# Global Markets Daily: China's Balancing Act Needs a Stronger Yuan and Stronger Demand

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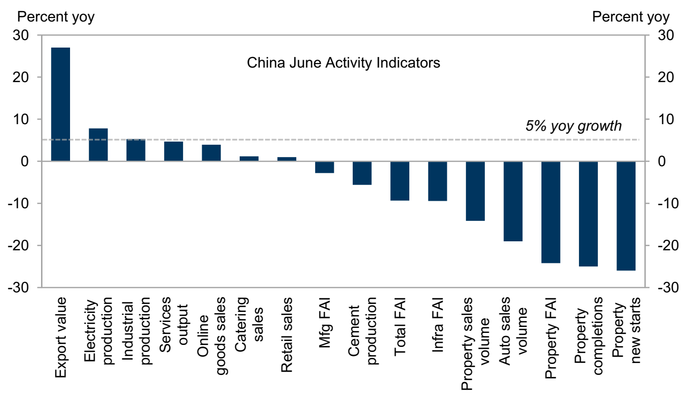
- Data in the first half of 2026 continued to paint a picture of a bifurcated Chinese economy—with weak domestic demand and strong exports. This has led to a renewed debate over whether policies to support demand or nominal currency appreciation are the right response.
- In our view, this is a false dichotomy. Viewed through the lens of the Swan model, the current situation has two facets that require two complementary policy responses.
- As we have argued previously, China's nominal exchange rate is significantly undervalued—around 20% at a minimum—on our GSDEER and GSFEER metrics. Together with its strong manufacturing competitiveness, this undervaluation—especially in the post-pandemic period—has helped produce a significant trade and current account surplus above a sustainable "norm." A gradual exchange-rate appreciation should help facilitate a return to external balance and mitigate protectionist pressures from the rest of the world.
- On the other hand, weak domestic demand, which deteriorated sequentially in Q2, raises the risk that growth falls below target or potential. A fiscal boost that supports near-term growth, alongside structural changes that gradually lift consumption's share of GDP growth—consistent with the goal laid out in the 15th Five-Year Plan—should move the economy closer to internal balance.
- That policy combination—expansionary domestic policy and currency appreciation—is unlikely to be enough to address all global imbalances, but it should help move China's own economy toward a better balance and provide a more robust basis for achieving its medium-term growth targets.

## China's Balancing Act Needs a Stronger Yuan and Stronger Demand

### A Swan's eye view of China's bifurcated economy

Data in the first half of 2026 continued to paint a picture of a bifurcated Chinese economy, with strong performance on the external side and a sluggish domestic sector. That perception was reinforced squarely in the latest monthly dataset. China's trade surplus expanded to a record $125bn in June—$1.5tn at an annual rate—even as property investment continued to decelerate and retail sales remained stagnant (Exhibit 1).

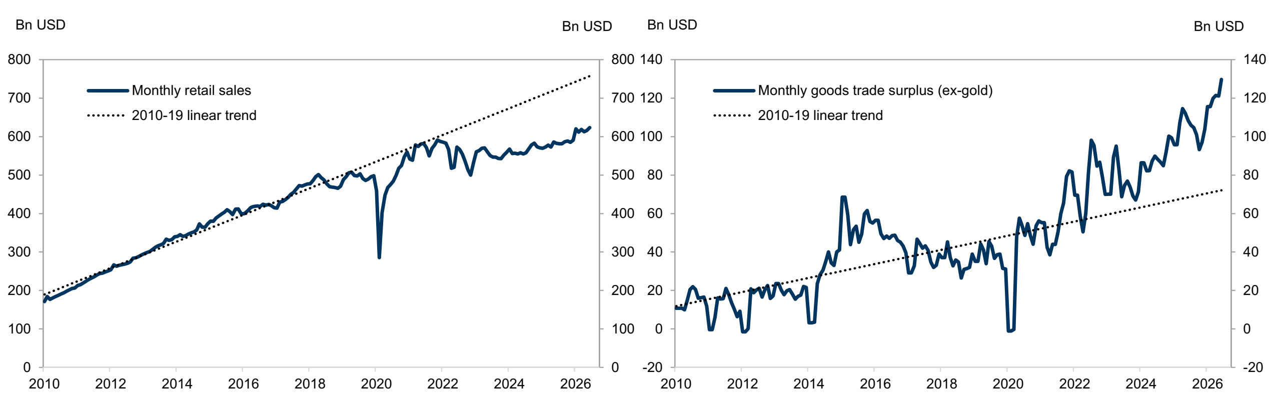
**Exhibit 1: The Chinese economy has been extremely bifurcated, with strong exports but weak domestic demand**




