

# China's Financial and Fiscal Decay

February 19, 2026

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China's financial and fiscal systems are increasingly inefficient tools to maintain domestic economic growth, making China's economy far more dependent upon exports in 2026 than in previous years. Policymakers are not addressing this metastasizing decay, particularly within the fiscal system.

As the Chinese New Year holiday ends, attention will turn to the National People's Congress (NPC) and China's domestic policy settings for 2026, including industrial policy and the 15<sup>th</sup> Five-Year Plan, the government budget, and targets for GDP growth. But there is a widening gap between Beijing's targets (and data measuring economic performance) and the actual capacity of China's policymakers to support domestic demand with the tools at their disposal. The best description for the weakness of China's domestic economy at this point is not crisis or collapse but prolonged decay—the declining efficiency and effectiveness of policy tools, producing weaker economic growth as a result.

The roots of this decay can be found in China's fiscal and financial systems. Beijing primarily influences the domestic economy through controls on the direction of domestic credit and government spending. But the overextension of these tools for political purposes over the past two decades has exhausted their effectiveness and capacity to guide China's economy today. The financial system lends rising proportions of a smaller volume of new credit to unproductive local government and state-owned enterprises simply to prevent them from collapsing, while fiscal spending is largely executed via those same indebted institutions. The net result is a declining payoff in terms of investment and economic activity for the same volume of lending or fiscal spending, while private sector investment remains weak. As production outstrips domestic demand, domestic prices fall and surplus output must be sold abroad, widening China's external imbalances.

Compounding those inefficiencies in recent years have been slowing inputs of new credit and fiscal revenues. We have described these problems at length in past notes (Jan 2023, "[The End of China's Magical Credit Machine](#)"; Mar 2025, "[China's Harsh Fiscal Winter](#)"). **As of now, none of these trends are changing.** The health of China's financial system deteriorated further in 2025, while fiscal revenues declined outright, as we predicted in our March note. Decay of China's policy tools will almost certainly continue in 2026—no reforms are underway to repair them.

As a result, China's domestic economy will remain weak this year, and export performance will be far more important for cyclical activity. China will unveil policies to support economic growth—interest rate cuts, special or single-purpose bond issues for fiscal

spending, capital injections for banks—but none of these will provide anything more than a temporary break from previous trendlines toward deflation and economic stagnation.

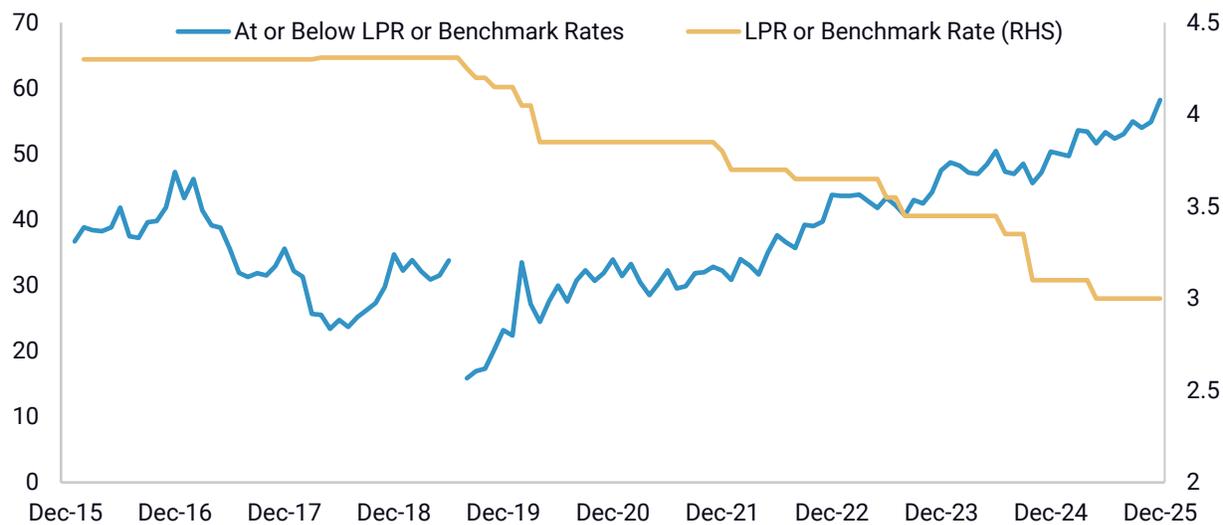
Investors' areas of focus early in 2026 have justifiably redirected to exchange rate policy and the equity market, where shorter-term capital flows can influence outcomes and changing prices. The NPC itself will be interesting given the plans it reveals for China's technological ambitions and expected growth rates of fiscal spending and nominal GDP, but it would take something truly unconventional like a 2009-style stimulus plan to break out of China's current deflationary malaise, and even that effect would be temporary. More significantly, there are no signs Beijing could implement such a stimulus via its financial system even if such a plan were on the cards.

