China Economic Update – February 2025

Are China's bond yields a flashing warning light around the future?

NAB Economics

Summary

In early January 2025, China's benchmark 10 year government bond yield dropped below 1.6%, its lowest rate ever recorded. Recent trends in Chinese bond markets have been in stark contrast with those evident in most advanced economies (AEs) – where, on average, yields have moved close to their highest levels in the post Global Financial Crisis period. In part the divergence in yields highlights the very different economic conditions in these regions following the COVID-19 pandemic – with China's weak domestic demand constraining bank lending and inflation while (at least anecdotally) unemployment has been relatively high. Expectations of further monetary easing in 2025 may explain the current inversion in the short end of the yield curve, however, the flat curve for longer dated maturities may highlight weak confidence around China's longer term prospects.

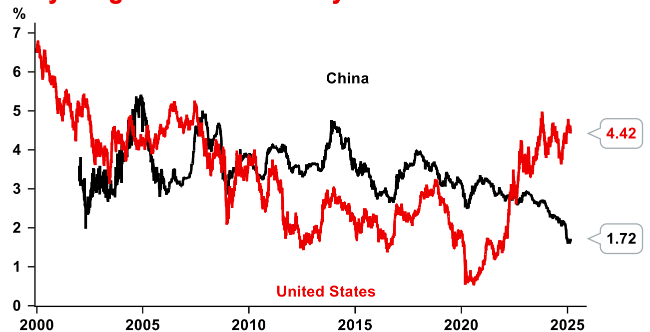
Key points

- China's bond rally has now persisted for over two years, bringing yields on government bonds to record lows. This is in stark contrast with recent trends in advanced economies.
- This rally reflects various imbalances in China's economy that have intensified since the COVID-19 pandemic. Most notably the easing of monetary policy (particularly the expansion of funds available for lending) in an environment of weak loan demand.
- While lower rates present an opportunity to expand fiscal spending at a relatively low cost, this rally also increases the risks within China's financial system – with regulators fearing collapses similar to SVB in the United States in 2023.
- The flattening of the yield curve for longer dated maturities has increased speculation around the risk of "Japanification" – essentially economic performance that echoes that of Japan during its lost decade following the early 1990s downturn, which was marked by persistent low inflation and weak economic growth.

China's two year bond rally defies market regulators

Compared with most major advanced economies – where inflation rose to four decade highs in late 2022 – China's inflation trends have remained subdued in recent years, reflecting weak domestic economic activity in the post-pandemic period. In a large part, this reflects various policy decisions during the pandemic – including the Three Red Lines policy (that burst China's property bubble, leading to a severe downturn in the sector), a lack of financial support for households during the pandemic (which constrained consumption and confidence) and a regulatory crackdown on some private sector firms (particularly in technology, which impacted investment and loan demand).

10 year government bond yields



Source: Macrobond, NAB Economics

In such an environment, it is not surprising to see bond yields at lower rates – all else being equal, bond yields tend to be lower when inflation goes down. However, bond prices can reflect a broad range of market expectations – including shorter-to-longer term expectations around inflation and economic growth prospects – as well as the relative performance of other asset classes.

China's current bond rally commenced in early 2023 but has consisted of a few distinct phases over this period. Taking the 10 year bond as an example, the yield on these bonds was almost 3.0% in mid-January 2023, but trended down to around 2.5% by mid-August, before a subsequent term selloff. The second stage of the rally commenced in late November (starting at 2.7%) through to September 2024 – when yields dropped close to 2.0%.

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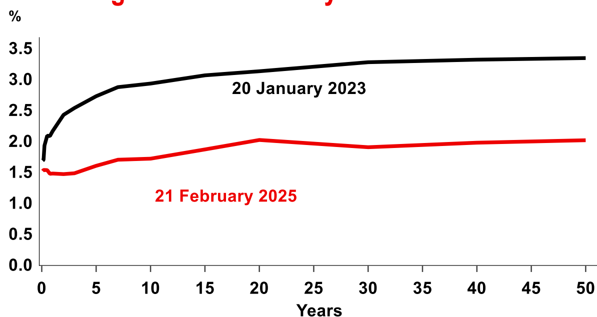
During this second period, the People's Bank of China, along with other financial market regulators, attempted to halt the rally with various methods – including warning financial institutions not to purchase bonds (particularly smaller banks), cancelling individual purchases by some buyers and implementing investigations and regulatory fines – all designed to discourage bond buying. This was combined with direct market intervention – when the PBoC borrowed long dated bonds from banks and sold them into the market in an effort to drive down prices (and push up yields, primarily for longer dated maturities).

However, these efforts were ultimately unsuccessful. The downward trend in bond yields accelerated sharply in late October – from around 2.2% to just under 1.6% in early January – the lowest rate in history (dating back to 2002). Given that Chinese authorities have signalled their intention to further ease monetary policy in 2025 – in an effort to provide additional support for the economy – it is plausible that yields could fall further.

The expectation of monetary easing appears evident in the current shape of China's yield curve. At the time of writing, the yield curve is inverted out to five years, with the yield on the 7 year government bond only marginally higher than the return on a 1 month bond. However, since the start of the bond rally in early 2023, the yield curve has flattened considerably for later dated maturities. At the time of writing (early February), the yield differential for both the 20 year and 50 year government bonds (versus the one month return) were just above 50 basis points, while the differential on the 30 year and 40 year bonds were marginally below 50 basis points.

