CHINA MATTERS

Time to Ease

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- China's growth momentum slowed sharply in recent months, with real GDP growth falling from 5.3% qoq annualized in Q1 to 3.6% in Q2. Retail sales and fixed asset investment both weakened meaningfully, raising downside risks to the government's 4.5-5% full-year GDP growth target. The slowdown reflected a negative fiscal impulse, disruptions from the Iran War, and adverse weather.
- The economy's divergence has widened, with exports and high-tech sectors remaining resilient while domestic demand continues to struggle. Among major activity indicators, only exports, electricity production, and industrial production grew more than 5% yoy in June. The "K-shape" pattern is visible across industries, with strong growth in high-tech manufacturing and adjacent sectors, but sluggish activity elsewhere.
- From a pure macroeconomic perspective, the Chinese economy can benefit from more market-based, long-term, expansionary, and demand-side policies. Lower effective mortgage rates relative to rental yields could be more effective in stabilizing property demand than administrative measures such as local government purchases of empty apartments. Longer-term policies that support jobs, incomes, and confidence would likely do more to sustain consumption than short-term subsidies such as the consumer goods trade-in program.
- However, geopolitical tensions and US-China competition are likely to keep policymakers focused on security and technological advancement, while high government debt and deficits make them reluctant to pursue significant fiscal expansion.
- That said, the current setup resembles mid-2024 in some respects, before a major easing package, with slowing growth momentum, weaker consumption and investment, equity market underperformance, and local government financing strains leading to more aggressive tax collections. We expect the July Politburo meeting to deliver stronger easing rhetoric. For now, the likely path is accelerated disbursement of existing fiscal resources, including the RMB800bn policy-based financing instrument and the remaining government bond quota, with further resources possible if needed. Key risks are central-level complacency and local-level implementation constraints during political turnover ahead of next year's 21st Party Congress.

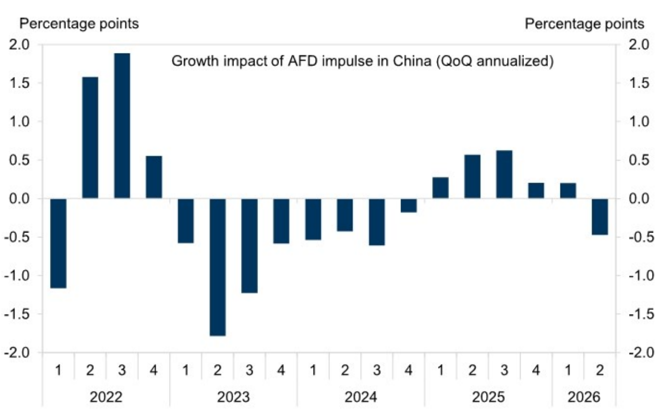
Time to Ease

The Slowdown and the Reasons Behind It

China's real GDP growth slowed notably from 5.3% qoq annualized (5.0% yoy) in Q1 to 3.6% qoq annualized (4.3% yoy) in Q2. Despite the top leadership's pledge at last December's Central Economic Work Conference to boost consumption and stabilize investment, retail sales growth dropped from 3.7% in 2025 to 1.3% yoy in the first half of 2026 despite higher CPI inflation. Fixed asset investment (FAI) growth weakened further, from -3.8% in 2025 to -5.7% yoy in 2026H1. The government's full-year growth target of 4.5-5%, which appeared on track a few months ago, is now facing increased downside risks.

What explains the sharp deceleration in growth in Q2? Part of it was due to the government's slowdown in fiscal spending after a strong Q1 GDP print. The fiscal impulse turned negative in Q2 by our estimates, contributing approximately 40% of the sequential decline in real GDP growth from Q1 to Q2 (Exhibit 1). The Iran War led to lower production of chemicals and refined petroleum products, which we estimate explains another 30% of the Q2 growth slowdown. The remaining 30% was likely driven by other factors such as inclement weather conditions and payback from front-loaded consumer spending during the Lunar New Year in Q1. As the Iran War escalates again and typhoons and flooding continue to affect many parts of the country in July, the sequential growth rebound embedded in our baseline forecast assumes the fiscal impulse will turn positive again in Q3 (Exhibit 2).

