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TOP of MIND

CHINA'S CONGRESS: AN INFLECTION POINT?

The 20th Party Congress of the CCP promises to be one of the most significant events in China's modern history, not only because President Xi is widely expected to secure a rare third term, but also as it comes amid the country's slowest pace of growth in decades. Whether the Congress marks an inflection point for economic policy, and what that means for growth and markets, is Top of Mind. We ask the Asia Society, UC San Diego's Susan Shirk, and the Jamestown Foundation's Willy Lam what to watch for that could presage a policy inflection. They agree: the composition of the Politburo Standing Committee, and how much Xi dominates it. But even if he fully dominates it (as they expect), could his policies shift to reprioritize growth? GS GIR's Hui Shan says no, suggesting China's growth challenges will likely persist. But Tsinghua University's David Li says yes, paving the way for China's economic miracle to extend. We also explore potential foreign policy shifts, with the Asia Society, Lam, and Shirk agreeing that China's territorial ambitions and China-US relations are key to watch.

"Under Xi, ideology is now driving policy—not the other way around.

- Asia Society Policy Institute's Center for China Analysis, led by the Honorable Dr. Kevin Rudd

The 20th Party Congress is an occasion not only for leadership changes, but also for policy changes, and one of the most fundamental policy shifts will be to refocus on economic growth as a top priority.

- David Li

While the US is not blameless, and US actions have been costly to China, the overreach of China's leadership presents the biggest risk to China as we know it today.

- Susan Shirk"

WHAT'S INSIDE

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Macro news and views

We provide a brief snapshot on the most important economies for the global markets

US

Latest GS proprietary datapoints/major changes in views

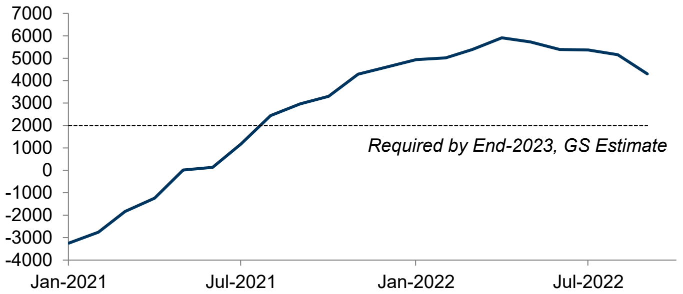
- We expect more Fed tightening (a 75bp hike in Nov vs. 50bp previously and a 25bp in Feb vs. none previously, for a peak funds rate of 4.5-4.75%) following the Sept meeting.
- We lowered our 2023 GDP forecast to 1.1% (Q4/Q4) on the back of the higher rate path and recent FCI tightening and as a result raised our YE23/24 unemployment rate forecasts to 4.1/4.2%; we now see 35% odds of a recession in the next 12m (vs. 30% previously).

Datapoints/trends we're focused on

- Jobs-workers gap, which has fallen by ~40% of the amount required by end-2023 to tame inflation without a recession.

US jobs-workers gap has fallen by roughly 40% of the amount required to tame wage inflation by end-2023

US jobs-workers gap, thousands



Note: The jobs-workers gap captures the difference between total labor demand and total labor supply (i.e., the labor force). When available, we match job openings data from the preceding month and unemployment data from the current month to account for the timing of data releases.

Source: Goldman Sachs GIR.

Japan

Latest GS proprietary datapoints/major changes in views

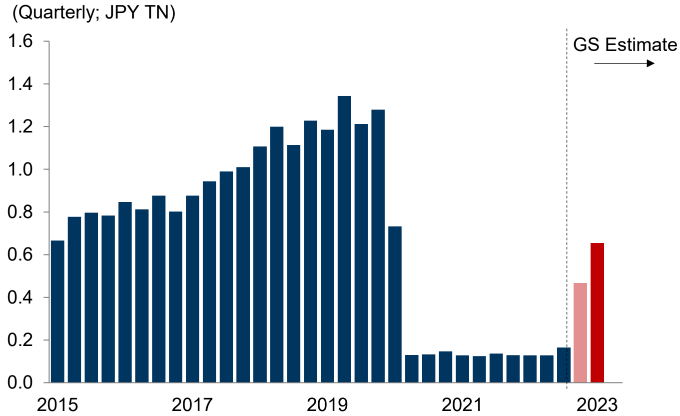
- We lowered our 3Q22 real GDP tracking estimate to 1.6% (qoq ann.), primarily to reflect downward revisions to our estimates for consumption due to weak data in Jul-Aug.

Datapoints/trends we're focused on

- Yield curve control, which we expect the BoJ to maintain through the end of Governor Kuroda's term in April 2023.
- FX intervention; we doubt yen depreciation can be sustainably countered by the Ministry of Finance's yen-buying.
- Inbound spending post reopening; we expect potential annual inbound spending of ¥6.6tn (vs ¥5tn pre-pandemic) after Japan reopens its borders on Oct 11 and full Chinese tourism returns (expected after 2Q23).

A recovery in inbound spending once Japan reopens

Recovery pace for inbound consumption over next 3-6m



Source: BoJ, Goldman Sachs GIR.

Europe

Latest GS proprietary datapoints/major changes in views

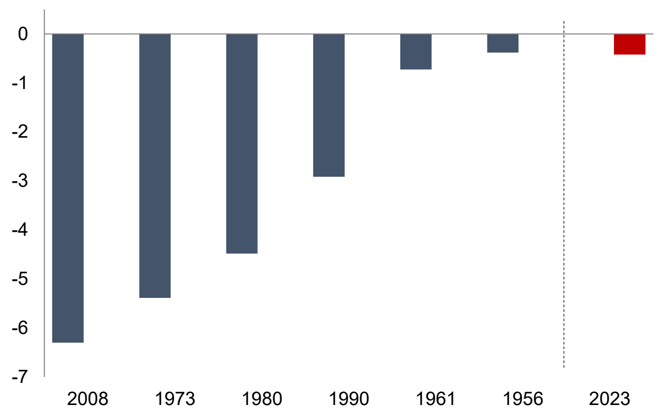
- We expect more ECB tightening (a 75bp hike in Dec vs. 50bp previously and a 50bp hike in Feb vs. 25bp previously for a 2.75% terminal rate) given our expectation of further inflationary pressures ahead and more Euro weakness.
- We expect more BoE tightening (a 100bp hike in Nov and Dec vs. 75bp previously) in response to the inflationary pressures from the government's new fiscal expansion.

Datapoints/trends we're focused on

- Growth; we expect a shallower-than-anticipated recession in the UK due to the fiscal expansion but a moderate (rather than mild) recession in the EA due to more severe gas tensions.

UK fiscal expansion likely to cushion the recession

Peak cumulative impact on GDP in recession episodes, %



Source: Bloomberg, BoE, Goldman Sachs GIR.

Emerging Markets (EM)

Latest GS proprietary datapoints/major changes in views

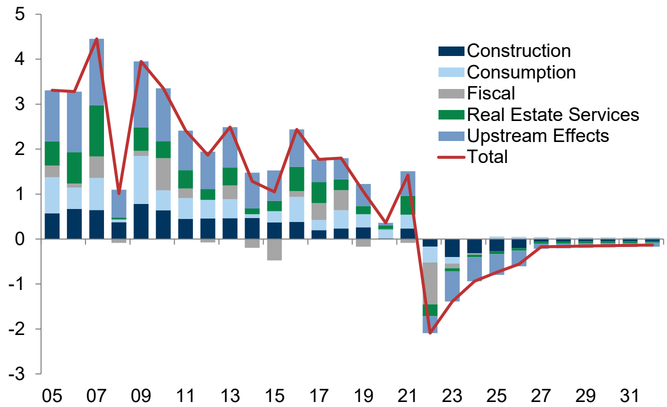
- We recently lowered our 2023 China GDP forecast to 4.5% to reflect a delayed growth rebound from reopening, which we think is unlikely to begin until at least 2Q23.

Datapoints/trends we're focused on

- China's 20th Party Congress; we don't expect major policy shifts immediately after, including in the property sector, which we continue to expect to be a sizable drag on China GDP growth this year and beyond.
- EM monetary policy; while the overall pace of EM rate hikes may be past the peak, we expect tighter EM monetary policy in response to a more hawkish Fed/DM central banks.

Property sector to remain a drag on China growth

Housing contribution to yoy China GDP growth, ppt



Source: Haver Analytics, Goldman Sachs GIR.

China's Congress: an inflection point?

The imminent 20th National Party Congress of the Chinese Communist Party (CCP) promises to be one of the most significant events for China in modern history, not only because President Xi Jinping is widely expected to secure a third term—a feat that no Chinese leader has achieved since Mao Zedong—but also because it comes at a time of substantial uncertainty in the economic giant, which is experiencing its slowest pace of growth in nearly five decades amid its ongoing dynamic zero-Covid policy (ZCP) and significant stresses in its property sector. Whether President Xi will use his further consolidation of power to shift China's policy focus to supporting economic growth rather than the goals of "common prosperity" and environmental and national security that have increasingly characterized his leadership—and the economic and market implications if he does or doesn't—is Top of Mind.

We first turn to several China watchers for insight on the closed-door Congress itself, and what signals to watch for that could indicate a policy inflection ahead—the Asia Society Policy Institute's Center for China Analysis, led by the Honorable Dr. Kevin Rudd, UC San Diego's Susan Shirk, and the Jamestown Foundation's Willy Lam. They explain that even as Xi is expected to retain his role as General Secretary, the composition of the new Politburo Standing Committee (PSC)—the most powerful decision-making body of the Party, helmed by Xi (see pgs. 6-7 for more detail on China's power structure and its factions)—will be telling; the more this historically 7-9 member body is dominated by Xi's faction, the more influence Xi presumably has been able to wield in leadership decisions, and the more likely policy will remain closer to the status quo.

But even if Xi dominates the PSC leadership selection as expected, will China's economic challenges compel him to shift policy priorities in the near term and/or beyond? The Asia Society, Lam, and Hui Shan, GS Chief China economist, think the answer is largely no. The Asia Society expects ideology—not economics—to continue driving China's policy. And, near term, Shan sees little shift in the dynamic ZCP until at least 2Q23 due to political and medical considerations, doesn't envision the property sector receiving much more support given the still relevant "housing is for living in, not for speculation" mantra, and expects declining—not rising—fiscal support given a continued focus on minimizing financial stability risks. Even more fundamentally, Shan expects the leadership to increasingly embrace a new economic development model that prioritizes goals other than economic growth. This, along with China's demographic headwinds, she says, suggests China's growth challenges could persist well beyond 2023.

David Li, Professor at Tsinghua University, is more optimistic about China's near and longer-term growth outlook. He argues that the Party Congress will quietly usher in a reprioritization of economic goals given the rising risk that the growth slowdown poses to the Party and to the country, which he says could soon overwhelm virus-related risks. He therefore expects a shift in the ZCP potentially as soon as the end of this year, but no later than early March, a winding down of the two year-long crackdown on tech platforms—which Shirk agrees with—and increased incentives for—and support of—local and all other levels of government to support businesses through China's unique "government and economics" paradigm that sees an increased role for government in the economy, which he believes is a new and better version of the modern market economy. And longer term, Li makes the case that despite China's demographic trends that seem growth-negative, a growing *healthy and educated* population that is hungry to catch up with the West should extend China's economic miracle for at least another decade or two.

Beyond the broad economic question, we also dig into whether policymakers are likely to shift their stance on addressing the severe stresses in the property sector, and the implications for long-held concerns about the stability of China's highly leveraged financial system. As Shan doesn't expect the property stance to change, Kenneth Ho, GS Chief Asia Credit Strategist, sees more defaults of Chinese property developers ahead. But he believes that stresses in the sector probably don't pose systemic risk to the country's financial system—a view that Li broadly shares. And GS China economist Lisheng Wang discusses the new steps Chinese policymakers are taking to contain such risks. All that said, Ho is closely watching two areas to assess the ultimate degree of risk—construction funding and the solvency of small banks that largely provide it.

Given all of the above, we then ask GS strategists whether investors can expect the Congress to mark an inflection point for generally hard-hit Chinese assets. Their answer is generally no, with further depreciation of the CNY over the near term, continued pressure on credit spreads, relative outperformance of select pockets of the equity market (although we remain overweight China broadly) that are aligned with strategic policies (and of China A shares vs. Offshore equities), and only a gradual normalization of short-term rates expected ahead.

But with tensions between Mainland China and much of the rest of the world running particularly high as President Putin's actions in Ukraine have increased focus on China's territorial ambitions and the pandemic and other factors have accelerated US and Western efforts to decouple from China, perhaps the most important question is whether the Party Congress could mark an inflection point in China's foreign policy, US-China relations, and China's role in the world more broadly.

