore need to increase by around one-third for the ratio to return towards its historical equilibrium.

Japan required a considerably larger adjustment: approximately a **60% net increase in liquidity** to return its debt-to-liquidity ratio towards normal levels.

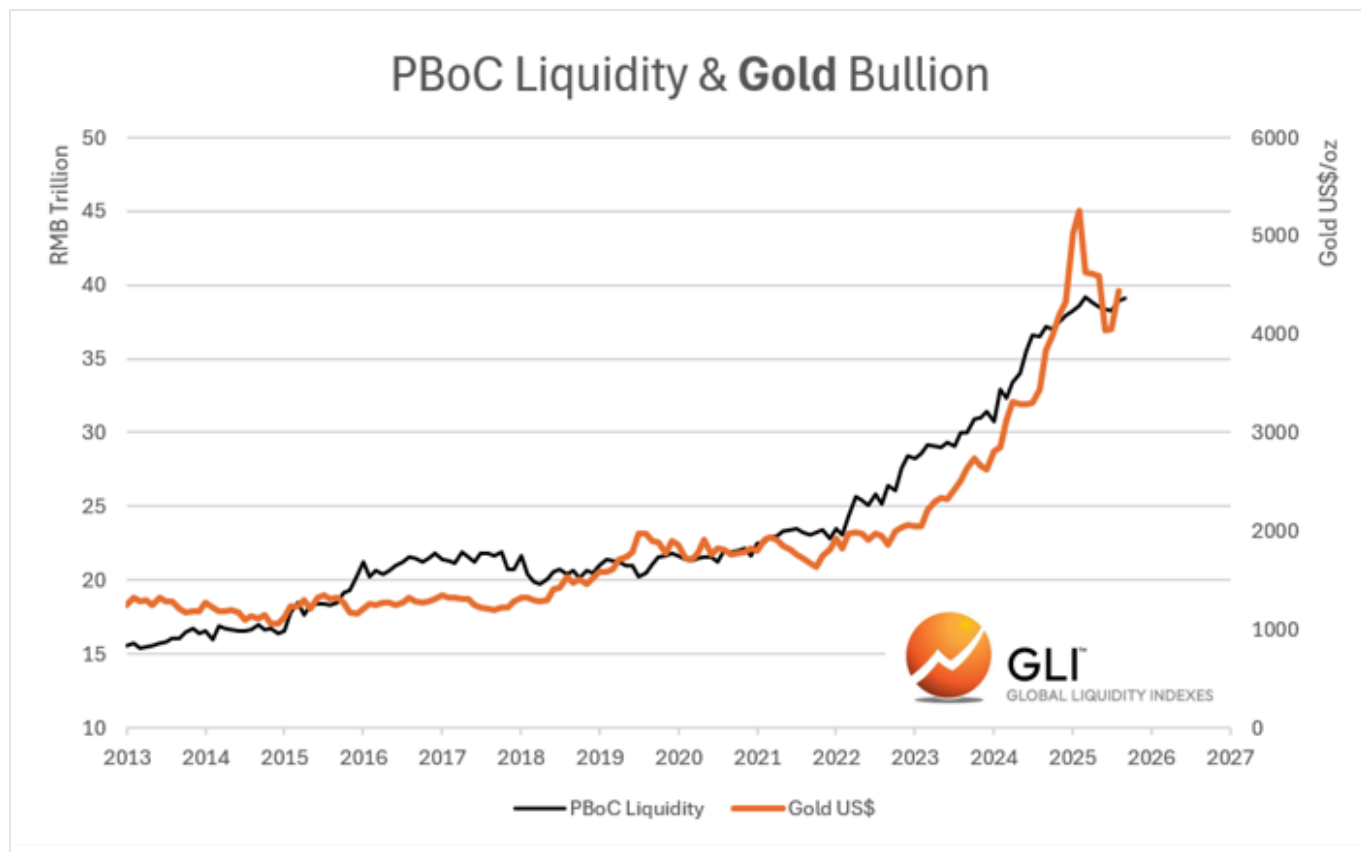
Viewed through this lens, China's required adjustment is substantial, but by no means unprecedented and it seems manageable in relative terms. Consider the next chart, which includes our projections. The challenge is increasingly not *whether* policymakers need to expand liquidity, but **how they choose to do it and over what timeframe**.