Source: CEIC, Goldman Sachs Global Investment Research

In truth, that bifurcation has existed for several years, especially in the post-pandemic period (Exhibit 2). As a result, overall growth in China has become increasingly lopsided, reliant on net exports even as domestic activity has been lackluster. But there are also global consequences. The persistent trade surplus and associated current account surplus have sparked protectionist responses, have been a key feature of global imbalances for many years, and have recently reignited a debate over whether policies to support domestic demand or nominal currency appreciation are the appropriate response.

**Exhibit 2: China's retail sales have remained persistently below the pre-Covid trend, while China's trade surplus has been above trend and rising**




Source: Haver Analytics, Goldman Sachs Global Investment Research

In our view, this is a false dichotomy. Drawing on the framework pioneered by Australian economist Trevor Swan, policymakers in open economies often face two simultaneous targets: achieving "internal balance," typically understood as demand growth close to potential, and "external balance," involving a sustainable current account balance. Achieving both targets simultaneously requires two instruments or poli just one.

- **Expenditure-changing policies:** These are demand-management t fiscal policy (government spending and taxation) and monetary pol rates)—that alter the total level of domestic absorption.

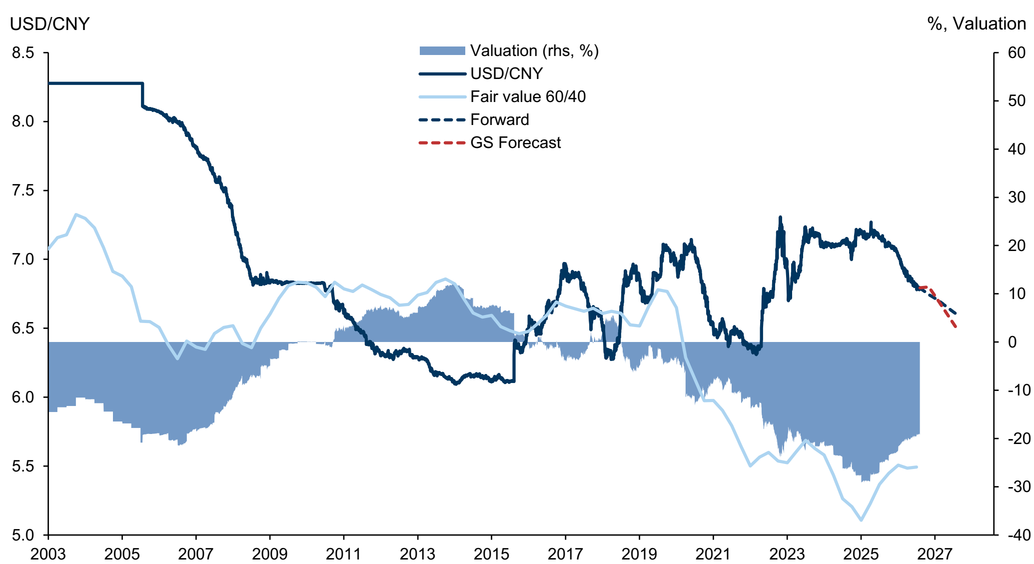
- **Expenditure-switching policies:** These are policies that alter the relative prices of domestic and foreign goods, thereby "switching" demand between them. The primary tool is exchange rate policy—depreciation makes domestic goods cheaper, while appreciation makes them more expensive.

The dilemma arises because achieving external and internal balance can often be in tension, although, at least in theory, a unique combination of policies exists that would move the economy toward both internal and external equilibrium. In China's case, as we discuss below, with domestic demand below potential and the current account surplus above sustainable levels, that combination involves fiscal expansion and structural reforms to boost domestic demand as well as currency appreciation. So there is no tension between the policy prescriptions currently being debated; China can and should do both.

