Goldman Sachs | Economics Research

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China Matters

No Rotation to Domestic Demand Yet (Shan)

- Large swings in US-China tariffs have led us to make significant changes to our economic and policy forecasts over the past two months. Despite lingering uncertainties, we expect the US effective tariff rate on Chinese goods to stay at around 40% through the remainder of the year. We project moderate policy easing and full-year real GDP growth of 4.6% in 2025.
- Taking stock of the current state of the economy, we have not seen a meaningful rotation in growth drivers from external to domestic demand. Export volume increased 13% yoy in April despite notably higher US tariffs. Retail sales growth has improved year-to-date, but much of it was related to the government-subsidized consumer goods trade-in program. For many eligible products, sales growth exceeded 20% yoy in January-April.
- On the other hand, the property sector softened somewhat in April and May, with both prices and activity sliding. The labor market appears extremely weak, judging from the employment sub-indices of various PMIs. While real GDP growth is on track to exceed 5% yoy in the first half of this year and unlikely to trigger policy stimulus, significant labor market slack could be the catalyst for further policy easing at the July Politburo meeting.
- Looking beyond near-term tariff headlines, we think the CNY may now be commencing a multi-year strengthening path against the USD. Our FX strategists estimate that the CNY is significantly undervalued. Our recent analysis shows that Chinese manufacturing competitiveness remains formidable and trade surpluses may continue to grow. A stronger currency can also help lift China's GDP as a share of US GDP which fell from 77% in 2021 to 64% in 2024.

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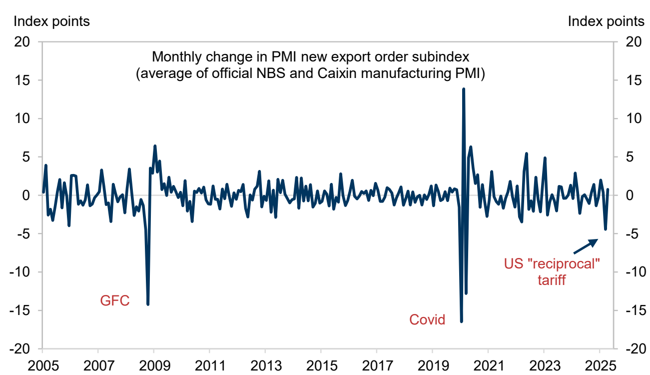
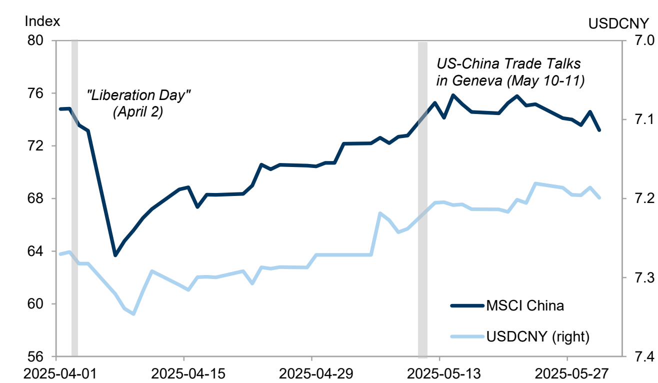
US tariffs on China, and consequently our growth forecast, have made a round trip over the past two months. On the back of rapidly escalating tariffs in early April, which led the US effective tariff rate on Chinese goods to jump from 31% to 107%, we cut our 2025 China real GDP growth forecast from 4.5% to 4.0%. Following the more-than-expected tariff rollbacks in early May where the effective tariff rate dropped from 107% to 39%, and incorporating realized growth year-to-date, we raised our real GDP growth forecast from 4.0% to 4.6%. The new export order sub-indices of the latest manufacturing PMIs have stabilized after a significant decline in April (Exhibit 1), and Chinese risk assets such as equity prices and USDCNY have retraced their post-"Liberation Day" moves (Exhibit 2).