The PBoC Has Already Started

In one important respect, China's monetary adjustment is already under way.

PBoC liquidity began expanding materially in early 2022. The stock of central-bank liquidity is now roughly **twice its 2019 level**, representing a cumulative increase equivalent to approximately **US\$3 trillion**.



Significantly, this expansion preceded a major rise in the US-dollar gold price.

That relationship offers an alternative—or at least complementary—causal explanation for gold's strength. Market commentary had previously attributed the move to geopolitical fragmentation, the freezing of Russian foreign-exchange reserves following the invasion of Ukraine, central-bank diversification and concerns over Western monetary debasement.

However, **Chinese liquidity may have been another important driver.** When Chinese creates *monetary inflation* it effectively devalues the paper Yuan against real assets, such as gold, and ultimately this will spill over into higher domestic prices and wages.

This channel also is reinforced by our broader distinction between the international effects of **Fed liquidity and PBoC liquidity.**

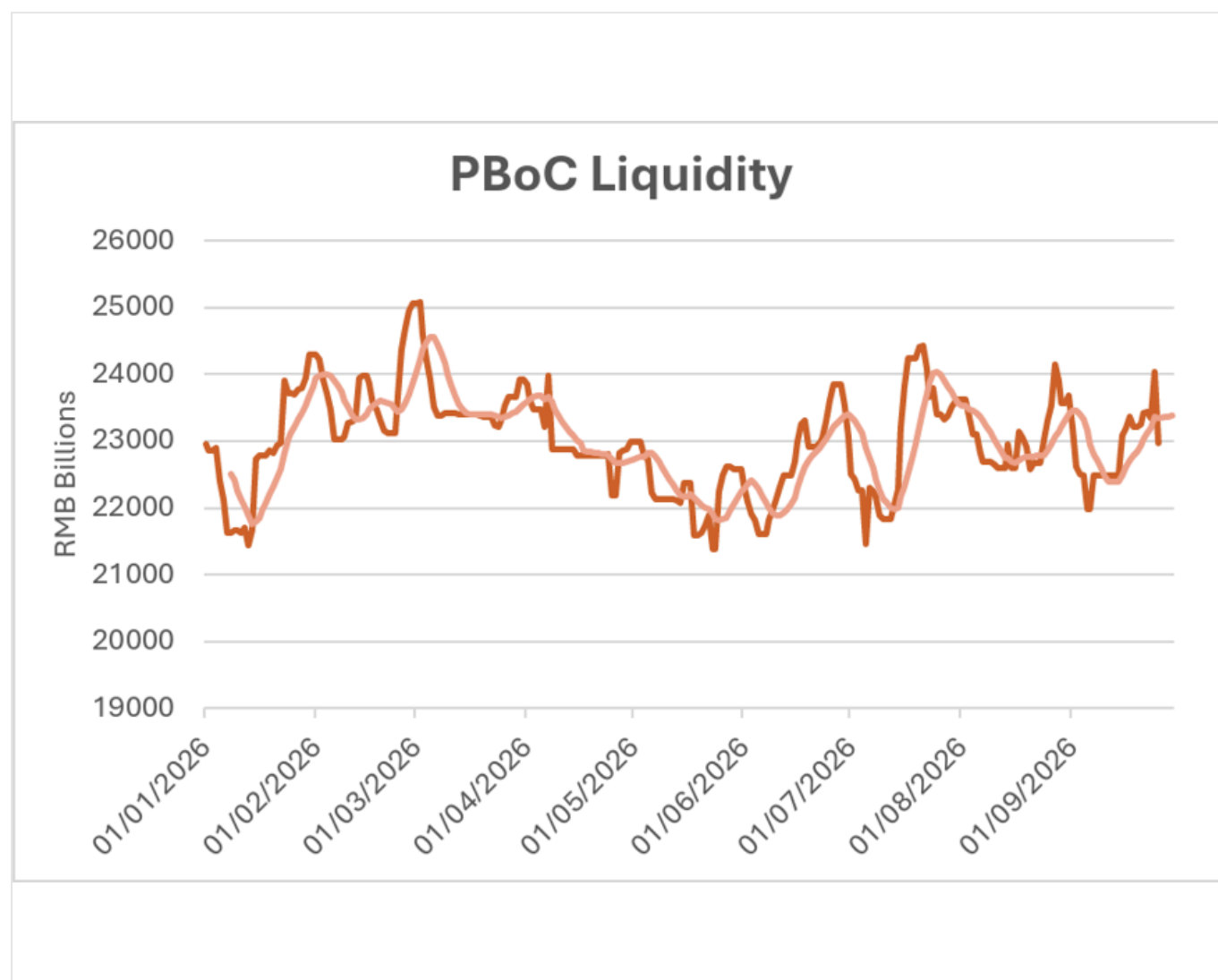
Fed liquidity operates primarily through global financial markets. It influences discount rates, risk appetite, leverage and therefore the pricing of equities, bonds and credit.