Exhibit 1: Fiscal impulse turned negative in Q2...



Source: Goldman Sachs Global Investment Research

Exhibit 2: ...Contributing to slower Q2 GDP growth

Source: NBS, Goldman Sachs Global Investment Research

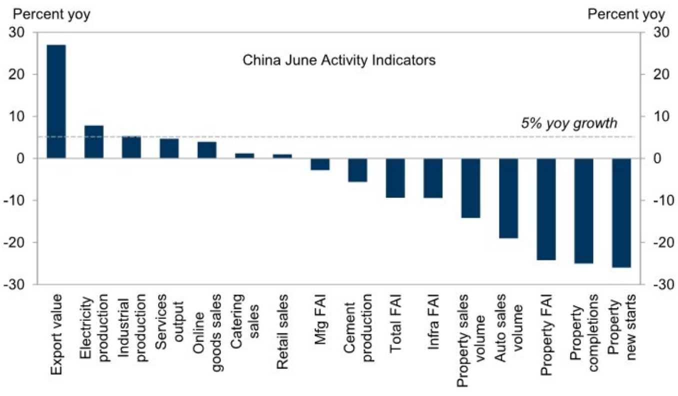
From Divergent to Very Divergent

The divergence in the Chinese economy over the past two years—strong exports and weak domestic demand—continues to widen. In June, among major activity indicators, only exports, electricity production, and industrial production growth registered above 5% yoy growth (Exhibit 3).[1] In the domestic economy, property sales and auto sales

[1] The export growth shown in Exhibit 3 is measured in nominal USD terms. Based on April and May breakdowns, much of the 27% yoy increase is likely driven by higher prices. June export volume growth data will be released by China Customs in late July.

volume declined 14% and 19% yoy, respectively. Property, infrastructure, and manufacturing investment fell by 24.2%, 9.4%, and 2.8% yoy in June, respectively.