Our external China watchers agree that Taiwan could be ever-more in focus ahead, as the Asia Society argues that Xi wants to achieve reunification by 2049, and Lam and Shirk point out that resolving the issue is one of Xi's main justifications for his third term. And while Shirk is watching for a potential improvement in diplomatic relations between the US and Mainland China following the imminent political events in both—and is agnostic about whether this could shift Xi's policy direction more broadly—Lam sees no signs of a meaningful détente in the relationship ahead, given Xi's overarching belief that "the East is rising, and the West is declining", and his intention to do everything possible to move the world in this direction. The Asia Society generally agrees, arguing that Xi is determined to be ready for a struggle with the US, and cautions that the next decade(s) will be dangerous ones.

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Interview with The Asia Society

We sit down with experts from the Asia Society Policy Institute's Center for China Analysis led by the Honorable Dr. Kevin Rudd—author of the recently published *The Avoidable War: The Dangers of a Catastrophic Conflict between the US and Xi Jinping's China* and former Prime Minister of Australia—to discuss the significance of the 20th Party Congress, and its implications for China's domestic and foreign policies. They argue that ideology—not economics—will continue to drive China's policy and its global ambitions.

The views stated herein are those of the interviewees and do not necessarily reflect those of Goldman Sachs.

Q: On October 16th, the Chinese Communist Party (CCP) will kick off its 20th National Congress. What's the significance of this event, and what aspects of it—that would have the most bearing on the future direction of China—are you watching most closely?

A: It's significant. Most importantly, this is the moment President Xi Jinping is set to secure an unprecedented third term in office, symbolically confirming his transformation of China into a state effectively under his personal control and potentially setting himself up to remain in power for life. More broadly, we're watching closely to evaluate how secure Xi really is, and how much more he will be able to entrench his control, in terms of how many of his most loyal acolytes he can successfully maneuver into the top leadership and positions of influence across the Chinese system.

Of course, Xi can't personally control every decision made in China every day, so an important objective of our Decoding the 20th Party Congress project is to closely track personnel changes in key positions across the system and evaluate the likely impact on policy areas. While Xi retains the final say on high-level decisions, these personnel selections could have a real impact on policy direction and implementation, especially in areas where ongoing uncertainty and debate exist on how to move forward—such as the economy. We're also keeping a close eye on the next generation of China's leadership, tracking rising stars and analyzing how they differ from current leaders and may impact policy and factional politics as they advance.

Q: Is this event more likely to mark a turning point in the direction of China and its place in the world, or a continuation of the status quo?

A: A bit of both. It will be a continuation of the status quo in the sense that Xi has already consolidated control over the Chinese system and its strategic direction, and not too much is likely to change in that regard. At the same time, as we noted, symbolically the affirmation of Xi continuing in power—along with whatever new ideological honorifics are bestowed on him and his "Xi Jinping Thought"—will be a highly significant moment domestically and beyond. Consider that Xi has been preparing for this moment politically for ten years now; once he has achieved it, he may feel even freer to pursue his strategic ambitions and secure his legacy in the pantheon of Chinese Communist Party (CCP) history by becoming the man to achieve such feats as reunifying with Taiwan.

Q: How have factors like China's slowing economy affected Xi's position? Has any serious dissent emerged that has affected his authority?

A: Some dissent has emerged, including some remarkably forthright articles over the last year critiquing Xi's policies. However, it is very hard to tell how much real resistance there actually is to Xi. Rumors of a serious split between Xi and Premier Li Keqiang on economic policy appear overblown, and there is no suggestion at present that Xi is at any risk of failing to get his way, let alone fall from power. But China's slowing economy is beginning to open Xi up to criticism in a new way. This makes Xi especially keen to ensure he has full control over economic policy, including by replacing Premier Li, Vice Premiers, and key economic and other policymakers primarily with his own loyalists at the Party Congress.

Q: More broadly, how did China go from opening up and embracing collective leadership under Deng Xiaoping to moving in the opposite direction today?

A: In the late 1970s, the Chinese leader Deng Xiaoping set aside the Marxist-Leninist orthodoxy of his predecessor, Mao Zedong, in favor of something more akin to state capitalism. Deng summed up his thoughts on the matter with characteristic bluntness: *Bu zhenglun*, "Let's dispense with theory," is what he told attendees at a major CCP conference in 1981. His successors Jiang Zemin and Hu Jintao followed his lead, rapidly expanding the role of the market in the Chinese domestic economy and embracing a foreign policy that maximized China's participation in a global economic order led by the United States.

Xi has brought that era of pragmatic, nonideological governance to a crashing halt. In its place, he has developed a new form of Marxist nationalism that now shapes the presentation and substance of China's politics, economy, and foreign policy. In doing so, Xi is now constructing theoretical castles in the air to rationalize decisions that the CCP has made for other, more practical reasons. Under Xi, ideology is now driving policy—not the other way around.

Xi has pushed politics to the Leninist left, economics to the Marxist left, and foreign policy to the nationalist right. He has reasserted the influence and control the CCP exerts over all domains of public policy and private life, reinvigorated state-owned enterprises, and placed new restrictions on the private sector. Meanwhile, he has stoked nationalism by pursuing an increasingly assertive foreign policy, turbocharged by a Marxist-inspired belief that history is irreversibly on China's side and that a world anchored in Chinese power would produce a more just international order.

Q: Given that context, do you expect any shifts in domestic policy post the Party Congress?

A: If Xi succeeds in getting his way at the Congress, he will accelerate his ongoing ambitions. This includes, at a fundamental level, his belief that China must be prepared for a multi-decade struggle with the US and the West. He will continue his efforts to make China economically and technologically self-reliant through "indigenous innovation," as well as selective decoupling to strengthen China's immunity to supply chain disruptions, especially in semiconductors. He will also persist in increasing his ideological control over the Party and the Party's control over all aspects of governance and life in China, including economic policy, as well as attempts to reengineer the culture, including through crackdowns on internet speech and cultural freedoms that he sees as dangerous avenues for Western liberalism to infiltrate China. Demographics will also be top of mind for Xi in his third term, and he'll keep trying to craft social and economic policy incentives that raise the country's birth rate.

Q: What about on the foreign policy front?

A: As we noted, Xi is determined to be prepared for a struggle with the US, and potentially a conflict over Taiwan, by being self-reliant, ideologically unified, and ready to fight. The fact is that Xi has a timeline for achieving the China Dream by 2035—when he will be 82—and achieving reunification with Taiwan by 2049. This means this will be an exceptionally dangerous decade(s), and that danger is likely to escalate in the late 2020s and early 2030s. The distinction between achieving independence and overt opposition to the US and its role in the world is already increasingly murky, and accusations that the US is seeking to "contain" its Chinese adversary can be used to justify ramping up conflict.

As for the China-Russia relationship that is also in focus, China's current alignment with Russia has already been strained, and the war in Ukraine is not in China's interests, though the likelihood that China would be willing to play a mediating role remains low. Ultimately, Xi would probably agree with Putin's vision of "the East" as engaged in a defining struggle with "the West" over the future of the world order. This means China and Russia have essentially the same goal.

Q: How does all of this fit into Xi's longer-term political and strategic vision?

A: Xi's economic policies are increasingly characterized by his personal interests in Party history, political ideology, and grand strategy—not economics. As the party apparatus increasingly asserted control of the economic departments of the state, China's policy debates on the relative roles of the state and the market became increasingly ideological. Xi also progressively lost confidence in market economics following the Global Financial Crisis of 2008 and China's homegrown financial crisis of 2015 that saw a bursting stock market bubble. His strategic orientation is pushing China away from the market despite the market being responsible for China's rise as a great power.

On foreign policy, Xi's ideology also emboldens him to take more decisive action on the world stage. In his Marxist-Leninist view, China's ultimate victory is guaranteed because the deep forces of historical determinism are on the CCP's side and the West is in structural decline. The CCP's code language for the last two decades that "China continues to enjoy a period of strategic opportunity" has meant to convey that China faced a low risk of conflict for the foreseeable future and thus could seek economic and foreign policy advantages while the US was bogged down elsewhere, especially in the Middle East. But in the wake of Washington's official labeling of China as a "strategic competitor" in 2017, the ongoing US-China trade war, economic decoupling, and hardening US alliances with Australia, Japan, South Korea, and NATO, the CCP is beginning to change its formal analytical conclusion about the strategic environment. That is likely to push Xi in an even more ideological direction, toward dialectical struggle.

Q: What poses the biggest risk to Xi's vision?

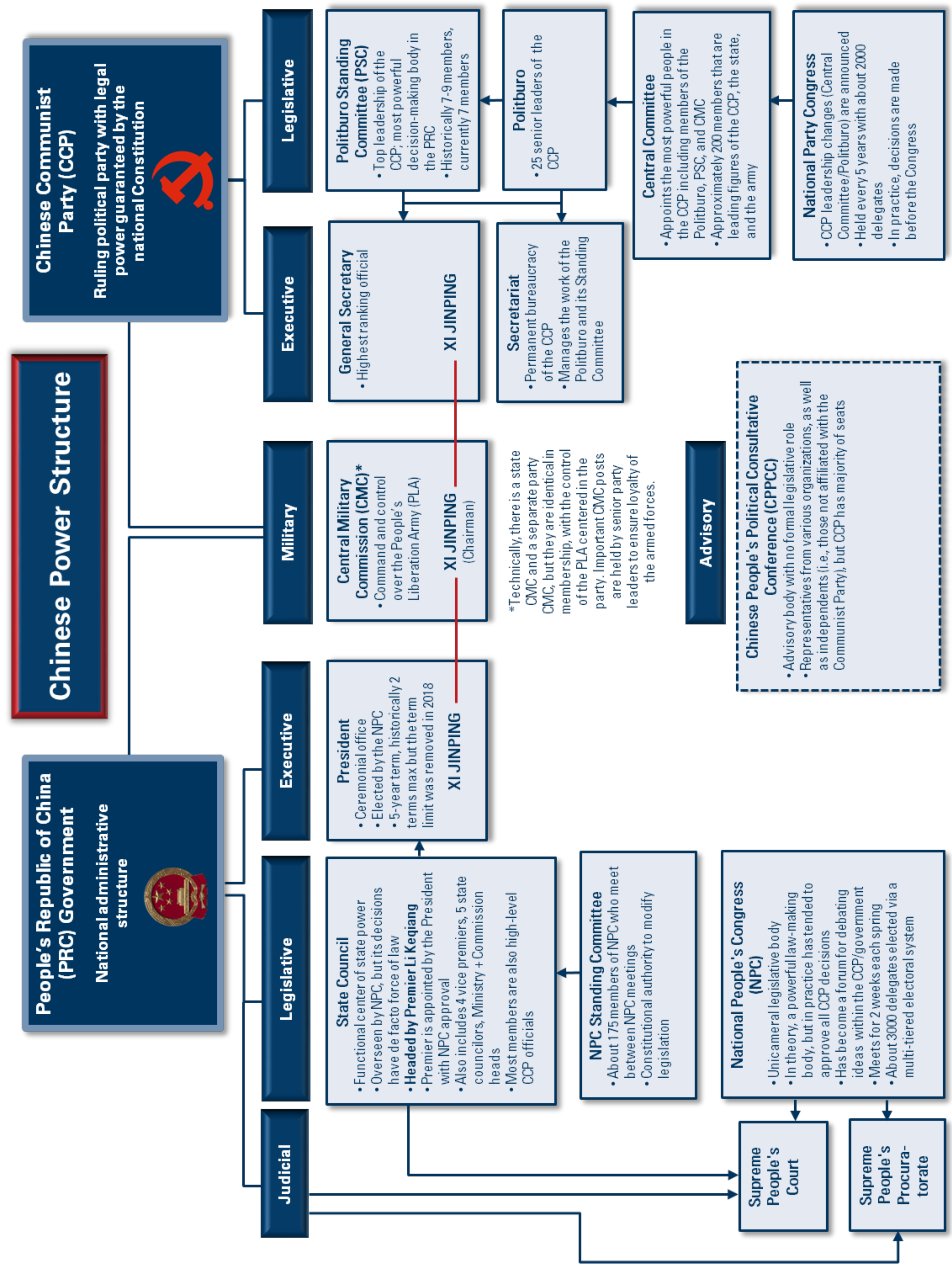
A: The real problem for Xi is that mismanagement of the economy could spur increasingly significant internal elite resistance within the CCP. There are essentially two sides in this debate. The first might be termed "Fortress China," led by Xi and his "Xi Jinping Economic Thought," which emphasizes the urgent need to prepare China for geopolitical competition by prioritizing economic and technological "self-reliance" and the Party-state's guidance of the economy, including through state-owned enterprises, industrial policy, and state subsidies. This also includes achieving "common prosperity" by reducing economic inequality.

A second group that could be called the "Reform and Opening" faction, however, feels that Xi's economic policies have—by rolling back market-based reforms, empowering the state sector, and limiting opening to international investment—only damaged private sector confidence, undermined productivity gains, and ultimately damaged China's economic prospects, resulting in rapidly slowing growth and threatening China's future as a superpower. Though they cannot be described as economic liberals, this faction would prefer to see a turn away from strident economic nationalism and toward more reformist and market-oriented policies. If officials who fall in this camp are unexpectedly successful at the Party Congress, they might have a chance of tilting China's economic policy toward the more reform and market-oriented approach. But, to reiterate, change at this scale is extremely unlikely. More likely, Xi will retain complete control over China's economic direction, which could well push it further into economic crisis.