**External balance requires continued gradual CNY appreciation**

The CNY is one of the most undervalued currencies in our G10 and EM coverage. A 60:40 average of our GSDEER and GSFEER metrics currently indicates that the CNY is about 20% undervalued versus the Dollar, after being close to 25% undervalued last year (Exhibit 3). While higher productivity in China versus its trading partners has been a key driver of the gradual strengthening in CNY fair value over the past few decades, the large current undervaluation emerged after the post-Covid inflation surge, when China's lower inflation rate relative to the US made a larger contribution. Likewise, during this period, China's deep competitiveness advantages developed over many years (Exhibit 4) helped the current account surplus expand meaningfully relative to our model estimate of what can be considered sustainable.

**Exhibit 3: We estimate that the CNY is at least approximately 20% undervalued**

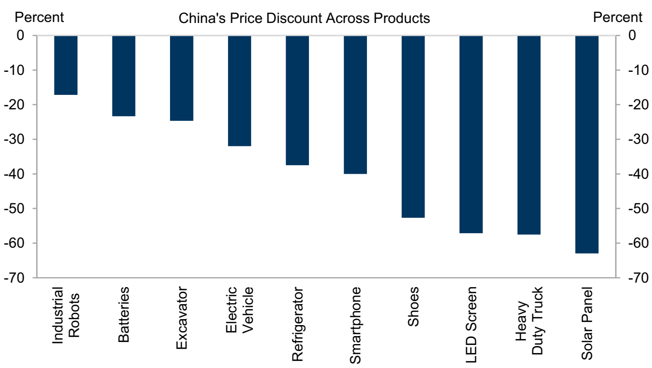



Source: Bloomberg, Goldman Sachs Global Investment Research

We estimate China's current account surplus at around 3.8% of GDP, using an HP filter to smooth the data and avoid large quarter-on-quarter swings, relative to a "norm" of 1.7% based on a model of long-term factors, historical averages, and our economists' assessment (Exhibit 5). Arguably, both estimates may be conservative. First, the IMF's

External Balance Assessment suggests that the "norm" is closer to 1%. Second, there are discrepancies between Chinese trade balance data and balance of payments (BoP) data released by China Customs and the State Administration of Foreign Exchange, respectively, with the trade balance data pointing to a larger surplus. Third, increases in gold imports this year have reduced China's trade surplus by around 1pp of GDP, while underlying gold demand has not shown notable increases. All of these suggest an even larger undervaluation.

**Exhibit 4: Chinese manufacturing competitiveness is widespread across industries**




For electric vehicles, we compare Tesla's manufacturing costs in China versus globally; for footwear, New Balance production costs in China versus the US. In heavy machinery, we compare global leading brand Daimler's excavators and heavy-duty trucks against domestic counterparts Sinotruk and Weichai. Industrial equipment comparisons include Fanuc versus Estun robots and Topcon solar module pricing in China versus the US. For home appliances, we compare Haier and Siemens refrigerators, Huawei versus Apple smartphones, and TCL versus LG LED displays

Source: Company data, Goldman Sachs Global Investment Research

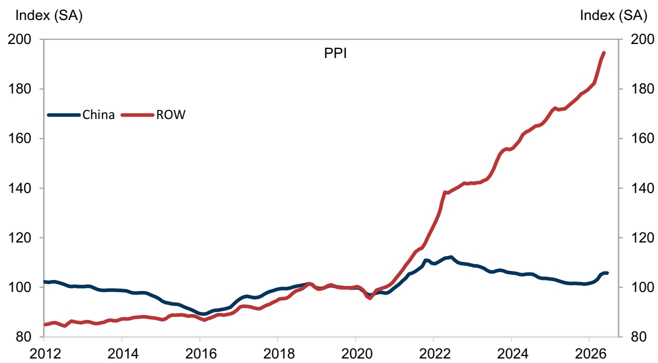
**Exhibit 5: China's current account surplus has been far above the sustainable "norm" in recent years**


Source: Haver Analytics, IMF, Goldman Sachs Global Investment Research

To be sure, much of the real depreciation of the CNY, and consequent undervaluation, was the outcome of broader macro trends in both China and overseas, alongside currency management. Significant fiscal stimulus in DM countries during the Covid pandemic, combined with severe global supply-chain disruptions, led to sharp increases in ex-China inflation. By contrast, stringent lockdown policies to control the spread of Omicron and a large housing downturn resulted in weak demand and deflationary pressures in China (Exhibit 6). Coupled with PBoC management aimed at keeping the CNY relatively stable against the USD in nominal terms, the CNY depreciated substantially in real terms.