## Doing less with less

Anyone looking at China's just-released credit data for January 2026 may be initially bewildered at the claims in the previous paragraph. After all, Chinese banks just extended 7.2 trillion yuan (\$1.04 trillion) in credit *in a single month* in January, roughly the same as the rise in all US commercial banks' assets for the *full year* in 2025. But astonishingly, the actual volume of lending in January continued declining in year-on-year terms, hitting a record low at 6.1%. From 2007 to 2016, China's banks averaged 18.1% asset growth, and from 2017 to 2024, they averaged 9%, with other measures of credit such as total social financing (TSF) in line with those rates. In 2025 and early 2026, credit growth dipped further, reaching new lows. The banking system is so large, at \$70 trillion in assets at current exchange rates, that double-digit growth rates of credit are nearly unfathomable.

Furthermore, the efficiency of credit in generating investment has declined considerably in recent years. An astonishing 58 percent of loans in December 2025 were made at or below the loan prime rate (LPR) of 3 percent. As Figure 1 shows, this proportion has more than doubled from levels in 2020 and 2021, even as the LPR itself has declined.

FIGURE 1  
Proportion of loans made at or below loan prime rate (LPR) or benchmark rates, 2015 - 2025  
Percent; percent (RHS)

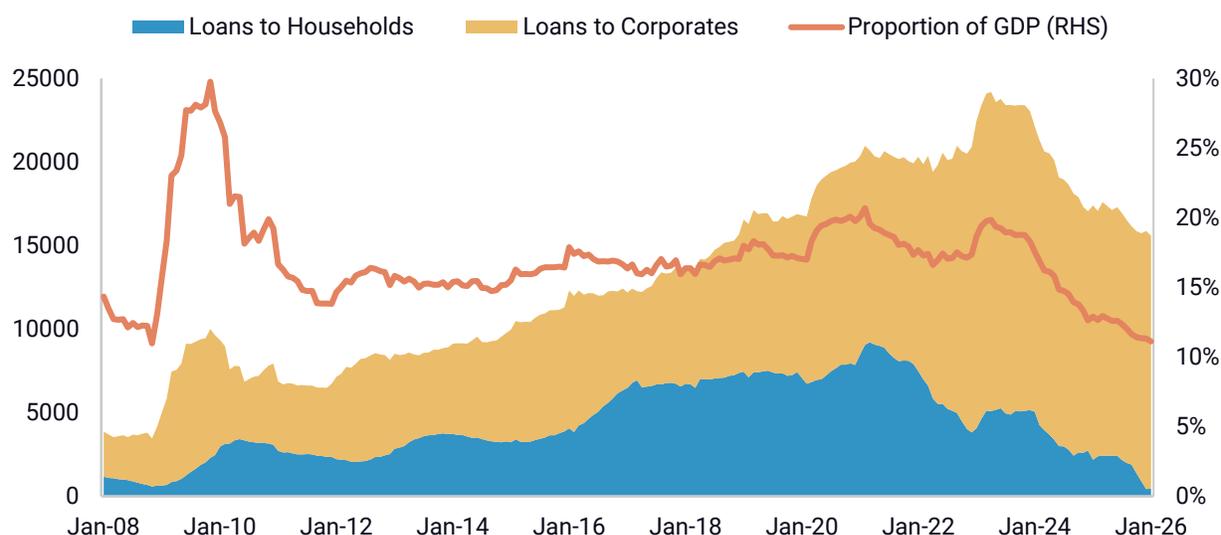


Source: PBOC quarterly Monetary Policy Reports, Bloomberg. The loan prime rate was introduced as the key measure of loan pricing in August 2019; prior to this date, benchmark 1-year lending rates were set administratively by the PBOC.