Chinese government bond yield curve



Source: Macrobond, NAB Economics

Why has there been a rally in Chinese government bonds?

The rally in bond markets is largely a symptom of the various imbalances in China's economy that have intensified since the COVID-19 pandemic. While a broad range of financial institutions – including fund managers and insurance firms – have contributed to the rally, much of the focus has been on commercial banks.

Loan demand in China has been extremely weak in recent times, with household borrowing constrained by the sharp downturn in property purchases – reducing demand for mortgages – and low confidence constraining other consumer lending. Similarly, the property downturn, weak domestic demand and tighter regulation has seen business lending remaining subdued. According to the PBoC's Total Social Financing data, new bank lending contracted by 24.3% in 2024.

In contrast, bank deposits continued to increase in 2024, rising by 6.3% to RMB 309 trillion. As part of the PBoC's monetary easing, the central bank cut the Reserve Requirement Ratio – the share of deposits that commercial banks were required to hold at the PBoC – twice in 2024, reducing the weighted average ratio from 7.4% to 6.6%, increasing the capacity of banks to lend at a time of weaker loan demand.

Given the lack of demand for loans, and poor returns in equity and property markets, banks and other financial institutions have had little other attractive asset options aside from government bonds.

Aren't lower rates a positive?

At face value, the bond rally presents a significant opportunity for China's government, which has already flagged its intention to boost fiscal spending in 2025. While not yet confirmed, it is rumoured that the target budget deficit will rise to 4% of GDP in 2025 (compared with a 3% target in 2025) – which would be worth around RMB 1.6 trillion. The bond rally would allow authorities to fund this spending at a significantly lower interest cost than would have been the case in previous years. That said, the effectiveness of fiscal spending in 2025 will not just be dependent on the size of the package but also where this additional spending is directed (given the existing imbalance between supply and demand).

However, there are also significant risks associated with the bond rally. The PBoC has noted that the yield disparity between Chinese and advanced economy bonds has increased the depreciation pressure on it is currency in recent times (despite the degree to which capital flows in and out of China are still controlled). However its longer term concern is the stability of the financial sector, highlighting the risk of insolvency – similar to that of Silicon Valley Bank in 2023 – should bond prices rapidly correct, something that could occur if capital outflow pressures intensify.

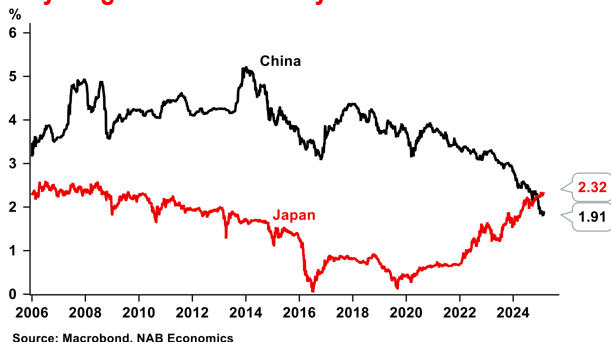
Do longer term bonds point to the risk of "Japanification"?

The comparatively weak performance of China's economy in the post-pandemic period has resulted in frequent commentary regarding the risk of so-called "Japanification" – essentially economic performance that echoes that of Japan during its lost decade following the early 1990s downturn, which was marked by persistent low inflation and weak economic growth. China's economic development via rapid industrialisation is reminiscent of Japan's rise, while the property bubble bursting and population decline are also similar to its decline.

These concerns have been intensified in recent times, with the yield on China's 30 year government bond dropping below that of Japan's in November, with the differential

subsequently widening. It is worth noting that yields on Japanese bond have lifted significantly since late 2021, as efforts to revive inflation have gained momentum.

30 year government bond yields



Source: Macrobond, NAB Economics

China's government bond markets are less developed that those of advanced economies, meaning that it can be more difficult to assess trends and signals from Chinese markets. However, that investors are continuing to purchase longer term bonds at diminishing rates of return does not paint a positive picture of China's longer term prospects and suggests that markets are pricing in a lower growth and lower inflation outlook.

Bond market trends make China's currency aims more difficult to achieve

The bond market is just one of many forces that impact the USD-CNY exchange rate. The PBoC's stated goal regarding the currency is "to maintain the stability of the value of the currency and thereby promote economic growth."

However, as our currency team have regularly highlighted, there is a strong and enduring relationship between the yield spreads between US and Chinese government bonds and the exchange rate. The bond rally has added downward pressure on the value of China's currency, which is now facing the added burden of fresh tariffs (that could be expanded further given Donald Trump's election proposals). These measures are likely to further pressure the currency going forward.

China exchange rate and bond spreads

Source: Macrobond, NAB Economics

Conclusion

We have highlighted for some time the ineffectiveness of monetary policy in China's current economic environment – with the increased quantity of funds (resulting from looser policy) helping to fuel the current bond rally rather than meaningfully support longer term growth. The bond rally provides an opportunity for Chinese authorities to implement comparatively low cost fiscal stimulus – however this stimulus should be focused on demand side measures that can reduce the imbalances that have contributed to China's current economic woes. The flatness of China's yield curve suggests that markets doubt that a major fiscal package is coming, and that China's long term picture may be one of low growth and low inflation persisting.

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