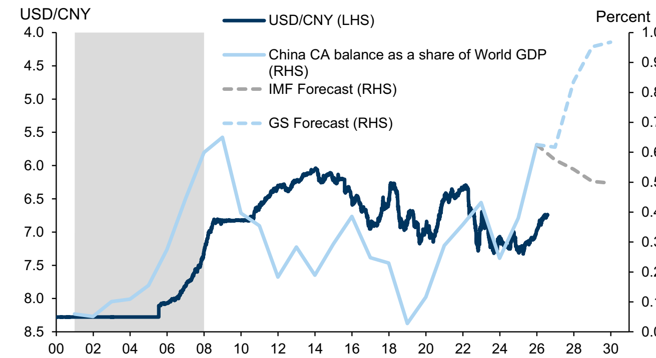
In any case, what is not in dispute is that the CNY is meaningfully undervalued and, along with China's strong competitiveness, this is showing up in a large current account surplus that is approaching unprecedented levels, both in absolute terms and relative to global GDP. Given our expectation of relatively muted inflation in China versus peers, some degree of nominal currency appreciation is warranted to move the real exchange rate closer to fair value. Without such a move, China's large surpluses may generate more protectionist responses from trading partners, threatening its access to external markets and its strong export performance. Therefore, as long as trading relations with major economies remain on a stable footing, we expect policymakers to allow a gradual move stronger in the CNY versus major currencies, in line with our 12-month forecast of 6.50 for USD/CNY. Indeed, the last period when China had a similarly dominant external position was also followed by substantial nominal currency appreciation (Exhibit 7).

**Exhibit 6: PPI inflation diverged significantly in China and ex-China post-Covid**




Source: Haver Analytics, Goldman Sachs Global Investment Research

**Exhibit 7: We expect China's current account surplus as a share of world GDP to rise to unprecedented levels over the next few years**




Source: Goldman Sachs FICC and Equities, IMF, Goldman Sachs Global Investment Research

**Fiscal policy and structural reforms would help achieve internal balance**
While the external side of the economy is strong, weak domestic demand, which deteriorated sequentially in Q2, raises the risk that growth falls below target or potential. A fiscal boost that supports near-term growth, alongside structural changes that gradually lift consumption's share of GDP growth—consistent with the goal laid out in the 15th Five-Year Plan—should move the economy closer to internal balance.

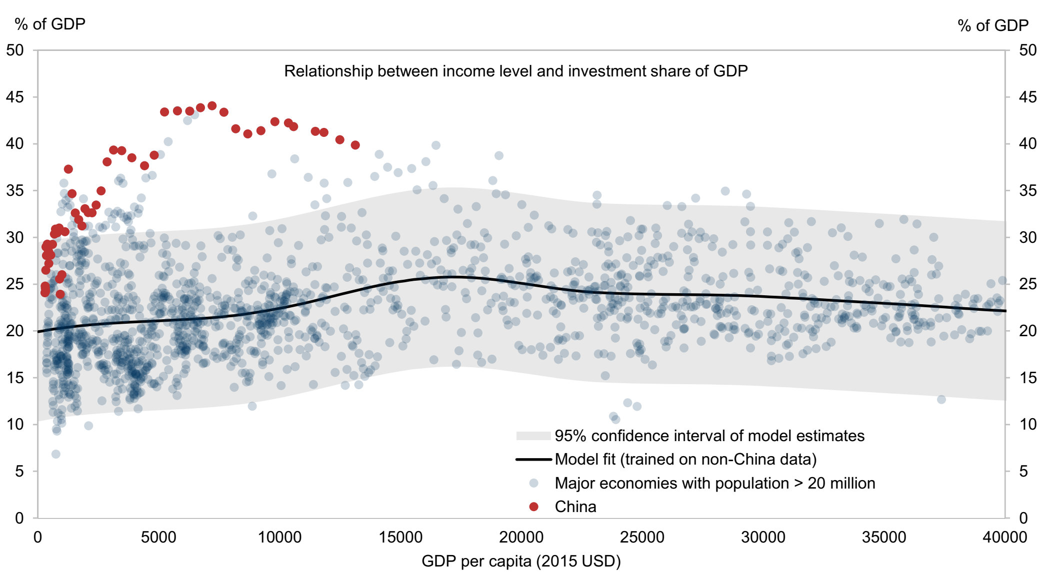
After a better-than-expected Q1, and given a conservative policy reaction function, China's fiscal stance tightened notably in Q2, resulting in a meaningful slowdown in real GDP growth. By our estimates, domestic demand has grown at a very sluggish pace of only 1-2% yoy this year. In May, both retail sales and fixed asset investment registered negative year-over-year growth, which is unprecedented outside of national lockdowns in 2020. At 4.3% yoy, Q2 real GDP growth fell below the lower bound of the full-year target range of 4.5–5%, and a further slowdown would put the target at risk. In response, top leadership stated at the July Politburo meeting that policy should "step up counter-cyclical adjustment," a phrase last used in April 2025 during the peak of US-China tariff escalation.

