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CHINA MATTERS

Path of Least Resistance

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- **The production-consumption gap is widening.** Industrial production growth accelerated to 5.2% yoy in August, while retail sales growth slipped to 0.4% yoy. Measurement issues suggest the supply-demand gap may be even wider than official data indicate. With policymakers focused on high-flying subsectors such as robots and semiconductors, there appears little urgency for broad-based easing, absent a sharp deterioration in the labor market, and the divergence could widen further.
- **From "property drags on the economy" to "the economy weighs on property."** China is nearing the typical 30% real house price decline and six-year timeline observed in historical international data of large-scale housing busts. But weak labor markets and still-falling rents are likely to prolong the downturn in many parts of China. Outside top-tier cities and premium segments, the path of least resistance is further price weakness.
- **Structural shift is a bigger headwind to employment than to GDP.** Credit growth has slowed materially as the economy pivots away from credit-intensive property and infrastructure toward AI and high-tech manufacturing. That mix can sustain exports and headline output, but it is less labor-intensive. As China presses ahead with technological innovation and manufacturing competitiveness, the drag on employment, household income, and consumption is likely to persist.
- **The growth target dilemma.** We expect sequential growth to pick up in coming months, supported by faster government bond issuance and increasing infrastructure investment. But that would still leave Q3 and Q4 real GDP growth at 4.4% yoy and full-year growth at 4.5%, the lower bound of the government's 4.5-5.0% target. Annual growth targets help coordinate resources and support the long-term objective of "doubling income by 2035," but they also push the government to lean on investment whenever growth slows, delaying rebalancing. The path of least resistance may be gradual RMB appreciation and more export-rebate cuts to manage large trade surpluses and rising trade tensions, alongside a gradual downgrade of the annual growth target—for example, from "4.5-5.0%" in 2026 to "around 4.5%" in 2027.



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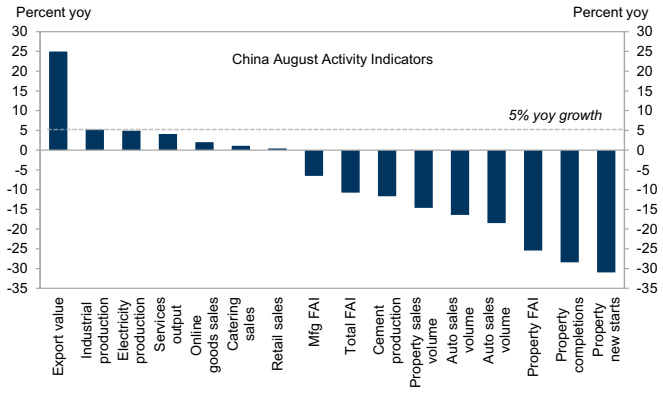
Path of Least Resistance

The Gap Keeps Growing

China's August activity data showed a widening divergence between supply and demand, and between manufacturing output and household consumption. Industrial production growth accelerated from 4.5% yoy in July to 5.2% in August, while retail sales growth slowed from 0.6% yoy to 0.4%. Among major activity indicators, only export value and industrial production growth exceeded 5.0% yoy in August. By contrast, many domestic demand gauges continued to post large year-over-year declines (Exhibit 1).

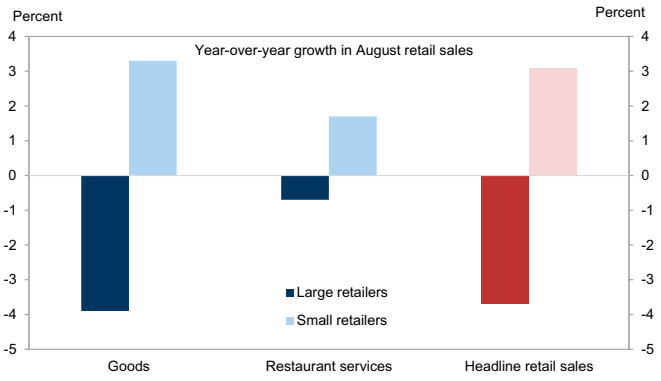
For exports, we can cross-check the data against trading partners' reported imports from China. Such "mirror data" support strong Chinese export growth. For domestic demand, however, there are statistical reasons why official data may understate the true weakness. For example, in retail sales, large retailers above the designated size are surveyed comprehensively, whereas small retailers are sampled and estimated because of their large numbers and the difficulty of surveying every small retailer each month (see our latest edition of "Understanding China's Economic Statistics" for more details). As a result, officially reported sales growth at small retailers tends to be smoother than that at large retailers and to hold up better during economic downturns. In August, sales at large retailers declined by almost 4% yoy, while sales at small retailers increased 3% yoy (Exhibit 2). This implies an even greater divergence between strong exports and weak domestic demand than official data indicate.