Exhibit 3: An economy that is powered by exports alone

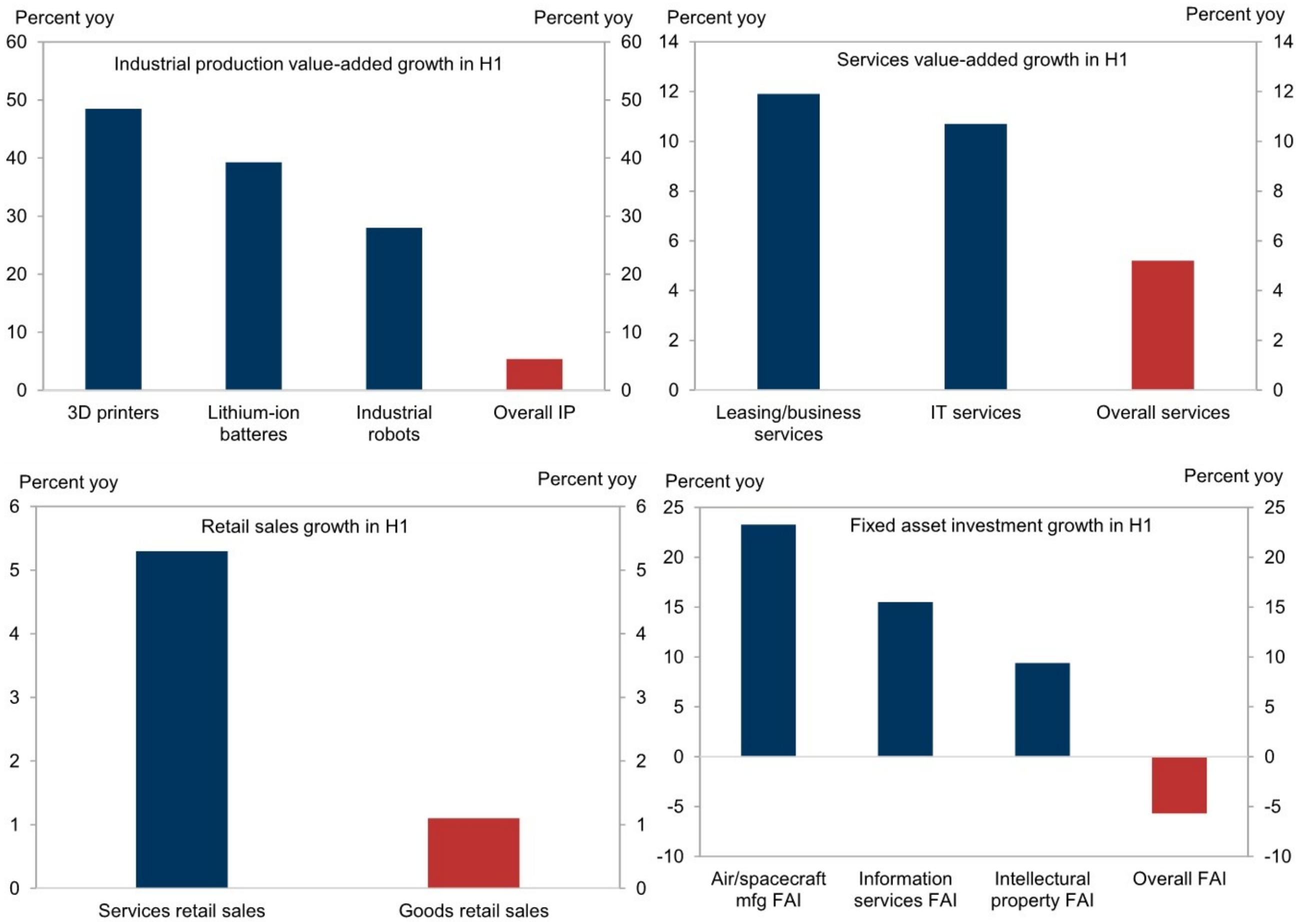


Source: CEIC, Goldman Sachs Global Investment Research

"K-shape" has become the buzzword amid the global AI boom, and there are many "K-shapes" in the Chinese economy as well. Drawing on statistics unveiled during the NBS press conference after the Q2 GDP release, Exhibit 4 demonstrates how differently various industries performed in 2026H1. For example, government officials highlighted that production of 3D printers, lithium-ion batteries, and industrial robots jumped 48.5%, 39.3%, and 28.0% yoy, respectively, in the first half of this year, much higher than the overall IP growth of 5.4%. In services, leasing/business services and IT services grew 11.9% and 10.7% yoy, respectively, more than double the rate of overall services production growth. In retail sales, while services sales growth held steady at 5.3% yoy in 2026H1, goods sales growth was very sluggish at 1.1% yoy. Within FAI, officials emphasized robust increases in investment in aircraft/spacecraft equipment manufacturing, IT services, and intellectual property products, whereas total FAI contracted notably.

Taken together, the Chinese economy is being propelled by strong performance in high-tech manufacturing and adjacent sectors that serve high-tech manufacturing. Activity in the broader economy outside of high-tech remains sluggish or has weakened. Resilient and growing exports reflect ever-expanding production capability amid stagnating domestic demand.

Exhibit 4: The many "K-shapes" in the Chinese economy



Source: NBS

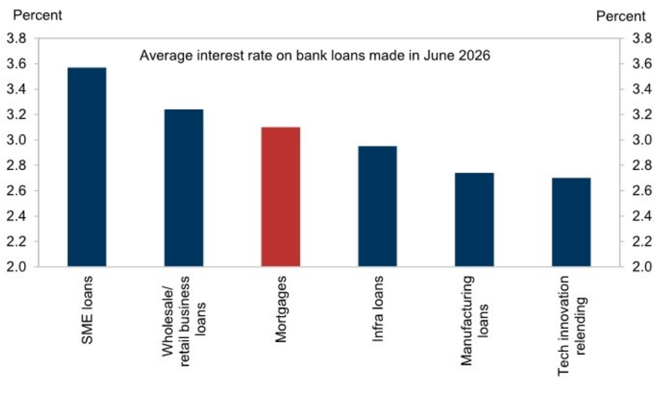
Options for Policymakers

Given the current macro setup, we think the domestic economy would benefit from policies that are more market-based than administrative, more long-term than short-term, more expansionary than contractionary, and more demand-side than supply-side.