Q: What outcomes of the 20th Party Congress would lead you to change your views on any of the above?

A: The composition of the Politburo and Politburo Standing Committee (PSC) will serve as a good indicator of Xi's actual standing, security, and control. We've considered some scenarios that would indicate Xi is in a less powerful position than expected. For example, if Wang Yang were to become Premier instead of retiring, or multiple members of Li's Communist Youth League Faction, such as Hu Chunhua, were to join the PSC at the same time. By contrast, if Xi's protégé Li Qiang replaces Li Keqiang as Premier and the PSC is packed entirely with Xi acolytes, like his close confidant Ding Xuexiang, it will show that Xi is even more powerful than we think.

The Chinese power structure



Source: Congressional Research Service, US-China Business Council, Congressional Executive Commission on China, iStockPhoto, Goldman Sachs GIR.

A look at the Politburo and PSC

Politburo Standing Committee (PSC)

The PSC includes the highest ranking officials in the Chinese Communist Party (CCP). There are currently seven members, at least two of whom are expected to retire. However, **the committee size has fluctuated over time, and could change again this year**.

General Secretary

The head of the Communist Party and highest ranking official in China. Historically, presidents have served a maximum of two five-year terms, but the term limit was abolished in 2018. **Xi is expected to stay in power for a third term, in a break with historical norms.**

Xi Jinping Age: 69 — **Li Keqiang** Age: 67 — **Li Zhanshu** Age: 72 — **Wang Yang** Age: 67 — **Wang Huning** Age: 67 — **Zhao Leji** Age: 65 — **Han Zheng** Age: 68

Politburo

Composed of 25 members, the Politburo is the chief political decision-making body in China. If traditional rules hold, officials over the age of 67 are expected to retire. The remaining members would be the primary candidates for the PSC. However, PSC members don't necessarily have to come from the Politburo.

Xi Jinping
Age: 69
General Secretary of the CCP, President of the People's Republic of China, Chairman of the Central Military Commission

Li Keqiang
Age: 67
Premier of the State Council

Wang Yang
Age: 67
Chairman of the National Committee of the Chinese People's Political Consultative Conference

Wang Huning
Age: 67
Primary Secretary of the CCP Central Secretariat, Head of the Central Policy Research Office

Zhao Leji
Age: 65
Secretary of the Central Commission for Discipline Inspection

Ding Xuexiang
Age: 60
Director of the General Office of the CCP

Li Xi
Age: 66
Party Secretary of Guangdong

Li Qiang
Age: 63
Party Secretary of Shanghai

Li Hongzhong
Age: 66
Party Secretary of Tianjin

Chen Quanguo
Age: 66
Deputy Head of the Central Rural Work Leading Group

Chen Min'er
Age: 62
Party Secretary of Chongqing

Hu Chunhua
Age: 59
Vice Premier of the State Council

Huang Kunming
Age: 65
Director of the Propaganda Department of the CCP

Cai Qi
Age: 66
Party Secretary of Beijing

Li Zhanshu, Han Zheng, Guo Shengkun, Wang Chen, Liu He, Xu Qiliang, Sun Chunlan, Yang Jiechi, Yang Xiaodu, Zhang Youxia, Chen Xi

Status

- Eligible to remain as PSC member
- Eligible for promotion
- Anticipated Retiree*
- Xi Jinping Faction

*Assuming the CCP adheres to the traditional "seven up, eight down" rule meaning that those over the age of 67 will step down from office, with the exception of Xi.
Source: Asia Society Policy Institute, Jamestown Foundation, www.gov.cn, Goldman Sachs GIR.

Interview with Willy Lam

Willy Lam is Senior Fellow at the Jamestown Foundation and is also affiliated with the Center for Asia-Pacific Initiatives, University of Victoria, B.C. Previously, he taught Chinese politics and international relations at the Chinese University of Hong Kong. Below, he argues that the 20th Party Congress will mark another step on President Xi Jinping's path toward extended rule and a continued restoration of Maoist values that focus on common prosperity, elevation of the state, and keeping China "red".

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Jenny Grimberg: What's the significance of the imminent Party Congress, and how would you compare the importance of this Congress to past Congresses?

Willy Lam: Every five years the CCP hosts a Party Congress comprised of around 2,400 delegates from the 95 million Party members. These delegates come to Beijing to endorse the leadership of the three most important decision-making bodies in the Party. They elect the 200-odd members of the Central Committee, who choose from amongst themselves the 25 members of the Politburo, who in turn choose the seven-person Politburo Standing Committee (PSC) that runs the country on a day-to-day basis.

This year's Congress is particularly significant because it will likely mark a major change to the Party Constitution, as well as to Party conventions and tradition, as President Xi Jinping—who has already been in power for two terms—seeks to revise the Constitution to enable himself to become the "people's leader for life". This implies that Xi would rule not only for an unprecedented third term, but also a fourth term, until the 22nd Party Congress in 2032 when he will be 79 years old, after which, health permitting, he might remain the power behind the throne even after he relinquishes his formal titles. Not since the era of Mao Zedong—who was considered a demigod and allowed to rule until his death in 1976—has this happened.

In the early 1980s, the "chief architect of reform", Deng Xiaoping, having lived through the chaos and ravages of Mao's Cultural Revolution, laid down very clear rules that no leader should be allowed to build up a cult of personality, imposing term limits of two terms of five years each, and establishing the institution of collective leadership, with power largely shared among PSC members and the General Secretary merely being the "first among equals". However, over his decade in power, Xi Jinping has successfully concentrated all decision-making powers into his own hands, to the point where he now towers over the other six members of the PSC. And the hold of Xi and his faction—who already dominated the 19th Party Congress five years ago—over the Central Committee, the Politburo, and the PSC will only be enhanced after this year's Party Congress. So, what we're about to witness goes against decades of tradition, as Xi continues in his role as the "Mao Zedong of the 21st century".

Jenny Grimberg: How has Xi been able to consolidate his power to such an extent?

Willy Lam: Xi does not seem to have expertise on finance, foreign trade, or global economics, and he speaks no foreign languages. But he is a master in power play, a Machiavellian type of leader who has effectively used the anti-corruption card since he came to power in 2012 to tame and intimidate his political enemies. Xi is also an expert in "palace politics", catapulting the Xi Jinping faction from virtual nonexistence to dominance over the CCP in just the span of a decade.

That's not to say that there's no opposition. The Communist Youth League Faction (CYLF) led by Premier Li Keqiang, as well as some Party elders, have voiced opposition to Xi Jinping's efforts to undermine Deng Xiaoping's reforms. Indeed, Song Ping—who, at 105 years old, is the Party elder of the Party elders—recently issued a thinly-veiled public warning that the only way forward for the Party and for China is to continue with Deng Xiaoping's reforms, not the resuscitation of quasi-Maoist policies that Xi embraces. But Xi's anti-corruption campaign has successfully silenced potential political rivals, many of whom have skeletons in the closet that are easily exploited. The opposition is also divided amongst themselves and have therefore been unsuccessful in uniting against Xi, which has given him a golden opportunity to monopolize decision-making, both on the personnel and policy fronts.

Jenny Grimberg: What does that mean for the composition of the new PSC? What are you watching closely?

Willy Lam: While retiring members of the PSC traditionally have the power to choose their successors, and Party elders also have a say, my informed speculation is that four out of the seven seats on the PSC will go to Xi Jinping and his loyalists—a solid majority. Of the three remaining seats, two will likely be filled by the CYLF, and one by a relatively independent senior cadre with no obvious factional affiliation.

Importantly, Li Keqiang, one of the two CYLF members currently on the PSC who represents the liberal wing of the Party, has now served two terms in the influential role of Premier—the administrative head of the central government. So, according to Party regulations, he must leave the position. With the credit he's earned over the past few months for handling difficult problems in the economy, Li may remain within the Standing Committee, but in a different capacity as Head of the National People's Congress—a position which doesn't carry much power on its own. So, all eyes are on his successor.

Vice Premier Hu Chunhua is the odds-on favorite to be promoted to Premier and succeed Li. While he also belongs to the CYLF and is believed to share Li's pro-market and pro-reform inclinations, he is no Li Keqiang—Hu spent 20 years in

Tibet building up his credentials as a loyal and pliable cadre, he doesn't speak English, and he hasn't traveled to the US or Europe much. So, he likely won't be as effective as Li in keeping a lid on Xi Jinping's restitution of Maoist values. Moreover, Xi's influence is also likely to dominate the personnel appointments of the larger 25-member Politburo and 200 odd-member Central Committee. All this is reminiscent of the Mao era, when the "Great Helmsman" ruled with nearly absolute authority.

Jenny Grimberg: So, you don't expect any meaningful shifts in policy after the Party Congress?

Willy Lam: No; a mixed approach to the economy will likely continue. Given Xi's embrace of Mao's statist, conservative policies, I expect a continued restitution of Maoist values, such as common prosperity, focusing the nation's resources on state-owned enterprises to the detriment of private enterprises, and keeping China "red", which means a China following the edicts of Marx, Lenin, and Mao. Xi has railed against the "color revolutions" he believes the US and other Western powers instigated to turn former Soviet states into capitalist ones and has warned that China must avoid such a fiasco.

At the same time, Xi has no choice but to continue with at least some of Li Keqiang's pro-market and pro-reform policies considering the country's difficult economic situation—unemployment has risen sharply to as high as almost 20% for the 16-24 aged population, formerly-successful high-tech firms are struggling to merely survive, and the real estate sector and banks are in crisis. These issues have led many forecasters to mark down their projected growth rates for China for this year.

Jenny Grimberg: Given these challenges, is a shift in the dynamic zero-Covid policy (ZCP) after the Congress likely?

Willy Lam: Some minor moderation of the policy is possible, such as restricting national lockdowns to just one province and one major city at a time. But I expect the main elements of the policy to remain in place until at least early next year, for both political and economic reasons. On the political front, Xi has used the policy as a litmus test for loyalty; going along with strict lockdowns has been a way for regional officials to demonstrate their loyalty to Xi, and those that don't may be demoted or fired. And on the economic front, the Chinese medical system has made billions from the strict quarantine measures, testing, and manufacturing of vaccines, which won't be easily given up.

Jenny Grimberg: What about on the foreign policy front? Is China's approach to the US most likely to become more or less friendly after the Party Congress?

Willy Lam: I don't see any signs that a meaningful détente between the US and China is ahead; on the contrary, relations could worsen. Xi probably realizes that China has to seek some kind of compromise with the US and its allies given the pain that's been inflicted on China's economy by Western efforts to decouple from China—including imposing boycotts on the supply of microchips and other components necessary for China's advanced tech sector. But the resumption of meaningful cooperation is unlikely given Xi's belief that "the East is rising, and the West is declining," and that those countries that effectively support Chinese-style socialism will end up on the right side of history. Xi is convinced that in the struggle between anti-Western, autocratic countries—China, Russia, and other members of the Shanghai Cooperation Organization (SCO)—and a US-led coalition, the anti-Western camp that is now centered around China will prevail, even though relations among SCO members are becoming increasingly fraught due to growing rivalries. China is also unhappy with the security pacts between the US, Japan, Australia, and India (the Quad) and between the US, Australia, and the UK (AUKUS). And the US has challenged China's territorial ambitions in the South China Sea—90% of which Beijing claims—by supporting ASEAN countries with competing claims. This all argues against even a temporary thaw in China-US relations anytime soon.

Jenny Grimberg: How is the sensitive issue of Taiwan most likely to evolve from here?

Willy Lam: Some observers have argued that because the Chinese economy and military—which put on a show of force that was perceived domestically as relatively weak following US Speaker of the House Nancy Pelosi's visit to Taiwan—still aren't able to challenge the US, Xi Jinping may have serious hesitations about using force to support the liberation of Taiwan. But two arguments run counter to this view. One, during WWII, Germany and Japan attacked much stronger countries, not because they believed they necessarily possessed an advantage on the battlefield, but precisely because they thought the window to victory and world domination was closing as their best days in terms of military equipment and economic resources were coming to an end.

Two, and this is not well-known, Xi Jinping has apparently justified his bid to become ruler for life by arguing that he is the only cadre with the expertise and knowledge to successfully liberate Taiwan, a feat which Mao himself failed to accomplish. While I don't expect any military action to this end during Xi's third term, in his fourth term he may think the window of opportunity is closing as the US-led alliance provides Taiwan with more potent means to fend off aggression from Mainland China. So, going forward, there's a real chance that Mainland China may adopt more aggressive and hawkish policies towards Taiwan, as well as the East and South China Seas.

Jenny Grimberg: If the Party Congress doesn't go as you expect what would that signal?