The straightforward explanation for this trend is that banks are finding fewer clients willing to borrow at interest rates above 3 percent. The more significant change is that this actually reflects a rising proportion of lending to state-owned enterprises (SOEs), and a declining proportion of lending to private enterprises. SOEs can typically pressure banks more effectively to reduce borrowing rates, particularly local SOEs and local government financing vehicles (LGFVs). The rise in the proportion of loans extended at or below the LPR points to the declining efficiency of the banking system in financing productive investments—the data has been consistent for years that state firms are far less efficient than private firms.

In addition, the overall volume of new loans is continuing to decline in absolute terms as well. Total new lending in annualized terms (12m rolling sum) peaked in early 2023 above 24 trillion yuan, and has now dropped by around 8.5 trillion yuan annualized to 15.6 trillion yuan. The drop in overall annual new lending has been around 9 percent of GDP in just the last three years. As Figure 2 shows, lending to households has collapsed, which indicates not only the ongoing property market weakness but the decline in borrowing via private sector sole proprietorships, which are recorded as household lending. New loans to households are rising by only 0.5% y/y in January 2026, an all-time low.

FIGURE 2  
Annualized new RMB loans to households and corporates, Jan 2008 – Jan 2026  
Billion yuan, percent of GDP (RHS)



Source: People's Bank of China.

Naturally, this weakness in lending makes it difficult for banks to earn profits, and therefore boost their capital bases and generate even more loans. Net interest margins for banks have fallen by more than half over the past decade, from around 270 bps in 2014 to a reported level of 142 bps in Q4 2025, according to National Financial Regulatory Administration (NFRA) data. Returns on assets are only 0.6% for the banking system as a whole, and annual profits have not risen since 2023, remaining at 2.38 trillion yuan for the full year in 2025.

The bottom line is that China's commercial banks have been lending to the same borrowers in recent years, but even less efficiently. They are producing less investment

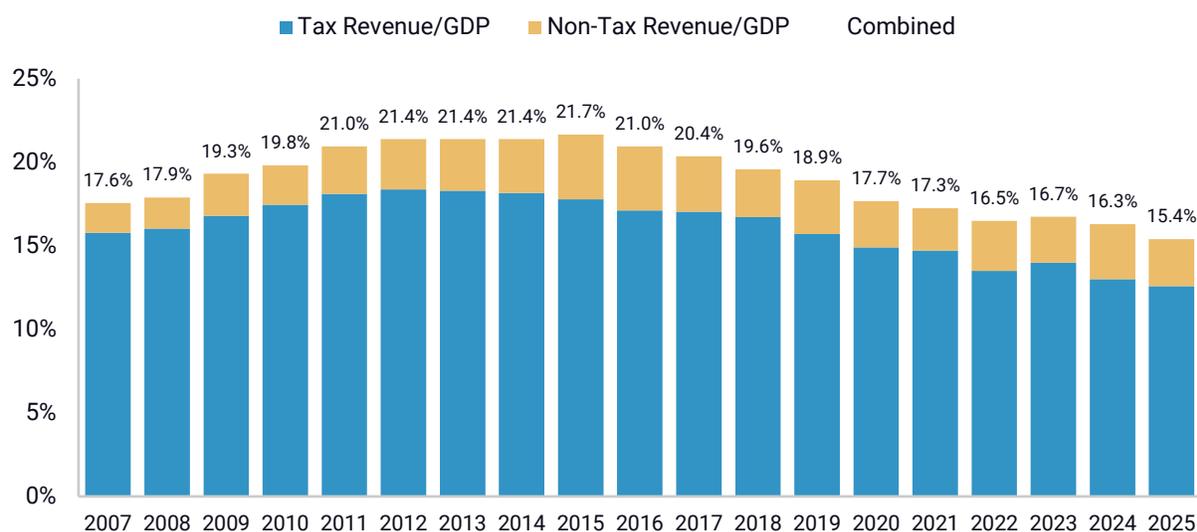
growth with fewer loans, and generating lower profits per loan, and lower profits overall. That declining profitability will impact their capacity to recapitalize out of retained earnings and make more new loans, which means that investment growth and economic growth will stay weak.