Market-based policies: According to the PBOC, newly issued mortgage loans had an average interest rate of 3.1% in June, unchanged from a year earlier. By contrast, interest rates on new manufacturing loans averaged 2.74%, 22bp lower than a year ago (Exhibit 5). With rental yields below 2.5% in many cities and home price expectations weak, mortgage rates remain too high to stimulate home-buying demand. In cities where demographic trends are not too challenging, Hong Kong and Shanghai's recent experience suggests that lower effective mortgage rates relative to rental yields can help stabilize property prices. Such market-based measures should be more effective and easier to implement than administrative measures such as local governments buying back empty apartments.

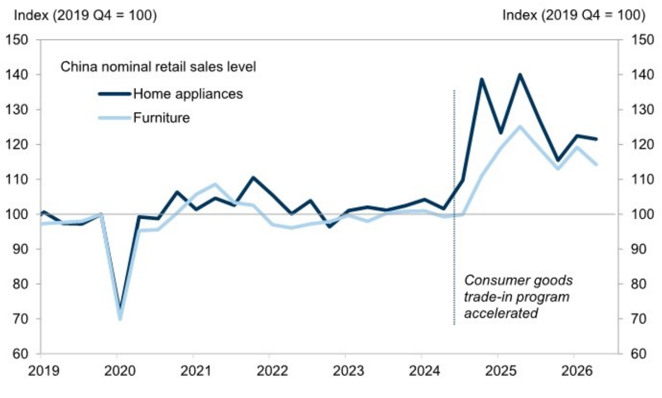
Long-term policies: Over the past two years, the government has subsidized consumer goods trade-ins to support household consumption. While the program pulled forward replacement demand for durable goods and temporarily boosted sales, it does not generate sustainably higher consumer spending. For example, home appliance sales growth plunged from 53% yoy last May to -15.6% yoy this May (Exhibit 6). To promote sustainable household consumption growth, long-term policies that create jobs, raise income, and bolster confidence are likely to be more effective than short-term subsidies.

Exhibit 5: June data show that mortgage rates are higher than interest rates on manufacturing loans



Source: PBOC

Exhibit 6: Government-subsidized trade-in program boosts durable goods sales temporarily

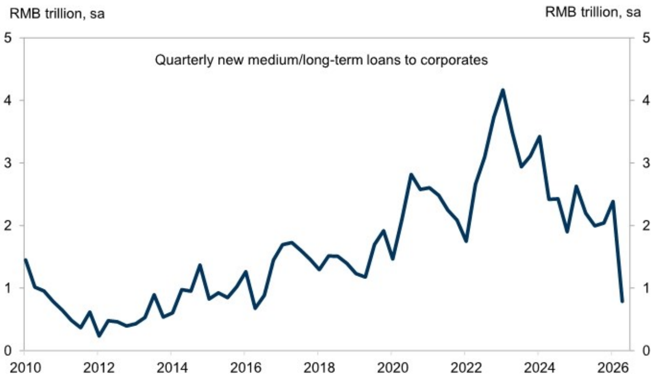


Source: Haver Analytics, Goldman Sachs Global Investment Research

Expansionary policies: Even though technology development has been a bright spot, the overall economy remains weak and has recently shown renewed signs of softening. In Q2, medium- and long-term corporate loan growth dropped sharply (Exhibit 7). Many indicators suggest that expansionary cyclical policies are needed. However, fiscal policy has appeared contractionary: government general budget revenues increased 4% yoy in January-May, partly due to higher inflation amid rising global commodity prices and partly due to strengthened tax collection efforts. Government general budget expenditures, on the other hand, fell by 0.8% yoy in January-May.