Willy Lam: I'm quite confident that Xi's faction can secure at least four seats among the seven member PSC, but if not, it would be a huge surprise and extremely telling. It would indicate that long retired but still highly respected Party elders and anti-Xi forces had managed to form a united front against Xi, which would probably signal the beginning of the end of Xi's dynasty. And it would mean that, despite the Party Constitution being revised to enshrine Xi as the "people's leader for life", cracks have emerged in his empire's armor, which would be a bad sign for Xi Jinping.

The price of China's new economic model

Hui Shan discusses the economic challenges China faces as it enters a new phase of economic development

The upcoming 20th National Party Congress carries special significance for China, partly as it is taking place at a time when the Chinese economy faces substantial cyclical and structural challenges. Cyclically, the Chinese government has yet to lay out a path to exit its dynamic zero-Covid policy (ZCP), and is struggling to achieve a soft landing in the property market. Structurally, the emphasis on Party control, common prosperity, and security and sustainability in many parts of the economy under President Xi's new development model has far-reaching medium- and long-term implications for China's economic growth, especially in the context of rising geopolitical tensions between China and the US. Together, this suggests that China's ability to maintain a relatively high growth rate going forward may be challenging.

Covid policy: a delayed reopening

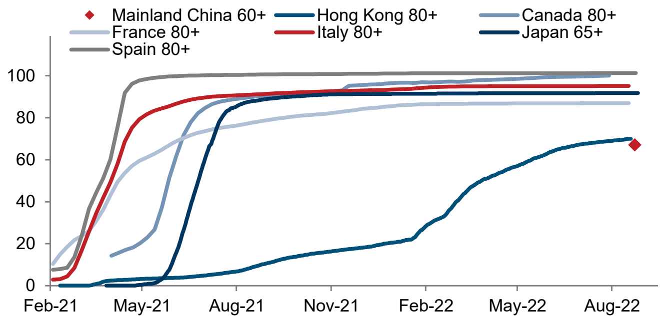
Even as most countries have embarked on the path to normalization after years of Covid-related disruptions, Mainland China has maintained its dynamic ZCP, which worked relatively well during the first two years of the pandemic, but has become more costly in the face of the highly-transmissible Omicron variant. Political considerations have certainly played a role in the decision to maintain the policy despite these rising costs. In a meeting with provincial-level officials to "welcome the 20th Party Congress" in July, President Xi emphasized Mainland China's Covid policy as one of the Party's major accomplishments, along with implementing the National Security Law in Hong Kong and continued anti-corruption efforts. It's therefore no surprise that the policy hasn't been shifted prior to the Party Congress.

However, significant medical considerations behind the ZCP make the completion of the 20th Party Congress a necessary, but not sufficient, condition for China's eventual reopening. Crucially, an orderly reopening requires sufficient protection of the elderly population via vaccinations. While most countries prioritized the elderly in their vaccination rollouts, China's elderly vaccination rate remains low. As of September 7, only 67% of the >250 million people aged 60+ in China had received three vaccine doses (three doses of China's domestic vaccines may be needed to achieve at least as much protection against hospitalization and death as two doses of mRNA vaccines, according to some medical research). For the 80+ age group—arguably the most vulnerable population—only 38% had received booster shots as of July. This, together with China's large population and relatively limited medical resources, especially in the less-developed inland regions, means that reopening in the near term would be both difficult and costly.

Instead, we expect China to begin reopening in 2Q23, after the Lunar New Year peak travel season and next March's Two Sessions, where the reshuffling of *government* officials (as opposed to *Party* officials at the 20th Party Congress) will take place. But even then, the reopening process is likely to be gradual rather than rapid, with certain restrictions to high-risk activities remaining in place for longer, and policies potentially re-tightening moderately should subsequent Covid waves prove severe. A full reopening of the border would also likely lag the easing of most domestic restrictions.

China's elderly vaccination rate is too low for an orderly reopening

Share of population with strong protection*, percent



Mainland China (three doses of Chinese vaccine), Hong Kong (two doses of mRNA vaccine or Chinese vaccine), Canada, France, Italy, Japan, and Spain (mostly two doses of mRNA vaccine).

Source: OWID, NHC, Goldman Sachs GIR.

Given these medical considerations, we would expect to see government preparations ahead of reopening. Signs that would indicate that the spring reopening we expect is on track would be renewed vaccination/booster campaigns (especially among the elderly), sufficient domestic production/supply of prophylactic drugs, an expansion of supplementary healthcare facilities such as field hospitals, and any changes to China's official Covid control guidelines or official communications to alleviate fears of Covid infection among the population.

Looking at the experience of other countries, we find a fairly consistent pattern of growth and inflation acceleration upon reopening. We estimate that China's current level of restrictions is suppressing the level of GDP by 4-5%. While much of this drag could be recovered on a full reopening, the experience of other economies suggests some permanent output loss. Moreover, based on evidence from places that previously had some version of a ZCP and subsequently reopened, China is likely to experience a surge in infections upon a full reopening given the lack of infection-induced immunity and Omicron's high transmissibility. Thus, we would expect no improvement in growth, or even a modest drag, in the first three months after reopening, with the biggest growth boost likely to occur from mid-2023 to mid-2024.

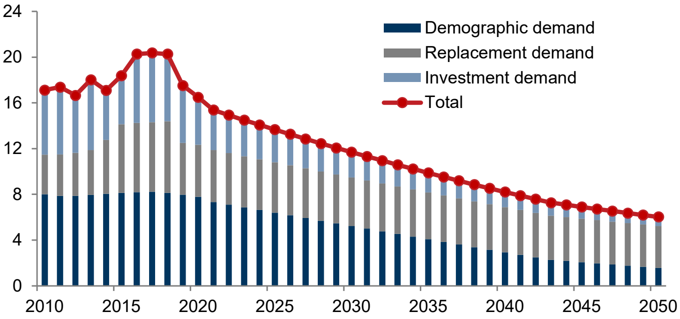
Property: houses are for living in, not speculation

The current property downturn in China is unprecedented in both depth and duration (see pgs. 18-19). Home sales have fallen to 2013 levels and housing starts to 2008 levels. Many property developers have defaulted on their liabilities, and "mortgage boycotts" have occurred in over 100 cities where borrowers who purchased pre-sold apartments threatened to stop paying their mortgages over fears that the property may not be delivered on time, or at all. We estimate that the real estate sector dragged down GDP growth by 2.6pp yoy in Q2 through its linkages to construction, consumption, local government land sales revenue, real estate services, and upstream sectors, such as steel and cement.

However, assuming President Xi secures a third term following the Party Congress, as widely anticipated by market participants, the "housing is for living in, not for speculation" mantra is unlikely to change. While the central government may continue to push banks to lend to the real estate sector and local governments may ease local policies further, we doubt that drastic measures such as abandoning all purchase restrictions, stimulating investment demand, and allowing property prices to rise sharply are in the cards. The latest news from Suzhou and Qingdao, both Tier-2 cities of around 10 million people each, is a telling example: home purchase restrictions were reimposed 24 hours after being removed. Fundamentally, China does not need to build nearly as many homes each year in the coming decades as in the previous few decades. Indeed, we estimate that the underlying demand for housing may fall from 18 million units per annum in 2010-2020 to only six million by 2050, so shrinking the real estate sector is the ultimate policy goal for top leadership. We therefore continue to expect a sizable drag from the property sector on GDP growth this year and beyond, which partly explains our below-consensus forecast of 4.5% for 2023 China GDP growth.

Housing demand will likely fall in the coming decades

Total demand for housing, millions



Source: Haver Analytics, Wind, Goldman Sachs GIR.

Policy stimulus: a conservative mindset

Fiscal support has played a central role in supporting growth this year as Covid and property have weighed on the economy. But we think the conservative mindset of controlling leverage and financial risks (see pgs. 20-21), "no flooding of easing measures", and keeping policy room for future downturns is unlikely to change after the Party Congress, and so we don't think a large stimulus package is in the cards. In fact, we think fiscal policy may turn into a moderate headwind, as we expect China's augmented fiscal deficit to contract by 2pp of GDP in 2023 after expanding by 3pp in 2022.

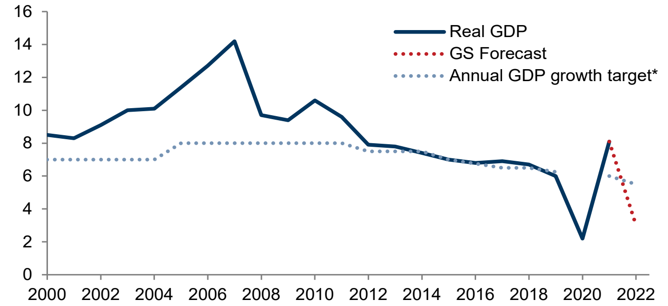
Growth: difficulties behind, and ahead

With economic growth faltering under the pressure of ongoing Covid lockdowns and further deterioration in housing activity, policymakers have downplayed the "around 5.5%" growth target they set at the beginning of the year. Although this will be the first year China misses its official growth target by a large margin (our 2022 real GDP growth forecast is 3%), achieving growth targets was proving increasingly challenging even before the Covid pandemic. In the 2000s and early 2010s, realized growth was robust, as China's rapid urbanization created strong demand for property and infrastructure investments and China's entry into the WTO unleashed its manufacturing and export power on the world. Such tailwinds, however, waned after the mid-2010s. Moreover, macro leverage expanded dramatically after the 2008-09 and 2015-16 easing cycle, leaving less room for policy easing that would increase the economy's already high debt levels.

This difficulty in maintaining a relatively high pace of economic growth is likely to continue over the medium to long term, for several reasons. One, China's demographic picture does not look encouraging (see pg. 26). Birth rates have fallen on the back of 25 years of the "one-child policy", and even after the government relaxed the policy in 2016 ("two-child policy") and again in 2021 ("three-child policy"), the downward trend continued—2021 may very well mark an overall population peak. Two, with property investment poised to decline and returns on infrastructure investment falling, the historical speed of capital accumulation will be difficult to maintain. And three, as tensions between the US and China continue to intensify, especially around high-tech areas, China's future pace of productivity growth looks increasingly uncertain.

China will likely miss its official growth target by a large margin

Percent change, yoy



**No official growth target was publicly set in 2020; 2021 target was "above 6%".*
Source: Wind, Goldman Sachs GIR.

A new economic development model

In 2000, China's per capita GDP was only around USD2k (real 2015 USD), compared to a global average of almost USD8k. At that point, Chinese policymakers' focus was squarely on economic growth. Fast forward to 2021, and China's per capita GDP reached USD11k, exceeding the world average for the first time in modern history. So, policymakers may now have somewhat different objectives as China enters its next stage of economic development. Indeed, President Xi has called for "understanding the new development stage, applying the new development philosophy, and creating a new development dynamic"(把握新发展阶段，贯彻新发展理念，构建新发展格局).

The key features of this new development model include ensuring Party control, common prosperity, environmental protection, and enhancing security. On common prosperity, the official plan is to make concrete progress in narrowing income and consumption gaps among households by 2025, to make material advancements and provide equal access to basic public services by 2035, and to ultimately achieve common prosperity by around 2050. And on security, the emphasis on food security, energy security, supply chain security, water security, financial security, internet and information security, and ecological security is loud and clear. While focusing on goals beyond economic growth is certainly justified—after all, policymakers around the world are increasingly focused on environmental and social challenges—this shift in focus to pursue other goals implies slower economic growth—a price China's leadership seems willing to pay for safer and more sustainable economic development over the long run.

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Interview with David Daokui Li

David Daokui Li is Professor of Economics and the founding Dean of the Schwarzman College at Tsinghua University. He is a former member of the Monetary Policy Committee of the People's Bank of China and the Chinese People's Political Consultative Committee. Below, he says that China's 20th Party Congress will usher in a reprioritization of economic growth goals.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: As the Chinese Communist Party (CCP) begins its 20th Party Congress, is China's economic miracle ending?

David Li: No. If you define China's economic miracle as a sustained period of moderately fast growth, then the miracle should continue for at least another decade or two because the recent sharp slowdown in growth owes primarily to two factors that are soon set to reverse—the dynamic zero-Covid policy (ZCP) and the leadership's recent prioritization of goals like social stability and environmental protection at the expense of economic growth. The 20th Party Congress is an occasion not only for leadership changes, but also for policy changes, and one of the most fundamental policy shifts will be to refocus on economic growth as a top priority. Beyond this important shift in priorities is the fact that China remains a country full of hard-working savers who are hungry to improve their quality of life and have the capacity to do so, with 10 million college graduates per year, 40% of whom major in engineering. This ambition and talent should continue to drive relatively strong growth, as the Chinese economy increasingly catches up to the technological successes of Western countries.

Allison Nathan: China's dynamic ZCP seems to be driven by a concern that a broader reopening would lead to an unacceptable number of fatalities given China's large and relatively unprotected population, so why do you expect a shift in the ZCP shortly after the Congress?