The banks' reported performance deteriorated in 2025 despite 520 billion yuan in capital injections into the largest banks last year. Expect to see even more capital injections, but continued weakness in financial system performance in 2026.

## Whither wherewithal?

The deterioration in China's fiscal conditions in 2025 was arguably more severe than the decay within the financial system. Tax revenues rose by 0.8% for the full year after a 3.4% decline in 2024, but non-tax revenues declined by 11.3%, after local governments were scolded for aggressively collecting one-off fines from businesses and entrepreneurs. The total decline in fiscal revenues was 1.7% outright. But as a proportion of GDP, tax and non-tax revenues fell nearly a full percentage point in 2025 to only 15.4%. This remains among the lowest recorded levels of the world's economies (below Mexico and Colombia among OECD nations), and well-below OECD averages in the range of 34%.

FIGURE 3  
Total tax and non-tax revenue as a proportion of GDP, 2007 - 2025  
Percent of GDP



Source: Ministry of Finance, Rhodium calculations.

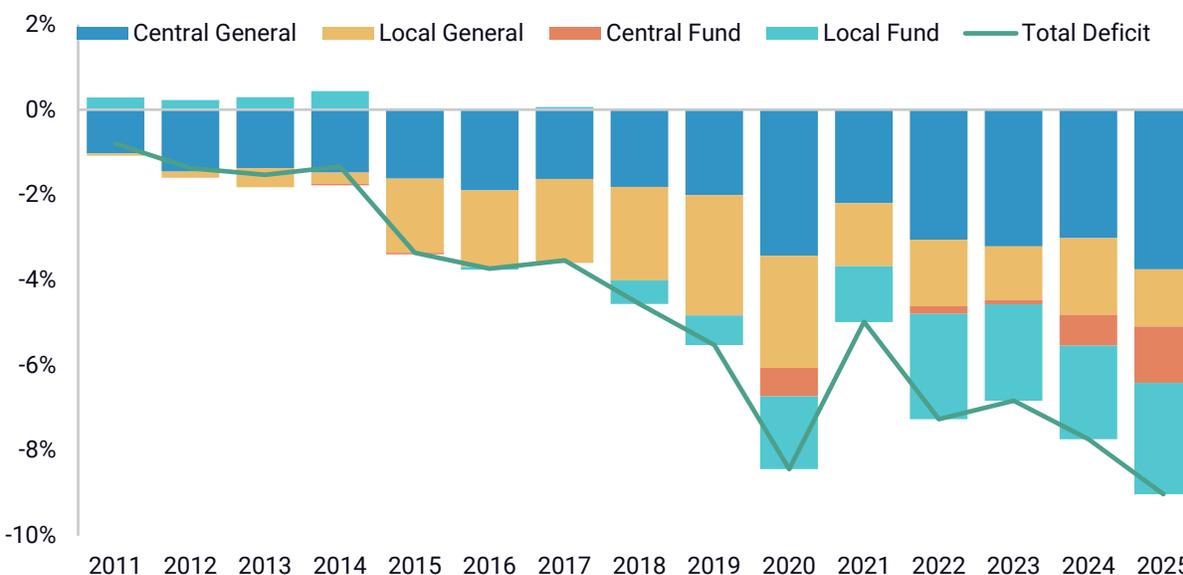
The Ministry of Finance had anticipated only a 0.1% rise in fiscal revenue in 2025, but actual performance was weaker. Similarly, based on the MOF projected fiscal deficit in the 2025 budget document, the government anticipated 4.9% nominal GDP growth for the full year. For the third consecutive year, actual economic performance as officially reported was even weaker, at only 4.0% nominal GDP growth.

The decline in investment activity along with falling domestic producer prices directly impacts China's tax base and the capacity to collect taxes. Interestingly, the Ministry of Finance did crack down on underreporting of individual income taxes in 2025, and

produced an 11.5% rise in individual income taxes for the year. But these only represented around 9% of China's total tax intake.