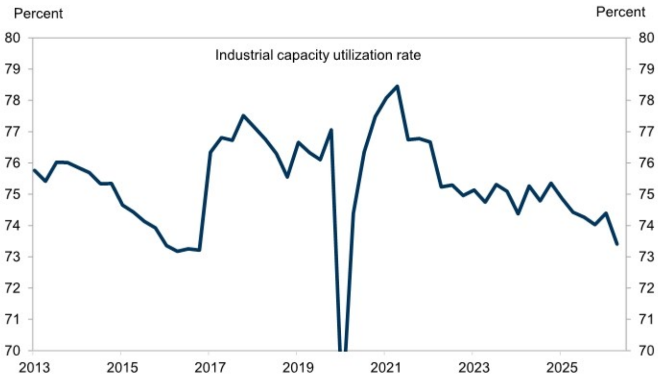
Demand-side policies: Policy support over the past few years has leaned heavily toward the supply side, including expanding capacity in emerging industries and building pedestrian shopping malls. Meanwhile, pushing local governments to resolve implicit debt, mandating the exits of local government financing vehicles (LGFV), and regulatory tightening in the financial sector have weighed on employment and income. These policies have inadvertently exacerbated supply-demand imbalances, contributing to continued declines in capacity utilization rates (Exhibit 8). The "anti-involution" campaign aimed at curbing excess capacity and reducing over-competition appears to have had limited effects so far. Polysilicon prices have fallen below mid-2025 levels as industry consolidation in the solar sector failed to materialize. Without stronger end demand, price increases in the upstream sector cannot be sustained.

Exhibit 7: Medium- and long-term corporate loan growth dropped sharply in Q2



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 8: Industrial capacity utilization rate has been falling over the past two years



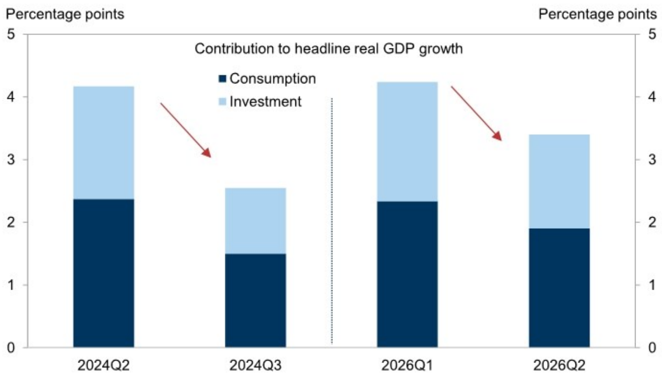
Source: Haver Analytics, Goldman Sachs Global Investment Research

What Policymakers Are Likely to Do

What policymakers might choose from a pure macroeconomic lens differs from what they will do once other considerations are taken into account. Against the backdrop of rising geopolitical tensions and intensifying US-China tech competition, the top leadership's emphasis on security and tech innovation is unlikely to change. In addition, already large augmented government debt, a persistently high augmented fiscal deficit, and structurally rising spending needs amid a rapidly aging population have made policymakers more cautious about fiscal expansion in recent years.

That said, we are seeing signs reminiscent of mid-2024, before policymakers announced a large easing package to support the equity market, property market, and local government finances. For example, year-to-date GDP growth is slowing, and the risk of missing the full-year target is increasing. Both consumption and investment growth decelerated notably (Exhibit 9). Equity market performance has weakened. Some local governments, under financial strain, have reportedly collected tax revenues more aggressively. Well-known government-affiliated economists have also become more vocal in calling for macro policy easing.

Exhibit 9: Both consumption and investment growth slowed from Q1 to Q2, similar to the experience of mid-2024



Source: Wind, Goldman Sachs Global Investment Research

These similarities suggest that the odds of policy easing have increased. We expect stronger easing rhetoric at the upcoming July Politburo meeting. In terms of concrete measures, we believe demand-side fiscal easing would be more effective, and policymakers may follow the steps below.