David Li: The ZCP will shift potentially by the end of this year but no later than early March when the new government is installed, because it's a matter of risk management. In the run-up to the Party Congress, China's leadership has worried about the health consequences of broader reopening and the possibility—while small—of an explosion of a virulent strain of the virus that would exacerbate any underlying social discontent. So, the leadership closely managed the health risks at the expense of growth. But once the leadership succession is in hand, policymakers will likely shift to managing economic risks over health risks because without a shift in the ZCP, economic and social risks could mushroom and become a bigger threat to the country than the virus.

Allison Nathan: Doesn't the renewed focus on economic growth that you expect conflict with President Xi's stated emphasis on quasi-Maoist values that prioritize common prosperity and enhancing security over economic growth?

David Li: No. As the Party rank and file assesses at the Congress its policies over the past five years and what policy should look like over the next five or ten years, I believe they will easily come to a consensus that the economy should be supported in order to resume a reasonably fast pace of growth. That's because without such growth, none of China's domestic social problems or international challenges can be mitigated. For example, many local governments in China are facing a rare shortage of tax revenue that is threatening their ability to pay year-end bonuses to teachers and other civil servants. If slowing economic growth continues to force this type of belt tightening, there is little doubt that social discontent will eventually rise. So, I strongly believe that after the Party Congress, a major and fundamental—though not necessarily high-profile—shift in economic policy will take place.

Allison Nathan: What form could this shift in economic policy take, and will it include market-oriented reforms?

David Li: The policies will be pro-market, but consistent with China's interpretation of a "market economy" rather than the US' interpretation. In the US, "pro-market" implies that the government steps away and allows the private sector and market forces to determine economic outcomes. In contrast, "pro-market" policies in China entail a *greater* role for all levels of government in supporting businesses and markets, which I call a "government and economics" paradigm. This paradigm, or model, is a new and better version of the modern market economy and should be more widely emulated in the US.

In practice, implementation of this policy shift will take three forms. One, providing greater government support to private investors and entrepreneurs via less taxation, regulation, and other measures that make it clear that these businesses have a place in the socialist economy and on the common prosperity agenda. Two, a tapering of the recent regulatory crackdown on internet platforms. And three, making economic growth a major KPI of local governments once again. In recent years, local government officials have been primarily assessed on social stability, pollution control, and Covid control. Going forward, I expect their performance to be increasingly assessed on GDP growth, tax revenue, employment, price stability, etc., as was the case in prior years of robust economic growth.

Allison Nathan: The crackdown on tech platforms has been a major focus of the leadership, so why is it set to end?

David Li: China's leadership embarked on the campaign to regulate tech platforms because it was worried that these platforms were interfering with—and having undue influence on—political and social issues, similar to the US Congress' concerns over Facebook. But this campaign is now ending because, after two years of tight regulation, policymakers no longer believe that these platforms are powerful enough to rock the boat of the current, exceptionally powerful, leadership. At the same time, the costs of this regulation—or overregulation, in my view—have been high, potentially forcing a wave of layoffs in the high-quality tech sector if they continue. So, I expect a greater tolerance of these platforms that are sources of dynamism and innovation in the Chinese economy ahead.

Allison Nathan: Are you concerned that the downturn in the property sector has substantially weakened local governments, and their ability to drive economic growth?

David Li: The downturn in the property sector owes to two separate problems—a short-term problem and a long-term problem. I am not very concerned about either, but the longer-term issue and its implications for local governments will be more challenging to navigate. The short-term problem stems from large property developers, who are generally entrepreneurial in nature, diverting funds they received from homebuyers and banks that were supposed to be used to complete property projects towards other, higher-yielding endeavors—whether that be new property developments, making movies, building lithium battery factories, etc.—many of which have failed. So, the homebuyers who prepaid for their apartments but haven't received them are understandably upset and, in some cases, have participated in public demonstrations and/or boycotted their mortgage payments. At the same time, tighter restrictions on developers to rein in an overleveraged property sector, combined with plummeting confidence in them, has led to substantial distress/defaults in the sector, which has had negative, knock-on effects for the banks that lent to them. So, this is a difficult and complicated situation. All that said, I am not too worried about this problem because the number of distressed developers is relatively small and the central government has set aside a sum of money on the order of $100 billion to address this problem, which is small relative to the roughly four trillion of new Chinese bank loans each year.

The longer-term problem facing the property sector is that, while China's still relatively fast pace of economic growth is leading to population growth in some cities, other cities are no longer attracting, and even losing, population. The cities that are gaining population by offering attractive jobs, like Beijing, Shanghai, and Shenzhen, are still experiencing increases in land values, and the governments of these cities can sell land to bolster their tax revenues—something that has been frowned upon in the past as it was viewed as contributing to a property bubble but can be done in the future. But the cities that are losing population are experiencing property and land price declines, which means a structural decline in government revenues that could become increasingly problematic in coming decades. This worries me, but I don't think it will amount to an economy-wide crisis, like the US subprime mortgage crisis, because China's high savings rate and different social and economic structure suggest extended families will use their savings to support each other. So, this problem will undoubtedly be painful for households and declining cities, but ultimately manageable, and will not spill over to the financial sector. I also expect a more intense system of transfer payments from the central to local governments following the Party Congress that will help support these local economies.

Allison Nathan: Are concerns about the high levels of debt in the Chinese economy justified?

David Li: No. Again, the Chinese economy benefits from a high savings rate, and these savings can easily be used to finance its debt. This situation stands in sharp contrast to the US, where the US must rely on international investors to finance its huge debt load. So, I don't worry about China's debt levels overall, but I do worry that the wrong policies are in place to deal with this debt. I've long argued that a large share of the high local government debt—which I estimate is about 100% of GDP compared to central government debt of at most 25% of GDP—should be transferred to the central government, for several reasons. One, the central government can borrow at much lower interest rates than local governments. Two, reducing the debt overhang of local governments will allow them to invest and consume more, which will boost growth. And three, the appetite for RMB debt issued and backed by the Chinese central government would likely be large because the RMB is still a reasonably good hedge against the US Dollar and would provide a useful diversification tool for foreign investors.

Allison Nathan: If debt levels aren't a concern, is another large fiscal stimulus to support growth likely?

David Li: I don't expect a bigger fiscal stimulus ahead because a substantial stimulus program is already in place; this year's fiscal deficit will be on the order of 5-7% of GDP, and anything much larger would be unacceptable since the Chinese policy community has been very averse to big deficits. However, I believe that the implementation of the fiscal stimulus could shift. Currently, stimulus is largely implemented through corporate tax cuts. But this approach is not very effective in boosting growth because the businesses struggling the most are too small to pay taxes. Directly subsidizing the income of poor households, like the US has done, would be a more effective way of boosting consumption and growth. I believe that this type of shift in approach to stimulus could happen before too long.

Allison Nathan: Longer term, are you concerned about demographic headwinds to growth given some forecasts that the Chinese population will peak this year?

David Li: No; I don't think demographics will be a major problem for the Chinese economy. First of all, the UN report that forecasted a near-term peak in the Chinese population was likely too pessimistic. Couples have been extremely cautious about having children during the pandemic, and this caution is likely to subside alongside Covid fears. But, more broadly, I have found that the fundamental driver of economic growth is not pure population growth, but rather growth in human resources—the healthy population multiplied by the average level of education. This makes intuitive sense; if pure population growth was the key driver of economic growth, countries with huge young populations fifty years ago like China and India should've grown more rapidly. They didn't because growth depends on the quality of the population. We calculate that China's healthy population is still growing, as is its average education levels. So, we estimate that China's human resources won't peak until 2050. That said, Chinese society should make better use of its healthy and educated population, for example by implementing flexible retirement policies so that healthy, productive people can work for longer. But as I said before, the Chinese population is increasingly better educated and economically ambitious, and that is the key reason why China's economic future remains bright.

Interview with Susan Shirk

Susan Shirk is Chair of the 21st Century China Center and research professor at UC San Diego. She is the author of numerous books on China, including her latest book—*Overreach: How China Derailed its Peaceful Rise*. Shirk served as Deputy Assistant Secretary of State in the Bureau of East Asia and Pacific Affairs from 1997-2000. Below, she argues that the overreach of China's leadership poses the biggest risk to the country's future.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: What's the significance of the imminent Party Congress?

Susan Shirk: I'm sure I'm not the only person of my generation who hears "20th Party Congress" and right away thinks of the 1956 20th Congress of the Communist Party of the Soviet Union, during which First Secretary Nikita Khrushchev delivered his "Secret Speech" that criticized Joseph Stalin's overconcentration of power. That speech officially kicked off de-Stalinization in the country and had tremendous reverberations for all communist countries. But China's 20th Party Congress will not be one of renouncing centralized leadership. Quite the opposite—it will confirm President Xi Jinping's authoritative leadership and intention to remain in power indefinitely. This marks a major turning point for the Chinese political system because it clearly marks an end to Deng Xiaoping's effort and dream of creating a resilient, institutionalized communist system of governance for China.

Allison Nathan: How did China get to this point?

Susan Shirk: It depends on what you mean by "this point". The Mao-like cult of personality around and centralization of leadership was established by Xi when he came to power a decade ago after the 18th Party Congress. Before then, China had an oligarchic system of leadership—Hu Jintao, Xi's predecessor, was a relatively weak leader on his own and the Politburo Standing Committee (PSC) had nine members, each of whom was responsible for his own stovepiped set of bureaucracies and sectors. But collective leadership under Hu and Wen Jiabao, Premier at the time, was highly corrupt, paving the way for Xi to dismantle it. But, somewhat counterintuitively, the shift in China's policies towards more domestic repression and international aggression dates back to the era of collective leadership, and Hu's second term more specifically. Whether such problematic policies will persist going forward remains to be seen, but the more concentrated form of Party leadership Xi established probably will.

Allison Nathan: How has Xi pulled off such a concentration of power, and what has that meant for policy?

Susan Shirk: Almost immediately after assuming the position of General Secretary in 2012, Xi Jinping launched an anti-corruption campaign. This was consistent with a broad consensus among the leadership as well as the ordinary public that reform to rid the country of corruption was needed. But the implementation was notable; the campaign was massive—an estimated four million officials were punished, including 500-1000 very high-level officials. This far-reaching campaign, combined with a fetishization of loyalty, has bred a culture of overreach, because subordinate officials are not only competing to remain unpunished, but also to be promoted, so policies are often overdone to please the leadership. In this culture of personalistic leadership, information feedback loops also fail, because subordinate officials are not incentivized to inform the leadership about the costs and downsides of China's policies. Xi relies on a close circle of loyal advisors for decision-making, and no longer delegates authority to the State Council or to technocrats in the government, even over economic policy. All this together has resulted in the implementation of policies that have proven harmful to China. The Chinese economy is on the ropes not just because of secular and demographic headwinds; China's own policies have played a large role.

Allison Nathan: What implications could that have for Xi's grip on power, and might those force him to shift policy?

Susan Shirk: This moment in time is a very unusual one in China's political history. Ever since Deng Xiaoping's Era of Reform, investors, businesses, and governments around the world have taken for granted that Chinese leadership would be pragmatic in the cause of economic development to improve the living standards of China's people so that they would continue to support Communist Party rule. And when the leadership ran into problems, it turned to the technocrats and used modern economics, technology, and every means possible to keep the economy humming along.

That's all changed now. China's leadership is harming the country's economic development, and doing so on the eve of a leadership transition. As my colleague Barry Naughton has highlighted, Xi Jinping has disrupted the political business cycle by not doing everything in his power to have a positive economic backdrop heading into the leadership transition. Will that prevent him from securing a third term? Probably not, because the Central Committee is packed with loyalists, who, even if they wanted to rebel, have very little ability to coordinate their actions. But it will almost certainly hurt Xi's popularity among the Party elite and the general public. A 20% youth unemployment rate and a downturn in the property sector that could ravage the savings of much of the middle class doesn't come without political consequences.

So, Xi has to do something after the Party Congress; the question is what. He could make a course correction in the policy process and/or actual policies, which is conceivable if the pragmatic gene of past leaders still lies somewhere inside Xi Jinping. Or he could shift the basis for legitimacy from economic development to hard, anti-foreign nationalism, which he's already done to some extent, but could do even more so.

Allison Nathan: Could domestic policies like the ZCP and private sector crackdown shift after the Congress?

Susan Shirk: Yes, because both policies have been very costly. Massive resources have been expended on testing, forced quarantining, and lockdowns under the ZCP—which has also inflicted a large hit to economic growth—and officials can't pay that price forever. The transition to more flexible Covid management, which would require mass vaccinations, will be difficult, but resources can be diverted from ZCP efforts to vaccination campaigns, as has occurred in many countries. Xi will also likely back off the private sector after the regulatory storm he unleashed on the platform economy and beyond last year, which was arguably one of the most blatant forms of overreach. The leadership continues to fear the power of the private sector and its ability to organize, but China needs it as an engine of employment and growth. Still, it will be hard for Xi to rebuild trust with private sector entrepreneurs.

Allison Nathan: As Xi potentially pivots to more aggressive nationalism, how might the issue of Taiwan evolve?