Exhibit 1: New export order sub-indices stabilized in May after declining in April



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 2: China risk assets have retraced their early April losses



Source: Bloomberg, Goldman Sachs Global Investment Research

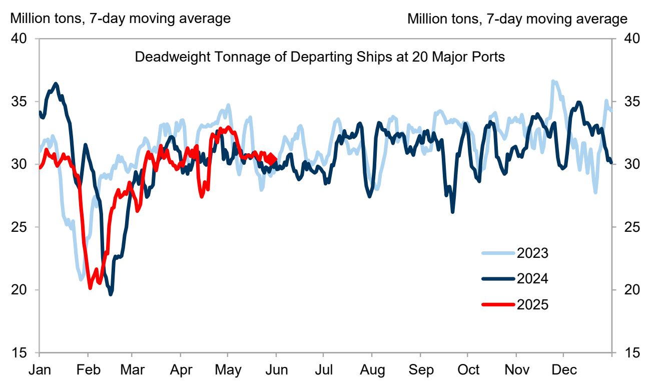
The US trade policy uncertainty index has declined from its April high. However, recent events, including the pending US court rulings as well as President Trump's post accusing China of violating the trade agreement, suggest tariff risks will likely linger. For now, we assume the US effective tariff rate on Chinese goods will remain at around 40% for the remainder of the year. But we would not be surprised if there are temporary increases and decreases in tariff rates in the coming weeks and months.

Exports and trade-in program strong, property and labor market weak

Despite notably higher US tariffs this year, Chinese exports have stayed remarkably resilient. For example, China Customs data show that April exports increased 8.1% yoy in value terms and 13% yoy in volume terms. Daily freight data suggest that exports stayed stable in May (Exhibit 3). Against this backdrop of still robust exports, policymakers feel less urgency to stimulate the economy and there has not been as much a rotation from external demand to domestic demand as we were expecting. The current account surplus was nearly 4% of GDP in Q1 and January-April goods trade surplus totaled US$370bn, US$110bn higher than the same period last year.

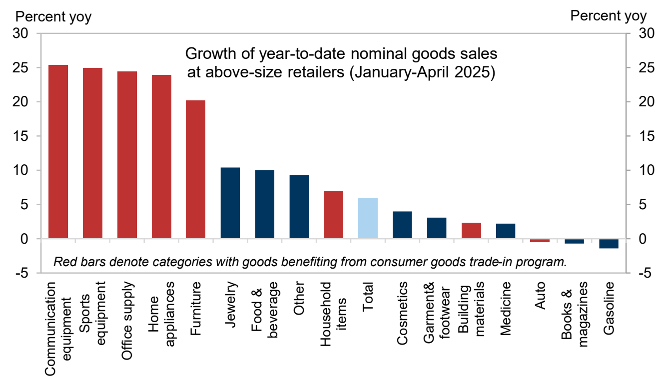
Retail sales growth improved moderately from last year, rising 4.7% yoy in January-April compared to 3.5% in 2024. Most of the improvement was driven by the government-subsidized consumer goods trade-in program (i.e., China's cash-for-clunkers). For those targeted categories such as communication equipment, sports equipment, office supply, home appliances, and furniture, sales growth rose to above 20% yoy during the first four months of this year vs. around 5% last year (Exhibit 4). The tailwind of the trade-in program is likely to continue in the near term. However, the boost will eventually fade, and durable goods sales may slump on the "pay-back" effect when the program ends.

Exhibit 3: Chinese exports appear more resilient than anticipated so far in 2025



Source: CEIC, Goldman Sachs Global Investment Research

Exhibit 4: Consumer goods trade-in program lifted retail sales this year

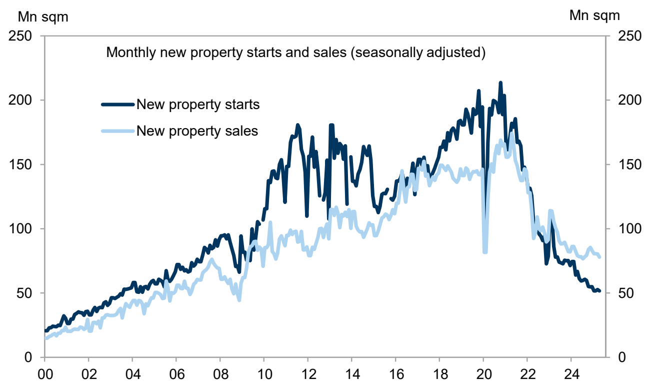


Source: Haver Analytics, Goldman Sachs Global Investment Research

China's property market weakened in April, with both prices and activity sliding after brief signs of stabilization in Q1. As of now, property new starts have fallen by around 75% from the peak while property sales have dropped by approximately 50% (Exhibit 5). While most of the declines are probably behind us, fundamentally speaking, China's property market is in the process of destocking to clear the excess built in prior decades. Government-funded destocking programs can speed up this process, but their implementation has been patchy and slow. Regardless, destocking simply means that new starts will run persistently below property sales, which depresses the contribution of the property sector to real GDP growth.