Exhibit 1: Only export value and industrial production grew more than 5% yoy in August



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 2: Official data show small retailers significantly outperformed large retailers in August



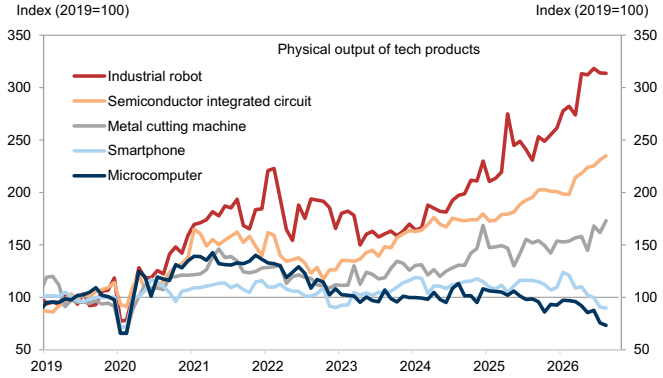
Source: CEIC, Goldman Sachs Global Investment Research

The remarkable divergence in the Chinese economy extends beyond exports versus domestic demand. Within tech-related manufacturing, for example, industrial robot and semiconductor output climbed 34.6% yoy and 20.6% yoy respectively in August, while microcomputer and smartphone output dropped 25.6% yoy and 22.3% yoy respectively (Exhibit 3). Similarly, within retail sales, communication equipment sales increased 27.3% yoy in August, while auto sales fell 18.5% yoy (Exhibit 4). These extreme divergences, driven in part by the ongoing AI capex boom and policies such as the consumer goods trade-in program, make it difficult to characterize the overall strength of the Chinese economy.

Because there are always high-flying subsectors for the government to point to,

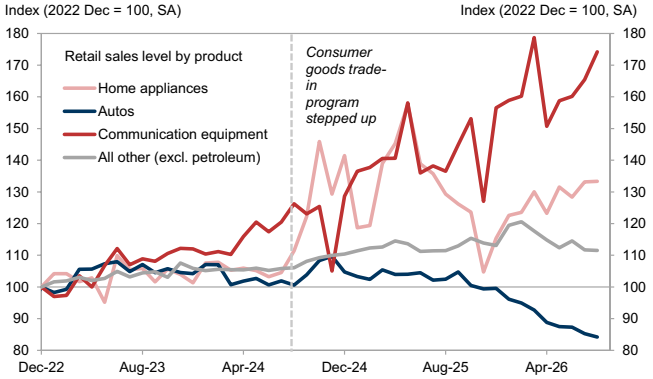
policymakers do not appear to feel much urgency to introduce additional easing measures, absent a sharp deterioration in the labor market. At the September 15 press conference, NBS officials highlighted industrial robots and semiconductors—but not smartphones or microcomputers—when discussing industrial production, and communication equipment—but not autos—when discussing retail sales. With top leadership continuing to emphasize advanced manufacturing, the path of least resistance may be a further widening of the gap between strong exports and weak domestic demand, and between strong industrial output and weak household consumption.

Exhibit 3: Significant divergence in physical output of tech products



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 4: Significant divergence in retail sales of different products



Source: CEIC, Goldman Sachs Global Investment Research

Property Markets: Where to Go Now?

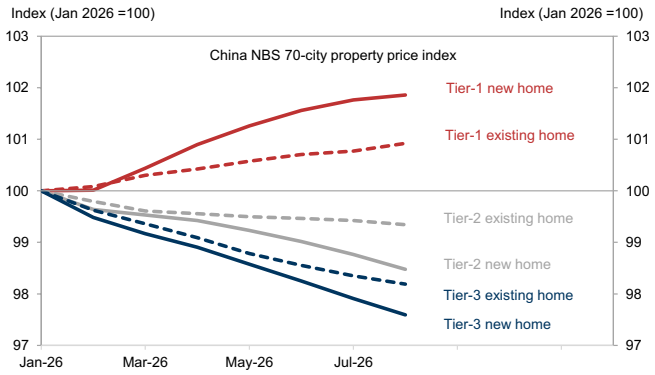
Significant divergence also applies to property prices. Based on the NBS 70-city property price indices, new home prices in Tier-1 cities (Beijing, Shanghai, Guangzhou, and Shenzhen) rose 2% from January to August this year, while home prices in Tier-2 and Tier-3 cities continued to decline (Exhibit 5).[1] Our previous research shows that typical large-scale housing busts last six years, with real house prices falling around 30% from peak to trough. By this standard, China's property market should be nearing a bottom as we head into 2027, six years after the 2021 housing peak, with real house prices having declined by more than 30%, according to our tracking.