Chinese PBoC liquidity will similarly affect domestic asset markets but it also operates directly through the real economy. China's enormous industrial base and its importance as a marginal consumer of raw materials mean that changes in Chinese liquidity can transmit rapidly into **commodity demand, industrial activity, energy markets and other hard assets.**

In short: **the Fed predominantly prices financial risk. The PBoC disproportionately prices real-economy risk.**

A More Complicated Picture in 2026

The picture in 2026 has been less straightforward. Evidence latest daily data on PBoC liquidity in the next chart, alongside a 10-day moving sum.



PBoC liquidity injections stalled following the outbreak of US–Iran tensions in March. They subsequently resumed following the mid-year MOU, but have not yet recovered their previous trajectory, potentially reflecting continuing uncertainty surrounding the Gulf conflict.

One possible interpretation is that the PBoC is deliberately managing domestic liquidity against China's external commodity requirements.

China's importance in global crude oil markets effectively makes it a **swing buyer**. If domestic liquidity influences China's ability or willingness to accumulate commodities, PBoC policy can indirectly affect global energy demand and, ultimately, oil prices.

The interaction between **Chinese liquidity, gold, commodity purchases and global energy prices** therefore deserves close attention.

If our interpretation is correct, it further strengthens the distinction between the international roles of the two major central banks:

- **Fed liquidity predominantly prices global financial risk**
- **PBoC liquidity increasingly influences global commodity and industrial risk**

This distinction has important consequences for portfolio construction.

What Comes Next?

China's current liquidity backdrop can best be described as **supportive rather than aggressively expansionary**. Yet, the future backdrop looks more positive, because Chinese policymakers face all of:

- weak nominal economic growth
- a heavily indebted property sector
- substantial local-government liabilities
- persistent refinancing requirements
- weak private-sector balance sheets
- ongoing deflationary pressure

Official Chinese GDP growth has been running at around 5%, but a range of market indicators paints a distinctly weaker picture. Falling prices, depressed real-estate markets, exceptionally low bond yields and continued dependence on State-directed spending are more consistent with an economy experiencing *debt deflation*. This means that **weak prices increase the real burden of debt, which weakens balance sheets and activity, placing additional downward pressure on prices.**

Bond yields offer another useful lens. Across other economies, long-term sovereign yields tend over time to bear a close relationship to nominal GDP growth. Using this benchmark, China's extremely low bond yields suggest much weaker underlying nominal GDP growth than the reported headline figures might suggest, implying low **1-2% real annual growth**.