Susan Shirk: Taiwan is the focal point of Chinese nationalism as the irredenta issue above all, but two factors may encourage some restraint on Mainland China's part. One, a widespread belief in Mainland China exists—true or not—that any leadership that tries and fails to forcefully resolve the Taiwan issue will be brought down and replaced with other leadership, and maybe even with another form of government. And two, the international community's response to President Putin's war on Ukraine probably encourages greater prudence on the part of any Chinese leader. That said, there's another prevalent belief that Xi wants to achieve reunification with Taiwan during his third term, and that that's the justification *for* a third term.

The goal of reunification is understandable. And at one point some form of loose reunification might have been achieved in a peaceful manner—after Ma Ying-jeou became President of Taiwan in 2008, Hu Jintao took concrete steps to thaw relations between the two sides and pave the way for more economic integration. But the massive military exercises Mainland China staged following US Speaker of the House Nancy Pelosi's visit to Taiwan has probably dissuaded the Taiwanese public from favoring reunification any time soon. And Xi recently issued a whitepaper on Taiwan dropping the long-held promise that Mainland China would not base any military forces or government administrative personnel in Taiwan should the two decide to reunite peacefully. So, Xi has all but shut off the path to peaceful reunification[1], yet another example of overreach.

Allison Nathan: What about relations between China and the US? Could evolving relations impact China's policies?

Susan Shirk: It will be critical to watch whether the Biden Administration makes a renewed push towards diplomatic engagement with China after the US midterm elections. Largely as a result of Xi's overreach, the bipartisan consensus in the US is sharply negative towards China, which has led to a dangerously unbalanced US approach towards China focused solely on sanctions and military pressure. I'm all for military deterrence and preparation, but where is the diplomatic engagement? Good old-fashioned diplomacy has been missing for six years, but it could return after the midterms.

Whether renewed diplomatic engagement would lead to a change in China's policies is an open question; we've not actually tested it during the last six years. I am genuinely agnostic about whether the US can influence China to move in a more moderate direction in some areas like the South China Sea and economic policy. Much will depend on if Biden and Xi can meet face to face. Biden has more experience with Xi than any previous US president—they spent a lot of time together as vice presidents. So, there's a foundation to build on.

Allison Nathan: You blame a lot of the current tensions on Xi's overreach, but shouldn't the US share the blame?

Susan Shirk: There is no doubt that while Xi is overreaching, the US is overreacting. And by embracing policies aimed at harming China, the US will only harm its own competitiveness, ability to attract global talent, and ultimately its own economy. I'm hopeful that another path can emerge that sees more debate around the costs and benefits of US policies and a moderation of our own actions towards China.

The biggest challenge for the diplomacy of the US and other major countries towards China is convincing China that we are still open to having China as a responsible global power, and by showing more restraint, especially in its foreign policy, the influence and global standing of China will only grow. In that environment, I believe the US approach to China would moderate. Again, I will be closely watching how policy in both the US and China evolves post the upcoming political events in both countries to see how likely we are to move down that alternative, less confrontational, path.

Allison Nathan: Would any composition of the PSC after the Congress signal a more moderate path lies ahead?

Susan Shirk: A more balanced leadership would increase the likelihood of moderation in China's policy stance. If, for example, Wang Yang, a reform-minded leader not from Xi's faction, becomes Premier, or current Premier Li Keqiang remains on the Standing Committee, that would indicate a greater potential for moderation. That said, if Xi instead lowers the mandatory PSC retirement age from 68 to 67 to remove Wang and Li, who are both 67, from the PSC—which is at least just as likely—and fills their positions with loyalists, that would be a very pessimistic sign for a moderation in policy.

Allison Nathan: What poses the biggest risk to Xi achieving his vision for China?

Susan Shirk: While the US is not blameless, and US actions have been costly to China, the overreach of China's leadership presents the biggest risk to China as we know it today. The middle class is a real wild card for China's future. Do Chinese students and their parents really want a curriculum that is increasingly ideological and involves less English-language learning? Will the country really benefit from these and other policies the leadership has implemented? Time will tell, but I'd say the future of China faces real dangers from this overreach.

[1] Editor's note: In an August whitepaper, Mainland China officially reiterated its preference for peaceful reunification, but did not rule out the use of force as a last resort.

Who calls the economic shots?

CHINESE COMMUNIST PARTY (CCP)

China's single political authority led by Xi Jinping, General Secretary.
Key responsibilities: Sets economic and financial priorities. Influences financial institutions' personnel decisions and activities.
Structure: Party Congress (2,300+ delegates), Central Committee (200-300 members), Politburo (25 members) and its Standing Committee (7 members—the top leaders).

"Leading groups" advise the Politburo on various issues

Central Leading Group for Financial & Economic Affairs
Sets broad direction of economic activity

Central Leading Group for Deepening Overall Reform
Advises on reform initiatives

Central Discipline Inspection Commission
Spearheads anti-corruption campaign

Central Economic Work Conference
Annual meeting, usually in December, for Central Committee members (who include key officials from the various entities on this chart) and other senior leaders to translate CCP priorities into a policy agenda

Chinese People's Political Consultative Conference

Advisory body led by Wang Yang, Chairman.
Key responsibilities: Consults on political decisions, advises on wide-ranging topics, supervises government. Issues proposals to CCP, NPC, State Council.
Structure: A national committee (~2,00 members incl. standing committee) and local committees (totaling 600,000+ members). Members are appointed.

GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

National People's Congress (NPC)

Unicameral legislature led by Li Zhanshu, Chairman.
Key responsibilities: Debates legislation. Enacts and amends laws. A powerful body in principle, but tends to approve CCP decisions in practice.
Structure: ~3,000 delegates elected for 5-year terms; includes a 175-member standing committee that handles most legislative issues throughout the year.

State Council

Highest government body led by Li Keqiang, Premier.
Key responsibilities: Implements laws, drafts legislation for the NPC, and issues regulations directly. Oversees a wide range of administrative organizations. Handles most day-to-day economic management decisions, including on key policies such as interest rate limits.
Structure: Premier, four vice premiers each with distinct areas of focus, state councilors, various ministry and commission heads, auditor-general, and secretary-general.

National Development and Reform Commission (NDRC)
Top economic planning body at the ministry level; develops 5-year plans
Allocates key domestic and overseas investments

Ministry of Finance (MOF)
Handles fiscal policy and administers national budget
Oversees government bond issuance

People's Bank of China (PBOC)
Implements monetary policy, sets CNY fix
Charged with ensuring financial stability and managing systemic risk
Can serve as lender of last resort

China Banking and Insurance Regulatory Commission (CBIRC)
Regulates and supervises banking and insurance institutions in China and their market conduct

China Securities Regulatory Commission (CSRC)
Regulates securities firms, investment funds/banks, and exchanges
Maintains securities and futures market order

Financial Stability and Development Committee (FSDC)
To strengthen financial regulatory coordination and supplement regulatory shortcomings

National Bureau of Statistics of China (NBS)
Responsible for collection, investigation, research, and publication of statistics

Ministry of Industry and Information Technology (MIIT)
Responsible for administration of China's industrial branches and information industry

Ministry of Housing and Urban-Rural Development (MOHURD)
To guide planning and construction of rural and urban areas in China

Ministry of Commerce (MoC)
Formulates foreign trade policy, export and import regulations, and foreign direct investments

Other entities not listed here play critical roles in economic decision making.

Ministry of Ecology and Environment reviews infrastructure and other investments

The **State-Owned Assets Supervision and Administration Commission (SASAC)** supervises SOEs

Source: China State Council, Goldman Sachs GIR.

China's property woes

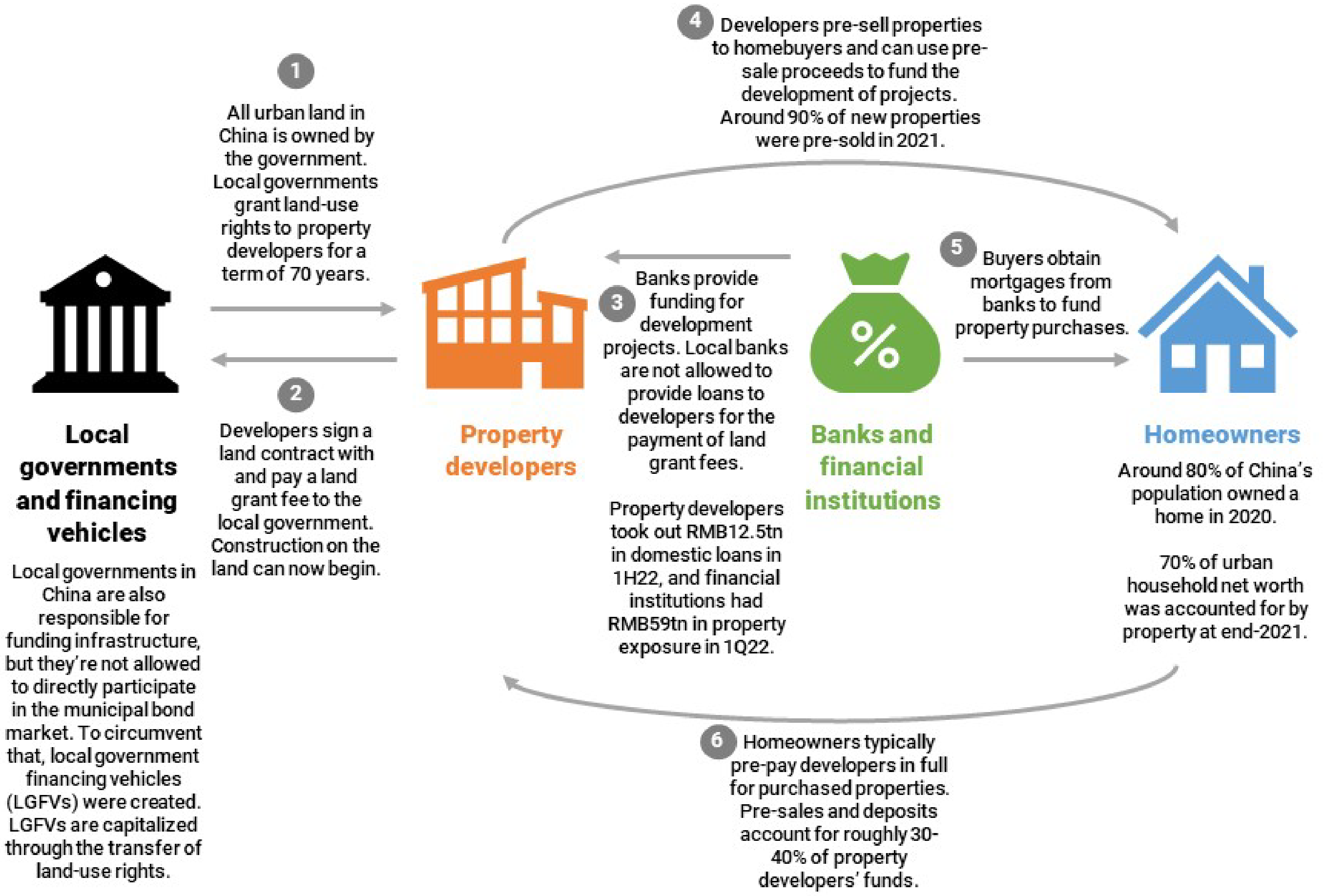
What's going on?

China's property sector has long served as an important engine of growth for the economy. As the country urbanized over the past few decades and household incomes grew, housing construction increased at a double-digit annual pace in the 2000s and even faster after the Global Financial Crisis, when policymakers eased policy to counter downside pressures from abroad.

This growth, however, came at the cost of higher leverage. To stem that and prevent it from negatively affecting the economy, in 2020, Chinese regulators imposed "three red lines" on developers—criteria they must meet to apply for financing: (1) a total liability to asset ratio below 70%, (2) a net gearing ratio below 100%, and (3) a cash to short-term debt ratio >100%. Constraints were also imposed on individual banks' property lending.

Credit conditions tightened sharply as a result, leading to a large slowdown in activity levels in the property sector. Completions fell as developers struggled to obtain financing, and homebuyers—who typically fully pre-pay developers for homes—started refusing to pay mortgages on homes that had yet to be delivered, putting further pressure on developers, and on the banks and local governments with exposure to them.

How does China's property market work?



The crisis in numbers

- **28%** YoY decline in property sales (RMB8.6tn so far in 2022)
- **37%** YoY decline in new builds by developers (~850 mm sqm of new builds so far in 2022)
- **31%** YoY decline in fiscal land sales revenue in 1H22
- **~1%** YoY decline in secondary market prices in 100 cities*
- **>100** Number of cities with mortgage boycotts by homebuyers

*Chinese cities are unofficially grouped according to tiers; as the tier numbers increase, cities get smaller, less affluent, and further from prime locations. Prices in Tier-1 cities rose in August, while prices in Tier-2 and -3 cities declined.
Source: Baker Mckenzie, Dezan Shira & Associates, NBS, PBOC, CREIS, CRIC, Goldman Sachs GIR.