However, we think China's property market may not follow this typical experience over the next few years. Take the US as an illustrative case of housing market bottoming in 5-6 years: although inflation fell in the first few years after house prices peaked, it largely moved higher in subsequent years (Exhibit 6). The broader US economy was recovering, with the unemployment rate falling, wage inflation normalizing, and rent inflation recovering. By contrast, five years after Chinese property prices peaked, China's labor market remains very weak, if not weakening, and rent inflation remained negative (-0.6% yoy) as of August 2026. If property has dragged down the overall economy over the past five years, we are now seeing more signs that the broader economy - especially employment, wage growth, and rent inflation - is increasingly weighing on the property market recovery.

[1] The NBS 70-city property price indices show less volatility than other house price indices in China, but the relative ranking across cities contains useful information. See China Data Insights: Understanding differences in China's home price measures, July 9, 2023 for more details.

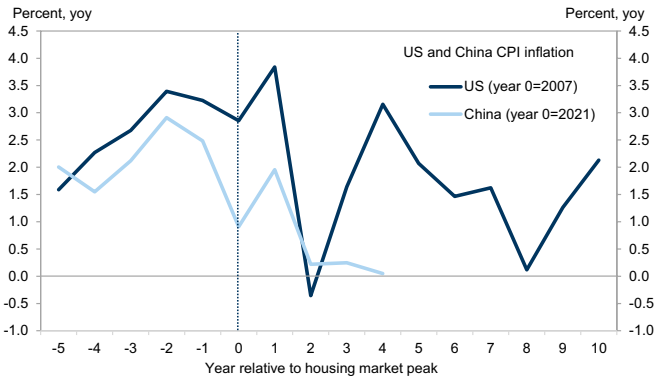
Policymakers do not appear eager to unleash significant easing to boost housing demand. In fact, the recent policy announcement to curb developer financing would likely slow land sales and local government revenue before reducing housing supply, making it a net negative for the housing market in the near term, in our view. Therefore, the path of least resistance may be continued house price declines outside a few top-tier cities and selected segments, such as new luxury homes in highly desirable locations.

Exhibit 5: House prices have diverged across city tiers this year



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 6: China's CPI inflation has been much lower than the US during the housing downturn



Source: Haver Analytics, Goldman Sachs Global Investment Research

Implications of China's Economic Transformation

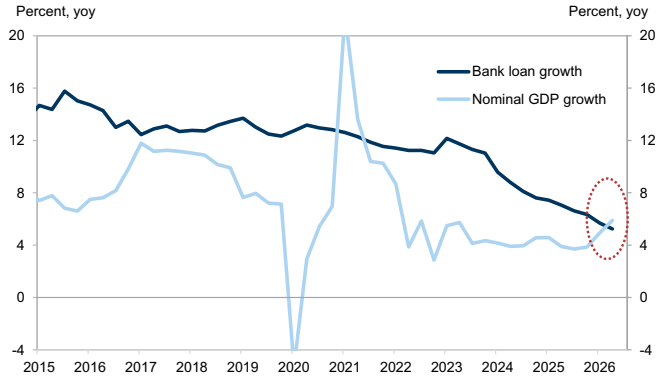
China's bank loan growth has slowed dramatically over the past three years, from above 10% yoy in 2023 to just 5% yoy in August 2026 (Exhibit 7). Even after factoring in increased government bond issuance to swap out bank lending to local government financing vehicles (LGFVs), total social financing (TSF) growth also declined, from close to 10% yoy in 2023 to 7.2% yoy in August 2026. PBOC Governor Pan Gongsheng recently argued that the credit slowdown is a natural outcome of China's structural transformation: as credit-intensive sectors such as property and infrastructure, which rely heavily on bank loans, give way to sectors such as AI and high-tech manufacturing, which are less credit-intensive and rely more on equity and corporate bond markets for financing, bank loan growth will inevitably decelerate without a material slowdown in GDP growth.

This argument has merit. But by the same mix-shift logic, China's structural transformation is negative for the labor market. For every unit of value-added created in the economy, labor intensity is more than 20% higher in services and more than 100% higher in construction than in manufacturing (Exhibit 8). As policymakers press ahead with this economic transformation, industrial production and exports are likely to continue benefiting from technological advancements and AI-enabled manufacturing, supporting headline GDP. However, employment, wage income, and household consumption are likely to remain sluggish as the economy shifts further toward less labor-intensive sectors.