This, in turn, raises an important exchange-rate issue.

China's Real Exchange Rate Problem

If the debt burden raises Chinese domestic costs by too much relative to the economy's underlying rate of productivity growth, the **real exchange rate** is forced to adjust downwards.

This can occur in two ways:

- Chinese domestic prices and wages fall
- the nominal Yuan falls

For a highly indebted economy, falling wages and prices increase the real value of outstanding nominal debts. This option would therefore **risk reinforcing precisely the debt-deflation mechanism** policymakers need to escape.

This leaves nominal currency depreciation as the less economically destructive adjustment mechanism. But that solution creates a different problem.

A materially weaker Yuan could make Chinese manufactured goods still more competitive internationally, increase China's trade surplus and amplify already significant trade tensions with other economies.

China therefore **cannot tolerate deeper domestic deflation, and she likely seeks to avoid a materially weaker external Yuan to prevent international outcry.**

The ideal solution is stronger domestic liquidity that boosts domestic prices and wages (implicitly devaluing debts), but does not affect the external value of the Yuan.

One possibly solution is to use the policy tools China already possesses—including capital controls, compliant State-controlled banks and her substantial foreign-exchange resources—to maintain a greater degree of separation between domestic monetary conditions and the external value of the currency.

In effect, the authorities may seek to achieve some characteristics of a **dual exchange-rate regime**: a domestically oriented Yuan shaped by the requirements of internal liquidity and an externally managed Yuan constrained by international trade and financial considerations.

This would not necessarily require the formal introduction of two currencies. Instead, existing controls and administrative mechanisms could create an increasingly significant wedge between domestic monetary conditions and those implied by a freely convertible exchange rate.

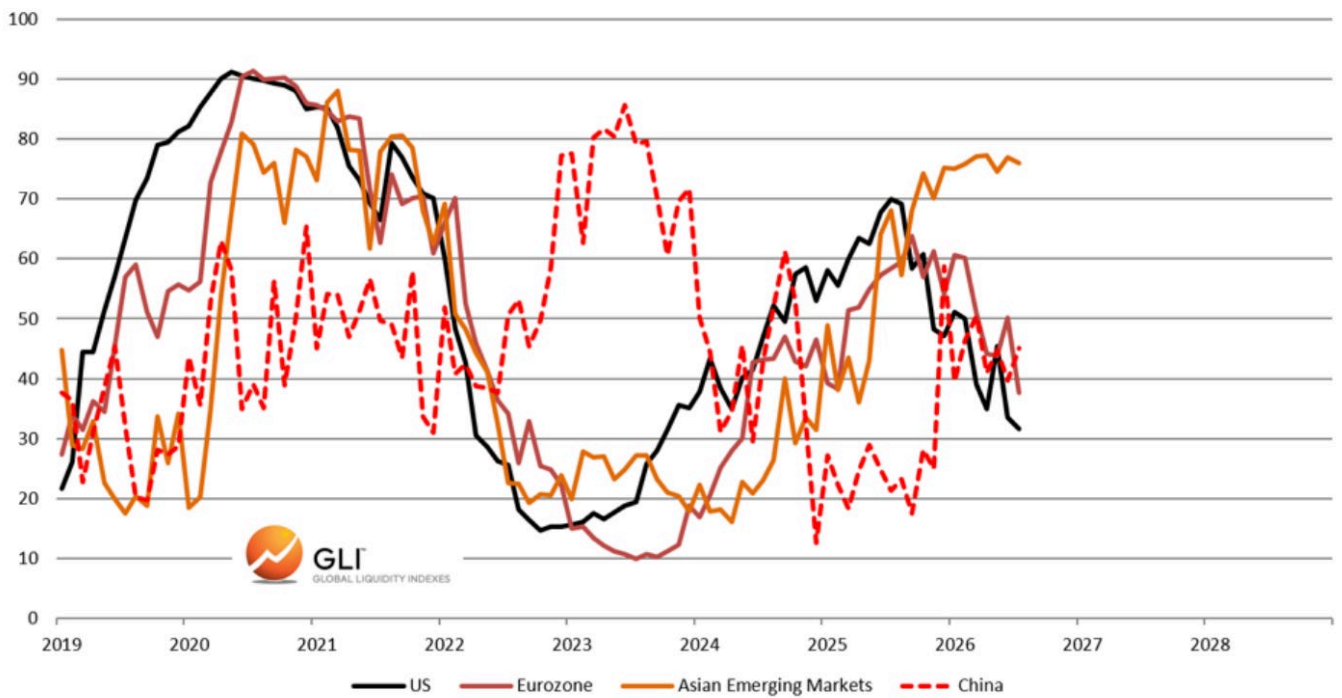
Hence, if economic growth cannot reduce China's debt burden sufficiently quickly, then adjustment must increasingly occur through the denominator of the debt-to-liquidity ratio. In short, **liquidity must rise.**