Special thanks to the GS real estate and banks analysts who provided the data.

China Property: pain, but not systemic

Kenneth Ho expects more defaults in the Chinese property sector, but argues that property sector stresses probably don't pose systemic risk to China's financial system

In the post-Global Financial Crisis (GFC) period, China experienced the largest credit boom ever recorded, as its debt-to-GDP ratio rose from around 150% in 2008 to over 260% at the end of 2016 largely on the back of an increase in corporate leverage by state-owned enterprises (SOEs) and property developers. Since then, credit cleanup has been a major focus of the Chinese leadership and leverage has largely stabilized, save for a pandemic-related rise in borrowing last year.

However, leverage within the property sector continued to rise well after this broader stabilization, prompting renewed policy efforts to delever the sector that resulted in a sharp tightening in credit conditions and a wave of defaults. Although this process has not been without pain, we maintain that allowing over-levered entities to restructure their indebtedness and reducing implicit government support, in the property sector and beyond, are positive steps that improve the process of credit allocation and the pricing of credit risk, and we believe that stresses in the property sector probably don't pose systemic risk to the Chinese financial system.

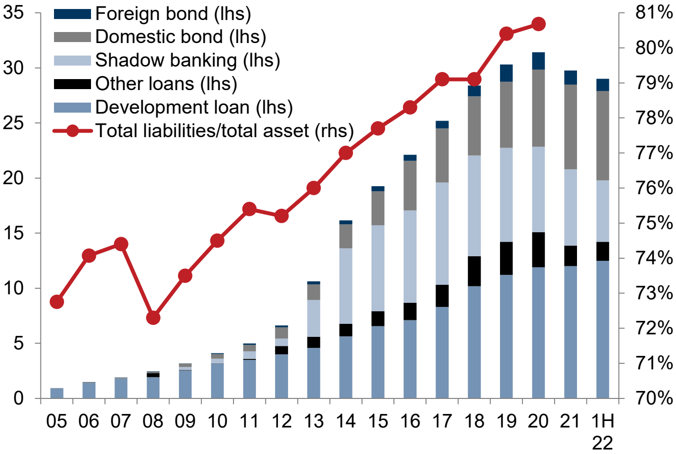
From deleveraging to activity declines

Property sector leverage has trended upward over the last decade. We estimate that total property developer-related borrowing reached RMB31tn[1] at the end of 2020, nearly 8x higher than at the end of 2010. This rise in borrowing occurred even as the government introduced policies to slow the growth in property development, including home purchase restrictions and limiting the availability of mortgages for non-primary residences. As a result, in late 2020 policymakers imposed "Three Red Lines" (see pg. 17) on the largest developers—a set of financial criteria they had to meet before they could borrow more funds.

Amid these renewed efforts to delever China's property sector, credit conditions tightened sharply, leading several developers to default and pushing leverage lower across the property sector—we estimate that the property development-related debt-to-GDP ratio fell from a peak of 31% at the end of 2020 to 26% in 1H22. However, tighter credit conditions also caused a large slowdown in activity levels in the property sector. In the year through August, the value of property sales fell by 28%, the volume of new starts fell by 37%, and the volume of completions fell by 21% (all yoy).

Property developer borrowing sharply rose in the decade to 2020

Total China property developer related borrowing (lhs, RMB tn), total developer liabilities/assets (rhs, %)



Source: Bloomberg, Wind, PBOC, China Trustee Association, Asset Management Association of China, Goldman Sachs GIR.

From activity declines to defaults, but likely not systemic

The slowdown in property sector activity levels has led to a large increase in defaults. In the USD corporate bond market, the China Property HY default rate has reached 34% ytd, and we forecast the default rate will rise further to 45% this year. That said, despite the stresses seen across the offshore bond market, we don't expect systemic stresses to emerge, for several reasons.

First, China lacks a domestic high yield bond market. Many risky borrowers therefore have difficulty accessing the onshore market, instead tapping the offshore market—which has a large high yield investor base—for funding. But with offshore funding accounting for only ~5% of total property developer funding, we think that even significant property defaults in the offshore bond market are unlikely to cause systemic stress in China.

Second, while RMB bank loans are the largest source of funding for property developers, we believe that China's banking system has significant capacity to absorb property credit losses given RMB10tn in risk buffers (in excess of the minimum CET1 capital requirement) compared with RMB8tn in potential non-performing loans (NPLs) (including RMB1.55tn in property credit losses and assuming an 8% loss rate on RMB19tn in property exposure). Even in a scenario in which losses emerge in the non-property loan book, we think that large banks would still be well-positioned to absorb the shock.

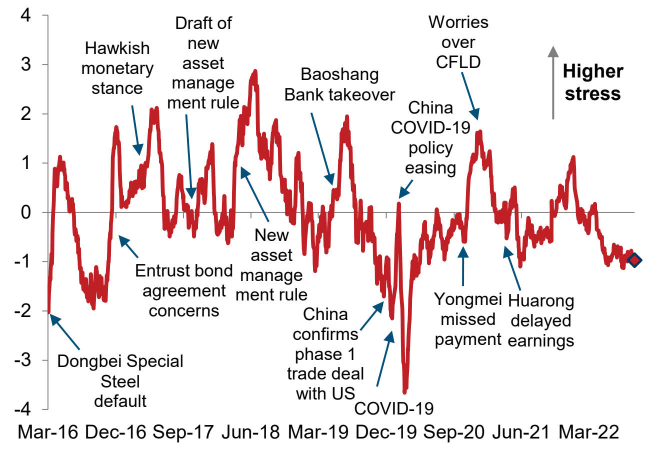
Third, China policy easing towards the property sector has increased in recent weeks. Policymakers have provided more support towards property completions, including news of funds being set up to support construction. Reflecting this increase in policy support, reported cases of mortgage boycott incidents—which arose as homeowners refused to continue making mortgage payments due to delays in the delivery of pre-sold properties—have recently stabilized. While we don't expect these efforts to significantly stem property defaults, we think they will help keep systemic concerns in check.

[1] We assume 50% of local government financing vehicle (LGFV) indebtedness is related to real estate development; this figure therefore includes debts in addition to funds directly borrowed by property developers.

Our proprietary GS China Onshore Credit Stress Index, which tracks a range of domestic credit indicators, currently shows no signs of stress in the domestic credit markets.

No signs of credit stress in China domestic credit markets

GS China Onshore Credit Stress Index, z-score



Source: Goldman Sachs GIR.

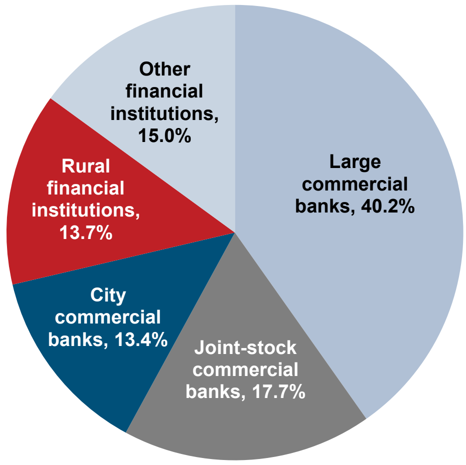
Watch for key risks

While we don't expect property stresses to become systemic, two areas are important to watch:

Construction funding. Stressed property developers need access to a continuing supply of construction funding (which are RMB-denominated loans) so that construction activities can continue and pre-sold properties can be delivered. Failure to do so could lead to a large increase in bad debts and have severe negative impacts on homebuyer confidence.

The solvency of small banks, which supply a significant portion of the construction funding. While the banking system as a whole has sufficient buffers to absorb a shock, small banks look more vulnerable (see pgs. 20-21), as they have much weaker risk buffers and are susceptible to higher losses. Most small banks operate in low-tier cities where property credit quality could further deteriorate on higher vulnerability of mortgage risk and local property developer defaults. Small banks also have more market share in property developer loans than mortgages, which increases the probability of defaults given the difficult refinancing conditions faced by property developers. Therefore, in a bear case scenario (assuming a ~15% loss rate for property credits), small banks would exhaust all of their risk buffers, and may require recapitalization. This is worth watching because small banks—including rural financial institutions and city commercial banks—together account for just over a quarter of total banking sector assets.

Rural financial institutions and city commercial banks account for around a quarter of total banking system assets



Note: Rural financial institutions include rural commercial banks, rural cooperative banks, rural credit cooperatives, and new rural financial institutions; other financial institutions include policy banks and China Development Bank, foreign banks, non-bank financial institutions, and asset managers.
Source: CBIRC, Goldman Sachs GIR.

A long road to restructuring

Continuing difficult credit conditions and downward pressure on China's economic growth suggest risks remain elevated for China property developers. With credit cleanup continuing to be an important policy objective and that the mantra of "housing is for living in, not for speculation" unlikely to change after the 20th Party Congress (see pgs. 10-11), we believe policymakers are unlikely to adopt a strong reflationary stance towards the property sector even as we expect further policy easing will be implemented to contain systemic risks. We estimate that nationwide new home sales will decline by 24% yoy in 2022, and a recovery in the physical property market is unlikely in the foreseeable future. As such, we expect defaults and credit stresses to remain elevated, resulting in further differentiation between weaker and stronger credits.

Stronger policy support that boosts property sector activity (e.g. a larger-than-expected real estate fund with central government support, scaling up shantytown redevelopment projects, etc.) could be a catalyst for the property sector to rebound more quickly than we expect. But with policymakers focused on ensuring systemic risk concerns are contained, we expect fully addressing stresses in the sector will likely take several years. The road to restructuring is therefore long, and as such we recommend that investors considering China HY property exposure consider only the best developers.

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Containing China's financial risks

Lisheng Wang assesses the health of China's financial system and discusses the steps policymakers are taking to prevent financial risks from becoming systemic

Concerns about the health of China's financial system have long abounded on the back of a decade-long downtrend in economic growth and uptrend in macro leverage. The recent shock of Covid, together with the downturn in the property sector that has severely affected developers, mortgage borrowers, and local small banks, has only exacerbated these concerns, especially amid several recent major risk events—the takeover of Baoshang Bank in 2019 and the Evergrande default and sharp selloff of Huarong bonds in 2021. How policymakers respond to these concerns and events going forward will be a crucial determinant of whether these risks can be contained or will instead become systemic as the leadership's focus shifts to deeper implementation of its new economic development model following the 20th Party Congress (see pgs. 10-11).

Key vulnerabilities in China's financial system

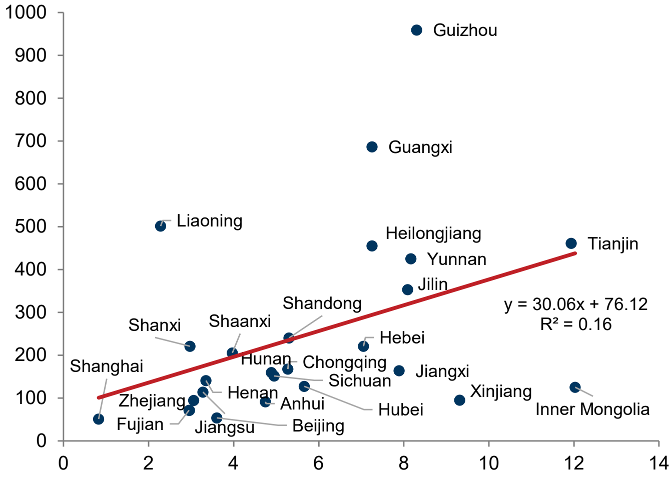
Although China's financial system appears healthy overall, we see three important areas of concern. First, **credit risks are still on the rise as the property sector continues to face financial headwinds.** We estimate that the share of property developer defaults among total credit defaults rose from 0% in 2015, to 34% in 2021, and 78% in 2022 (through July), mainly due to the unprecedented tightening measures imposed on the property sector in 2H20 and 1H21 to rein in the overleveraged real estate industry (see pg. 17), the adverse impact from Covid lockdowns, and significant risk contagion across property developers (see pgs. 18-19).

Second, **the health of small banks has deteriorated**, partly owing to property sector stresses. While the capital adequacy ratios (CAR) of most large banks improved over the course of the pandemic, they generally worsened for most small and rural banks, which have also suffered from a more significant narrowing of net interest margins. Although we estimate that China's banking system has significant capacity to absorb property credit losses given the RMB10tn in risk buffers (in excess of the minimum CET1 capital requirement) vs. RMB8tn in total non-performing loans (NPLs), in a bear case scenario in which losses also emerge in the non-property loan book, we think that some small and shadow banks could be vulnerable.

And third, **some local governments look particularly stretched**, also related in part to the property sector downturn. Local governments have faced significant challenges from slumping land sales as well as additional expenditures on Covid controls and slowing economic growth more broadly, which has reduced tax revenues. These headwinds could continue to weigh on the balance sheets and funding capabilities of local governments and local government financing vehicles (LGFVs), especially in less-developed inland regions, and may worsen with the withdrawal of policy stimulus in coming years.