The net result was a rapidly expanding overall government deficit, including both central and local government spending, reaching 9.0% of GDP for the full year (Figure 4). Should revenues continue declining in 2026, the deficit could widen to 9.5-10.0% of GDP this year. China can continue to finance widening deficits, but the commercial banks themselves are doing so. Hence there is little difference between fiscal spending and policy-driven lending within the Chinese system—they are executed by the same entities (local SOEs and LGFVs), and financed via the same banks, either in the form of a government bond or a loan. The only practical difference is the interest rate or profit to the banks.

FIGURE 4  
China's fiscal deficit by component and total deficit as proportion of GDP, 2011 - 2025  
Percent of GDP

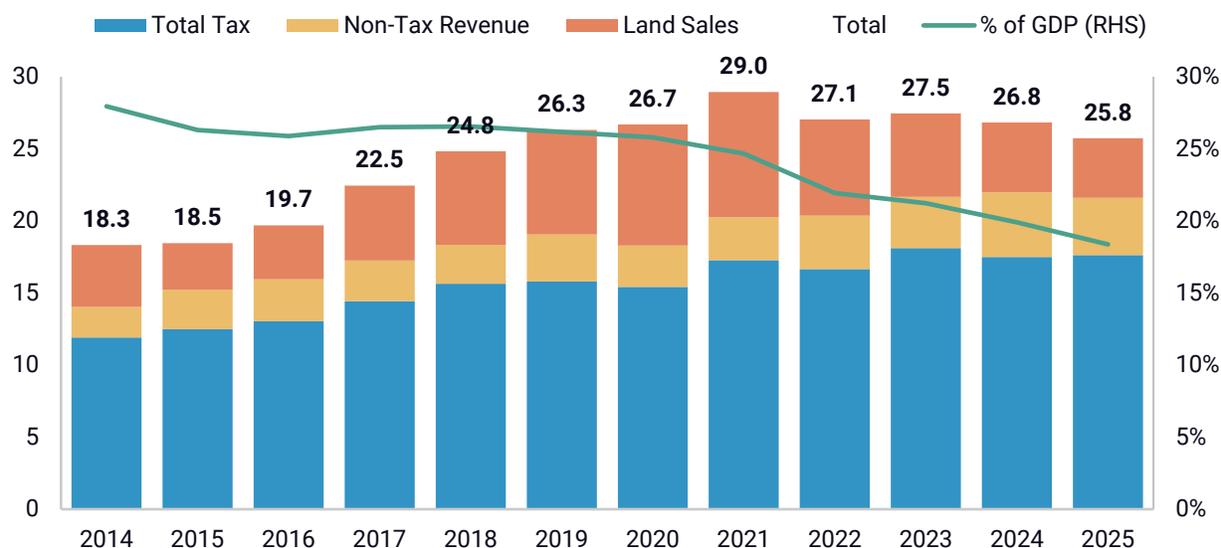


Source: Ministry of Finance.

Land sales also continued declining, impacting local government fiscal conditions and localities' capacity to manage debt, despite the 10 trillion yuan planned local debt swap announced in November 2024. The decline in land sales revenues was almost 15% in 2025, with total land sales revenues reaching 4.15 trillion yuan last year, or less than half of peak levels of 8.7 trillion yuan in 2021. Land sales proceeds are paid by developers to local governments with a one-year lag. This means that the decline in land transactions in late 2025 will certainly produce even weaker land sales revenues in 2026.

China has many stabilization funds that can be used to adjust full-year totals, but the primary drivers of the fiscal position and fiscal revenues are total tax revenues, total non-tax revenues, and land sales by local governments. Those totals are listed in Figure 5 below, and reveal a decline in almost 1.1 trillion yuan in these three sources of revenue in 2025. Total revenues from these three sources are now below 2019 levels. Framed in another context, the decline in these three key sources of China's fiscal revenues in 2025 exceeded all estimated hardware investments in the AI and robotics sectors last year (See Jan 7, "[China's 'New' Strategic Industries Will Not Produce 5% GDP Growth](#)").

FIGURE 5  
**China's most important components of fiscal revenues, 2014 - 2025**  
 Trillion yuan, percent of GDP (RHS)



Source: Ministry of Finance, Rhodium calculations.