The scale and timing will determine not only China's economic trajectory but potentially the next phase of the global commodity cycle.

Investment Implications: US Beta, Chinese Alpha

The final piece of the argument is the striking divergence between Chinese and US liquidity cycles. The two economies increasingly appear to operate **out of phase.**

Regional Liquidity Cycles



This matters because much of the developed-market financial system remains highly sensitive to US monetary and liquidity conditions. US liquidity therefore remains the dominant determinant of broad financial-market beta.

China offers something different. If Chinese liquidity accelerates while the US liquidity cycle weakens—or simply follows a different trajectory—the resulting economic and market impulses need not be highly correlated.

That creates opportunities for portfolio diversification. Consider two cases:

#1 A gradual Chinese liquidity expansion

A controlled increase in PBoC liquidity would likely favour:

- gradual stabilisation in domestic economic activity
- improving property and private-sector balance sheets
- moderately stronger industrial demand
- stronger commodity consumption
- an eventual improvement in Chinese risk assets

#2 A forceful Chinese liquidity expansion

A much larger monetary response could generate a considerably more powerful reflationary impulse, with potentially stronger effects on:

- **gold**
- **industrial metals**
- **energy**
- **global manufacturing activity**
- **Chinese equities and other domestic risk assets**

The sequencing matters. Given China's role in global raw-material demand, the first evidence of reflation may appear in **liquidity-sensitive commodities and hard assets before it becomes obvious in headline Chinese economic statistics and equity indices**.

That is why the PBoC deserves to be analysed differently from the Federal Reserve: The Fed remains the dominant monetary institution for pricing global financial assets, but the PBoC increasingly proves the more important central bank for pricing the marginal unit of **world industrial demand**.

Conclusion

China faces a difficult but increasingly unavoidable adjustment.

Its debt burden is too large to be resolved comfortably through economic growth alone. Deflation is making that burden heavier, not lighter. And allowing domestic prices and wages to absorb the full adjustment would risk intensifying the balance-sheet recession policymakers are trying to contain.

The only remaining lever is liquidity. China's debt-to-liquidity ratio suggests that the scale of the required expansion could be significant—potentially around one-third of the existing liquidity pool if China is ultimately to return towards its historical equilibrium.

The PBoC has already started the process. What remains unclear is its **speed, scale and transmission mechanism**. Those uncertainties represent both the risk and the opportunity.

A cautious PBoC response could leave China trapped in a prolonged Japanese-style balance-sheet adjustment. A sufficiently powerful liquidity expansion could instead turn China into an important source of global reflation, with consequences reaching far beyond Chinese equities.

In that scenario, the principal beneficiaries may initially be **gold, commodities, energy and global industrial activity**, before the improvement finally feeds through to Chinese financial assets.

Meanwhile, China's liquidity cycle remains substantially detached from—and often opposed to—the US cycle. For global investors, that leads to a clear portfolio framework:

Manage portfolio beta through US equities Seek extra alpha through Chinese stocks