The most concerning aspect of the Chinese economy at present is the labor market, in our view. Chinese employment and wage data are sparse and laden with measurement issues (see "Understanding China's Economic Statistics" for more details). As a proxy, we look at the employment sub-indices of various PMIs (Exhibit 6). Even in manufacturing sectors which have significantly outperformed the rest of the economy on strong exports and government support, the employment sub-indices are only around the 30th percentile of their historical distribution (0% means weakest and 100% means strongest on record). In the construction sector and among small businesses, the employment sub-indices rank lower than the 5th percentile. Although real GDP growth is on track to exceed 5% yoy in the first half of 2025, and therefore unlikely to trigger additional policy easing at the July Politburo meeting, labor market weakness could be a catalyst.

Exhibit 5: Property activity slid in April



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 6: Labor markets are very weak, especially in construction and among small businesses

Type	Index	Date	Level	Percentile
Employment sub-index of PMI surveys	Caixin manufacturing	May-25	48.4	35.7%
	NBS manufacturing	May-25	48.1	31.7%
	Emerging industries	May-25	49.5	20.1%
	NBS services	May-25	46.6	17.8%
	Caixin services	Apr-25	49.2	16.2%
	CKGSB business conditions	May-25	48.3	4.0%
	SME confidence	May-25	47.9	2.4%
	NBS construction	May-25	39.5	1.6%
PBOC Survey of Urban Depositors	Current Employment Sentiment	2024Q4	30.9	3.1%
	Future Employment Expectation	2024Q4	42.1	1.5%

Note: Sample period for PMIs is 2015-present. Sample period for the PBOC survey is 2009-present.

Source: Haver Analytics, Goldman Sachs Global Investment Research

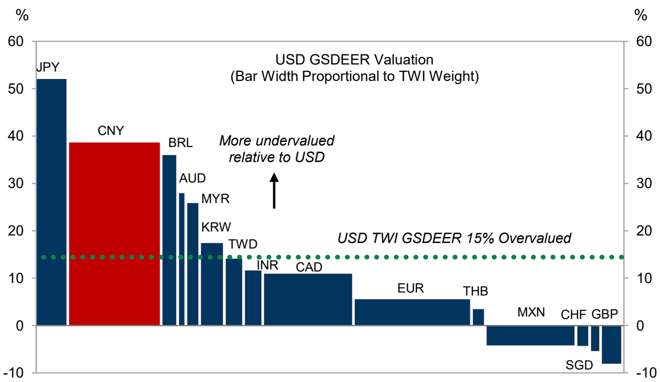
Reasons for CNY to strengthen against the USD

Looking beyond the near-term tariff ups and downs, as well as the challenges in the property and labor markets, we see compelling reasons for the CNY to strengthen against the USD on a medium to long-term horizon. In fact, we revised our 12-month USDCNY forecast from 7.35 to 7.00 in early May ahead of the Bessent-He trade talks in Geneva.

First, based on our FX Strategy team's estimates, the CNY is significantly undervalued relative to the USD (Exhibit 7). Although valuation alone does not imply an imminent correction, and undervaluation or overvaluation can stay in place for a long time, significant deviations from economic fundamentals do increase the risk of subsequent adjustments toward the "fair value", especially after the market experiences significant shocks and new catalysts emerge.

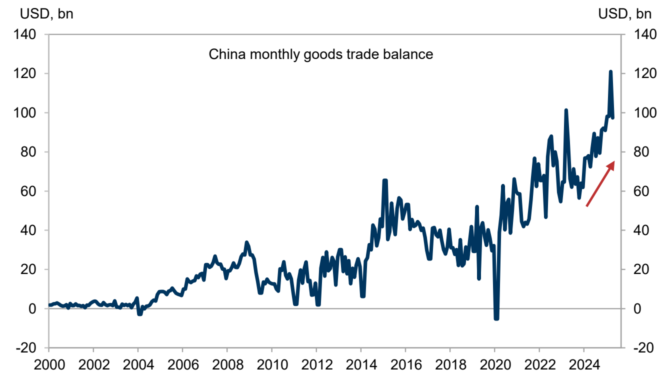
Second, as we discussed in our latest deep dive, Chinese manufacturing is extremely competitive on a host of factors, including but not limited to still low labor costs, abundant capital, cheap energy, and significant government subsidies. At the same time, although US tariffs have risen sharply, most of China's trading partners have not imposed significant tariffs on Chinese products despite their deteriorating bilateral trade balances with China. Chinese goods trade surplus has exceeded US$100bn per month and shown no signs of letting up (Exhibit 8).