Reversing this trend requires significant and systematic efforts to reform the social safety net, improve income distribution, and raise labor's share of GDP. These are multi-year or even multi-decade projects, and we have seen few signs that this process is moving quickly. In the meantime, China's structural transformation implies continued

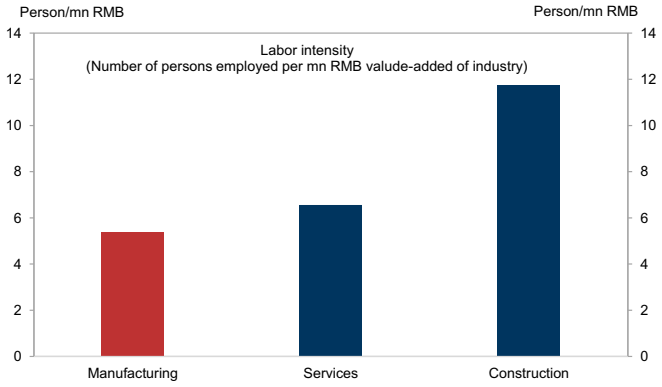
strength in exports and persistent weakness in domestic demand. To manage already very large current account surpluses and rising tensions with trading partners, the path of least resistance is for policymakers to choose easier options—such as gradual RMB appreciation and removal of VAT export rebates for more products—than harder options such as fundamental reforms.[2]

Exhibit 7: Bank loan growth has fallen below nominal GDP growth



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 8: Manufacturing is less labor-intensive than services and construction



Source: NBS, Goldman Sachs Global Investment Research

Growth Target Dilemma

In recent weeks, government bond issuance has accelerated somewhat, and policymakers have signaled plans to step up infrastructure investment, especially on the "Six Networks" projects.[3] The State Council held meetings on building grid and logistics networks on July 31, communication networks on August 21, underground networks on August 31, and computing networks on September 11. But even after penciling in a pickup in sequential growth in the coming months on accelerated investment, our forecasts for Q3 and Q4 real GDP growth are both 4.4% yoy, below the government's full-year target range of 4.5-5.0% (Exhibit 9). Our forecast for 2026 full-year real GDP growth is 4.5%, exactly at the lower bound of the target range. Two years after the September 2024 policy pivot, when policymakers meaningfully loosened monetary, fiscal, property, and equity market policies to boost confidence and halt the continued decline in GDP growth, meeting the growth target is becoming a challenge again.

Herein lies the dilemma in setting annual growth targets. China's economic planning system centers on the GDP growth target, which helps coordinate resources across ministries and different levels of government. Shifting to other targets, such as inflation or employment, would face various implementation challenges. At the same time, pressure to reach the growth target each year often leads to accelerated infrastructure investment, which is under policymakers' control and can translate into GDP quickly. These dynamics make rebalancing away from an investment-driven economy difficult, but a fundamental shift to a much lower annual growth target would put the long-term goal of "doubling income by 2035" at risk, as this goal requires a 4.17% annual growth rate from 2025 to 2035.

[2] Over the past year, policymakers have started to remove VAT export rebates for select products, including solar panels and batteries.

[3] "Six Networks" projects include water networks, new power grids, computing power networks, next-generation communication networks, unban underground pipeline networks, and logistics networks.

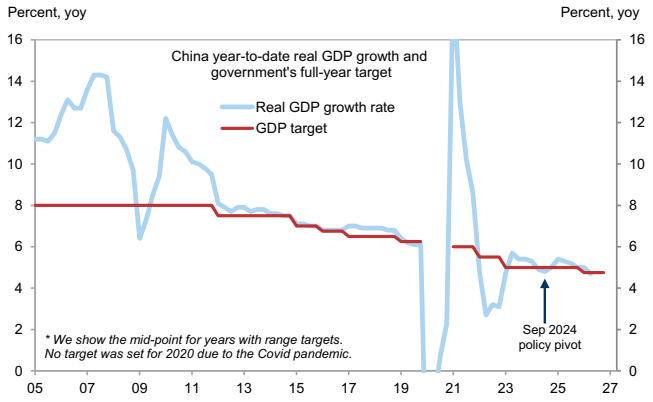
A decisive move to rebalance the domestic economy may involve either expanding fiscal spending substantially to boost consumption or drastically shifting fiscal spending from investment to consumption. Policymakers are reluctant to do the former because of debt sustainability concerns, given that China's augmented fiscal deficit has run in double digits as a share of GDP every year since 2015. They are also reluctant to do the latter because of growth target concerns, as the GDP impact of reducing investment would be immediate, whereas the benefits of strengthening the social safety net would come much later. The path of least resistance may be to gradually lower the annual growth target, for example from 4.5-5.0% in 2026 to around 4.5% in 2027. More signals on next year's growth target should emerge as the December Politburo meeting and Central Economic Work Conference approach later this year.

Exhibit 9: We expect sequential growth to edge up in Q3 and Q4 on faster government bond issuance and increased investment



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 10: Risk of GDP growth not reaching this year's target has increased



Source: Haver Analytics, Goldman Sachs Global Investment Research

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