First, accelerate the implementation of available policy space and tools. The RMB800bn new policy-based financing instrument approved at this year's March "Two Sessions" has not yet been tapped. Once deployed, we estimate it could lift GDP by 0.5pp. Of the nearly RMB12tn government bond issuance quota allotted for 2026, nearly RMB7tn remained available as of end-June. Therefore, we think the first step is likely to be to accelerate bond issuance and the spending of proceeds in Q3.

If the resulting fiscal impulse is still not strong enough to reverse the growth deceleration, the second step would be to tap the unused government bond issuance quota approved in previous years. We estimate that RMB1.8tn of such resources is available. If still insufficient, the third step would involve the National People's Congress (NPC) approving additional fiscal resources, although the bar for such action is high.

Ultimately, we think the government has a strong desire to meet its full-year GDP growth target of 4.5-5%. We expect real GDP to grow 4.6% this year (Exhibit 10). Risks to this view are twofold. The first is complacency on the central government's part. Base effects will become more favorable for year-over-year comparisons in coming months. For example, the government slowed the speed of subsidy disbursement for the consumer goods trade-in program in the second half of 2025. FAI dropped 10% sequentially in 2025Q3, and auto sales fell 7% in 2025Q4. If policymakers believe they only need 4.3% yoy real GDP growth in H2 to reach the full-year target, and that the lower base in the second half of last year makes this a relatively easy task, they may remain fiscally conservative. The second risk is political constraints at the local level. Even if funding is sufficient, the combination of limited projects with decent returns, continued anti-corruption campaigns, and political turnovers ahead of next year's 21st Party Congress may prevent fiscal spending from accelerating meaningfully in H2.

Exhibit 10: We expect real GDP to grow 4.6% this year

		2019	2020	2021	2022	2023	2024	2025	2026F
GDP	**% yoy**	**6.1**	**2.3**	**8.6**	**3.1**	**5.4**	**5.0**	**5.0**	**4.6**
Domestic Demand	pp	5.4	1.7	6.9	2.5	6.0	3.4	3.4	3.4
Consumption	% yoy	6.3	-0.2	9.4	2.7	8.3	4.0	4.6	4.4
Household Consumption	% yoy	6.1	-1.9	12.1	1.7	8.8	5.2	4.3	4.0
Government Consumption	% yoy	6.9	3.8	3.5	5.2	7.2	1.2	5.2	5.5
Gross Fixed Capital Formation	% yoy	5.5	3.6	2.5	3.5	4.5	2.3	1.2	2.0
Net Exports	pp	0.7	0.7	1.7	0.5	-0.6	1.5	1.6	1.2
Exports of Goods (nominal USD)	% yoy	0.5	3.6	29.6	5.6	-4.7	5.8	5.4	10.3
Imports of Goods (nominal USD)	% yoy	-2.7	-1.0	30.6	0.7	-5.5	1.0	0.0	14.9
Inflation									
CPI	% yoy	2.9	2.5	0.9	2.0	0.2	0.2	0.0	1.0
Core CPI	% yoy	1.6	0.8	0.8	0.9	0.7	0.5	0.8	1.1
PPI	% yoy	-0.3	-1.8	8.0	4.1	-3.0	-2.2	-2.6	2.0
Other									
Current Account Balance	% GDP	0.6	1.5	1.6	2.2	1.4	2.4	3.7	3.4
USDCNY (eop)	level	6.97	6.54	6.37	6.95	7.09	7.30	7.00	6.70
OMO 7-Day Repo Rate (eop)	%	2.50	2.20	2.20	2.00	1.80	1.50	1.40	1.40
TSF Stock Growth (eop)	%	10.7	13.3	10.3	9.6	9.5	8.0	8.3	7.2
Augmented Fiscal Deficit	% GDP	11.7	16.6	11.2	12.3	11.3	10.6	11.0	11.5

Source: CEIC, Goldman Sachs Global Investment Research

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