Exhibit 7: CNY is significantly undervalued based on the GSDEER model



Source: Goldman Sachs Global Investment Research

Exhibit 8: China's monthly goods trade surplus has reached $100bn and is still growing



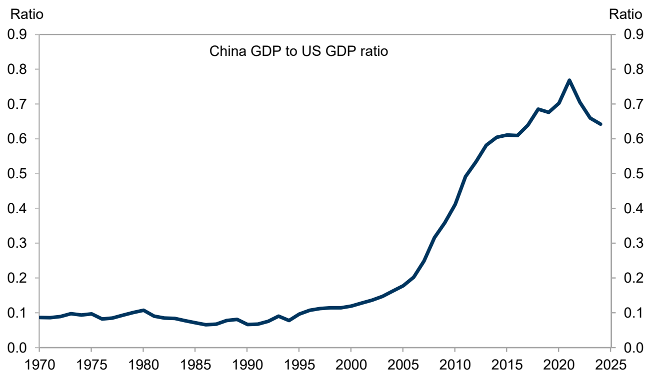
Source: Haver Analytics, Goldman Sachs Global Investment Research

Third, Chinese policymakers may want to see the CNY strengthen rather than weaken against the USD. In recent years, Covid lockdowns, a severe housing bust, and the lack of confidence among businesses and households have led to weak growth, prolonged deflation, and CNY depreciation. As a result, China's GDP as a share of US GDP dropped from 77% in 2021 to 64% in 2024 (Exhibit 9). With the backdrop of US-China competition, a lower USDCNY would boost China's GDP relative to US GDP and make it easier for the Chinese government to double per capita GDP from US$10.5k in 2020 to US$21k by 2035 as pledged by President Xi in late 2020. Additionally, gradual appreciation of the CNY against the USD helps rebuild market confidence, alleviate capital outflow pressures, and on the margin facilitate the economic rebalancing toward more consumption relative to production.

Two pushbacks to our view are that, first, CNY appreciation hurts Chinese exports amid US-China tariff escalation, and second, the Chinese government may wish to keep its currency weak and only allow appreciation as a part of a comprehensive trade deal with the US. On the former, Chinese products are often 20-60% cheaper than global competitors. Gradual appreciation should not alter Chinese manufacturing competitiveness by much. Moreover, our previous research shows that trade-weighted CNY matters more to exports than USDCNY. With the broad USD weakening and USDCNY largely stable in recent months, CNY has depreciated meaningfully against major trading partners. Any appreciation vs. USD could be partly or fully offset by broad USD weakening. If CNY appreciation is broader than just vs. USD, it could help alleviate other countries' concerns that Chinese goods will be redirected to their markets in the face of higher US tariffs.

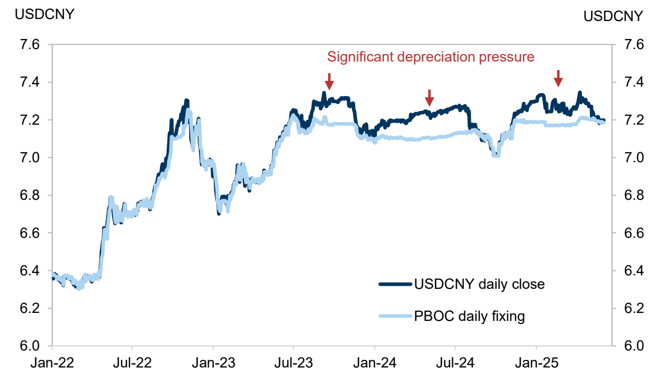
On the timing of CNY appreciation against the USD, the experience of the past two years indeed suggests that USDCNY is to a large degree a policy choice. After all, the PBOC has managed to keep USDCNY broadly within the 7.0-7.3 range since mid-2023 despite widening US-China interest rate differentials and tariff escalations (Exhibit 10). As such, it is likely that the timing and pace of CNY appreciation will be influenced by policy considerations such as US-China trade negotiations.

Exhibit 9: China GDP as a share of US GDP has fallen from 77% in 2021 to 64% in 2024



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 10: The pace of CNY appreciation is likely a policy decision



Source: Bloomberg, Goldman Sachs Global Investment Research

Taken together, we expect the strengthening of the CNY against the USD to take place gradually due to policymakers' preference for stability and control. Because Chinese households and businesses are under-exposed to foreign assets, the PBOC can smooth the speed of FX moves by allowing for more capital outflows when the pressure of CNY appreciation increases. Hence, we believe the government has both the desire and the capability to keep USDCNY on a mildly declining path over the medium to long run.

Hui Shan

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