The most important implication of all of these developments is that the era of fiscal trade-offs has already arrived, and the stress is deepening. 2025 was more difficult than 2024, and this year will likely be more difficult than 2025. Beijing's spending capacity or wherewithal in absolute terms is declining. The channels through which Beijing can utilize that capacity are increasingly inefficient in generating growth as well. This is what fiscal and financial decay looks like based on the granular data within the Chinese system.

## What policy changes would matter?

As a result of this decay, many of the minor policy decisions that will emerge from the NPC in March have only very limited or temporary economic significance. Beijing is facing an essentially zombified financial system, which cannot die but continues wreaking havoc on the more dynamic sectors of the economy. The changes that would be significant at this point include:

**Meaningful write-offs of non-performing assets within the banking system**, around 10 percent of assets or 30 percent of GDP, along with the necessary recapitalization of banks. These are ballpark estimates but the point is that enough bad assets would need to be recognized to improve future lending and credit efficiency. Any gains from such steps would be lost if the result was simply to keep lending to LGFVs following a large-scale restructuring. Chinese banks wrote off 1.5 trillion yuan in non-performing loans in 2025, which was 50% higher than in 2022. But we are skeptical that banks can increase these write-offs of bad assets on their own given declining profits. Total banking system profits last year were only 2.38 trillion yuan. There will need to be a larger government-led recapitalization to change the efficiency of credit allocation.

**Tax changes unlocking around 4-5% of GDP in new revenues over time.** This would need to involve taxing household consumption and services enterprises, and broadening

China's tax base. A property tax may be part of these measures. This is likely to be the direction of travel, but progress is likely to be slow, as by necessity this would also impact household consumption growth and economic growth.

**Significant changes in export tax rebates.** China could unlock around 1.5 percent of GDP in new tax revenues by simply canceling rebates paid on value-added taxes for exported products. This is highly improbable, because it would effectively raise taxes on exports, an increasingly important driver of China's economic growth.

If those changes sound extreme and improbable, that's because they are. The options Beijing faces to correct its financial and fiscal decay are now very stark. The International Monetary Fund (IMF) released their annual Article IV report [for China yesterday](#), and it calls for a "comprehensive and more forceful policy response" to boost domestic consumption and resolve domestic deflationary pressures, while minimizing trade tensions resulting from China's weakening domestic demand.

Beijing appeared unimpressed by the Fund's recommendations. The new official line appears to be that GDP growth will remain at 4.2% until 2035 (p. 18), when China can become a "mid-level developed economy." In Beijing's view, productivity growth from advanced technologies will deliver the necessary economic growth—reforms are not necessary. In terms of domestic consumption, the "authorities' views" section of the Article IV report clearly indicated that Beijing was not contemplating aggressive policy changes to boost consumption, and that any reduction in the savings rate would be gradual (p. 31). In addition, Beijing questioned whether its own external imbalances were a problem or were being measured correctly (p. 18), attributing China's export strength to "economies of scale, an integrated supply chain, nimble regulation, and a large and well-educated pool of labor, with REER depreciation and industrial policy support playing a secondary role."

Moreover, while there was a welcome airing of some of the data quality issues we and other analysts have raised, there was no discussion at all of the most glaring contradiction in China's reported economic data in 2025—an outright decline in reported fixed asset investment last year, the broadest measure of economy-wide investment activity. In the report's statistical tables, the Fund estimated that fixed investment grew by 1 percent in real terms in 2025, and would accelerate to 2 percent growth in 2026, while China would emerge from deflation in 2027.

**Beijing's revealed policy preferences over the past three years are resistance to reform and acceptance of the decay of its policy tools.** It is impossible to read the "authorities' views" section of the Fund's Article IV report and conclude that Beijing is about to embark upon some of the dramatic policy changes listed above, or more significant structural reforms to the economy. The changes we mentioned would represent de facto fiscal tightening moves that would collect more taxes, and would therefore face strong resistance within the political system, even if Beijing wanted to push ahead. In the past, President Xi Jinping used the phrases "a warrior cutting off his own wrist" or "a phoenix reborn from the ashes" to describe Beijing's determination in pushing ahead with reform, but there has been little evidence of this commitment in recent years. When reform can create conditions for crisis, decay is a much easier option, with predictable results for economic performance.

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