Near-term easing through accelerated government bond issuance and investment can help the government achieve its growth target this year, but sustained improvement in growth requires long-term, demand-side expansionary policies. Such policies are likely to take different shapes and forms than the traditional monetary and fiscal easing used during the GFC and the 2015 downturn, as policy room is more limited now than it was then. Based on PBoC estimates, China's nonfinancial debt-to-GDP ratio rose from 141% in 2008 to 301% in 2025. Over the past six years (2019-25), China's nominal GDP growth averaged 6.0% per year, while our estimate of the augmented fiscal deficit averaged 12.1% of GDP. China's monetary policy rate is 1.4%, and further cuts are constrained by banks' net interest margins, which are central to China's financial stability, even though real interest rates remain high given depressed inflation expectations. Against this backdrop, domestic policies that can help achieve internal balance are likely to involve both fiscal expansion and structural reforms.

At present, as local governments struggle with evaporating land sales revenue and households repair balance sheets after property prices have declined by more than 30%, higher government bond issuance and fiscal spending can help prevent negative feedback loops (e.g., corporate arrears unpaid by local governments leading to corporate bankruptcies and layoffs), and help fill the void in domestic demand. At the same time, fiscal spending may need to shift from investment that boosts production capacity to public consumption that bolsters demand, including education, healthcare, and public pensions. China's investment share of GDP ran consistently above 40% between 2007 and 2024, creating enormous production capacity (Exhibit 8). The combined employer-employee contribution to pension and medical insurance is 32% of wages in China, higher than in many other countries. We think it is time for limited fiscal space to shift toward consumption.

Indeed, many parts of the Chinese economy face various restrictions, and removing them can unleash demand without taking on significantly more government debt. For example, high-end medical and recreational services, education, media, and entertainment all face significant constraints due to "common prosperity" and ideological considerations. Distortions induced by the hukou system, which restricts access to services in urban areas, and by the financial system, which favors state-owned enterprises over private businesses, are significant. Insufficient property-rights protection makes private entrepreneurs reluctant to invest. The lack of collective bargaining power among workers tilts income distribution toward capital rather than labor. Structural reforms that unleash China's growth potential are difficult to advance politically and may have uncertain short-term impacts, but they are necessary to support long-term private demand and restore internal balance.

**Exhibit 8: China's investment share of GDP has been much higher than other economies**




We use the Generalized Additive Model (GAM) in fitting the non-linear relationship between GDP per capita and investment share of GDP using data from 1970 to 2024.

Source: Haver Analytics, Goldman Sachs Global Investment Research

## A better balance for China, but only part of the solution for global imbalances

To be clear, resolving global imbalances—large current account deficits and surpluses globally—requires more than exchange rate adjustments and policy shifts in China. It is also likely to require adjustments in other major trading blocs. A Swan's-eye view of the US, with its large current account and fiscal deficits and overvalued exchange rate, would point to the need for currency depreciation, along with a fiscal contraction that facilitates a lower trade deficit there, but we see little sign of that occurring in the near future.

So a policy combination of expansionary fiscal policy in China and CNY appreciation would not be enough to address global imbalances, but it should help move China's own economy toward a better balance and provide a more robust basis for achieving its medium-term growth targets.