Inland provinces tend to have higher local government deficits and higher LGFV bond credit spreads

Adjusted government deficit ratio (x-axis, % of 2020 GDP), AA+ rated LGFV bond credit spreads (y-axis, bp)



Provinces with a share of national GDP below 1% have been excluded from the chart (i.e., Tibet, Qinghai, Ningxia, Hainan, Gansu). We estimate the effective government deficit as the difference between total government expenditure and total government revenue, adjusted by the funds transferred from the central government to local fiscal budgets. Total government revenue refers to the sum of fiscal revenue and government-managed fund revenue, while total government expenditure refers to the sum of fiscal expenditure and government-managed fund expenditure.

Source: Wind, local government budget reports, data compiled by GS GIR.

Stepping up efforts to contain financial risks: the new FSF

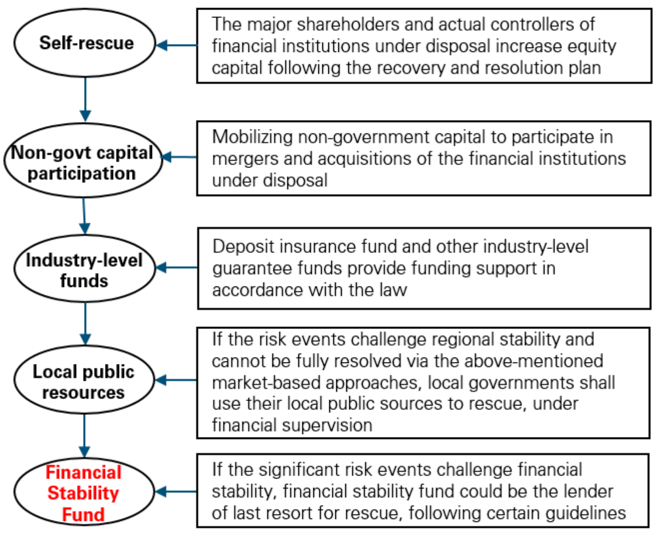
In the past, the process behind the reduction of financial risks has been hampered by the difficult tradeoff governments face between risk contagion and moral hazard, a lack of policy coordination across different government bodies and market entities, and occasionally insufficient expectation guidance from the government during market turmoil. Although China has made many improvements to strengthen its financial system over the past decade, recent events have demonstrated that shocks and risks are becoming larger and less predictable over time, increasing the need for a tail risk insurance fund to deal with potential extreme scenarios and keep financial risks from becoming systemic. This is especially the case today, as some financial risks that had been masked by policy stimulus in recent years may become more visible as the easing tide ebbs.

To this end, in March 2022, the Chinese government unveiled a plan to establish a new financial stability fund (FSF), run by a newly-established mechanism for coordinating national financial stability and development (affiliated with the State Council), with broader support and coordination from other major ministries (the PBOC, NDRC, Ministry of Justice, MOF, CBIRC, CSRC, and SAFE), and mainly funded by contribution fees from systemically important financial institutions (SIFIs), similar to the Single Resolution Fund (SRF) in Europe. Several solid steps to implement the FSF have since occurred, broadly covering the assignment of responsibilities among the participating ministries, legislation, and fundraising. As of May 16, the FSF was reported to have raised RMB64.6bn in funds[1].

[1] According to an article published by the Party Committee of CBIRC in the party-run *Qiushi* magazine on May 16.

The FSF is meant to act as a lender of last resort to address systemic financial risks that the first-line of defense against financial risks implemented by financial institutions, local governments, the deposit insurance fund and other industry-level security funds are unable to resolve. Had it existed at the time, we believe the FSF may have had an important role to play in addressing the Huarong and Evergrande risk events, which appear systemically important to the financial system. And, going forward, we believe it could streamline risk reduction thanks to a clearer assignment of responsibilities and better policy coordination, and tamp down market volatility as it lowers the probability of a crisis and other tail-risk events.

The pecking order of funding sources for financial risk disposal



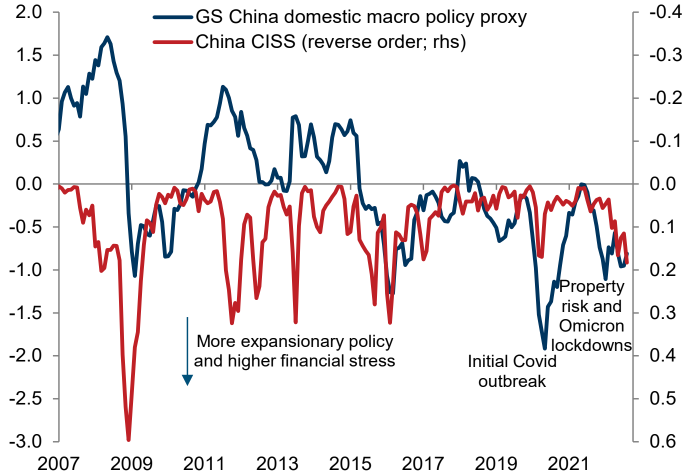
Source: PBOC, data compiled by Goldman Sachs GIR.

Implications for future policies

The burgeoning FSF is a solid step on the path to containing financial risks. However, the potential for some entities, sectors, and regions to face more financial stresses going forward than they have in the past, suggests the need to also further strengthen weak links in the financial system and reduce financial risks *ex ante*. In an effort to do so, in coming quarters the government may plan to issue more local government special bonds (LGSB) to help replenish the capital of small and medium-sized banks, push forward the orderly M&A of some troubled small banks and property developers, encourage asset management companies to help banks dispose of non-performing assets, and establish market-based funds to provide targeted liquidity support for some troubled sectors. The government may also require the PBOC to maintain flush liquidity conditions to facilitate the orderly disposal of financial risks, and indeed, the Chinese government's practice over the past decade suggests that macro policy, especially on the monetary policy front, tends to ease when financial risks increase. This, together with the FSF, are important steps on the road to improving the Chinese financial system's safety net.

Macro policy tends to ease when financial risks increase

GS China domestic macro policy proxy (lhs, z-score); China financial stress index (rhs, index)



China CISS refers to China composite indicator of systemic stress from ECB. Source: Wind, Haver Analytics, CEIC, ECB, Goldman Sachs GIR.

A comparison of China's FSF with major financial stability-related funds in DM economies

Funds	Founding entity	Fund management body	Target	Funding source	Funding size
Orderly Liquidation Fund (OLF) in the US	US Congress	Federal Deposit Insurance Corporation (FDIC)	Systematically important financial instutions (SIFIs), including banks, insurance companies, and other financial institutions	No funds prepared pre-emptively while the FDIC raises funds from the US Treasury as needed, any net cost post-resolution is recouped from the surviving G-SIFIs	N/A
Single Resolution Fund (SRF) in Europe	European Parliament and Council	Single Resolution Board (SRB)	Banks and their subsidiaries, asset management companies	All banks across the 21 members of the European Banking Union are required to pay an annual fee by law to the SRF	€66 billion (Jul 2021)
European Financial Stability Facility (EFSF)	Council of the European Union	Board of Directors of the EFSM	Euro area member countries invovled in EFSF (for addressing sovereign risks)	Funded by the issuance of EFSF bonds and other capital market instruments	€780 billion (Oct 2011, but no longer lends)
European Stability Mechanism (ESM)	19 Euro Area Member States	The Board of Governors of ESM	Euro area member countries involved in ESM (for addressing sovereign risks)	Funded by the issuance of ESM bonds and other capital market instruments	€700 billion (Sep 2012)
Financial Market Stabilization Fund (FMS/SoFFin) in Germany	German Parliament	Federal Agency for Financial Market Stabilization (FMSA)	Financial institutions	Through mandated contributions from individual German states and by issuing debt securities up to a maximum of €100 billion	€480 billion (Oct 2008)
Financial Stability Fund (FSF) in China	PBOC and several ministries	Financial Stability and Development Committee of the State Council	SIFIs	All SIFIs need to pay an annual fee by law to the FSF; other funding sources yet to be unveiled	RMB 64.6bn for the first batch (as of May), with fundraising completed by end-Sep. Total size of funding yet to be announced

Source: Various FSF websites, data compiled by Goldman Sachs GIR.

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A snapshot of our views

We ask GS strategists to weigh in on the asset implications of China's 20th Party Congress.

Equity

Relative continuity likely to buoy pockets of the equity market post-Congress

Kinger Lau, Chief China Equity Strategist

Tim Moe, Chief Asia Equity Strategist

Q: Do you expect the 20th Party Congress to mark an inflection point for Chinese equities?

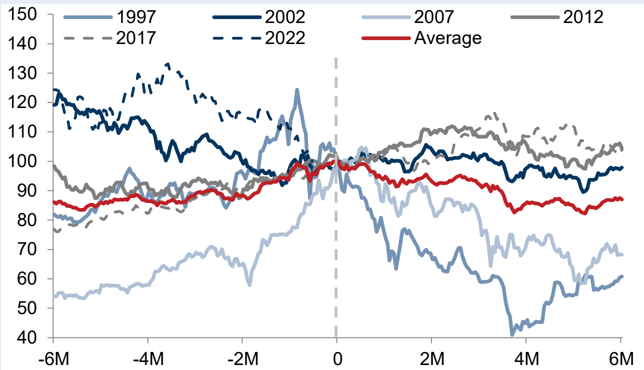
A: The Party Congress has historically been a positive anchor for the equity markets, at least in the short run, with MSCI China generating roughly 12%/2% returns, on average, 3m/1m ahead of the event and delivering positive returns ahead of four of the past five Congresses. We also find that Chinese equities tend to trade substantially better ahead of Congresses without changes to the Party Secretary position (1997, 2007, and 2017) than ahead of those where a transition took place (2002 and 2012), which may be particularly relevant ahead of this year's Party Congress given the possibility that President Xi will continue as Party Secretary. However, whether these historical precedents will be valid this time around is highly uncertain, especially considering that Chinese authorities' adherence to the zero-Covid Policy (ZCP) at a time when cases of the highly-transmissible Omicron variant are recorded in multiple provinces and cities could soften the policy easing impulse that has been provided by policymakers so far during this downturn. Looking past the run-up to the Congress, our economists also do not expect a drastic shift of policy dynamics post the Congress (see pgs. 10-11).

Q: What sectors of the equity market—if any—are poised for the largest upside following the Congress?

A: Our economists' expectations that China's long-term policy goals, including manufacturing upgrades, supply chain security, de-carbonization, and the promotion of common prosperity, will be further emphasized and pursued following the Congress reinforces our view that investors should align their portfolio with strategic policy directions to trade for sustainable alpha in China. Our "Common Prosperity" portfolio offers investors broad exposures to "mass but unique consumption", "hard" technology and manufacturing upgrading, green/renewable energy, and SOE reformers. The policy "status quo" that our economists expect also favors stocks more exposed to policy accommodation, cyclically and/or structurally, which underscores our Overweight stance on Autos, Consumer Durables, TMT (Retailing and Media), and Semis, and Underweight stance on (POE) Developers and Banks.

Chinese equities usually trade well in the run-up to Congress

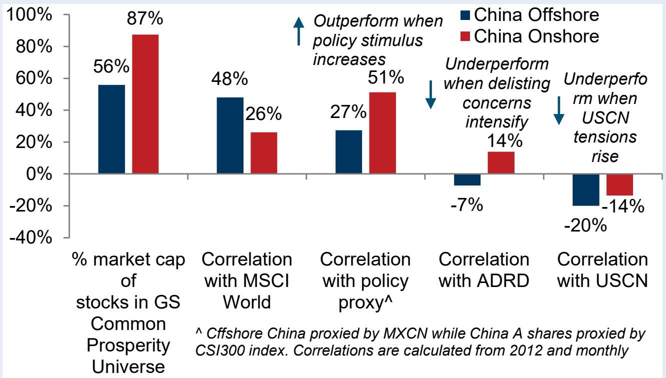
MSCI China Index around Party Congresses



Source for exhibits: MSCI, FactSet, Bloomberg, Wind, Goldman Sachs GIR.

Chinese A shares look better positioned than Offshore equities

A shares vs. Offshore equities



Note: ADRD refers to our recently-introduced ADR Delisting Barometer.

Q: How should investors be positioned in Chinese equities?

A: Chinese equities have had a difficult several months, with the MSCI China index having fallen by around 55% from its peak (on February 18, 2021), as global growth has slowed, rates have risen, and the Dollar has strengthened further, and we recently lowered our 2023 China earnings growth forecast from 14% to 9% as our China economists now expect a delayed reopening. That said, we remain overweight China with a 12m MXCN target of 69. Within equities, we believe that China A shares look better positioned than Offshore equities from a macro and policy perspective, for several reasons. One, China A is a captive market with less than 5% foreign ownership that has historically been less sensitive to external risk factors, which puts it in a relatively better position at a time when a worsening growth-inflation trade-off and aggressive policy tightening by central banks are pressuring risk assets globally. Two, we find that China A tends to outperform Offshore equities when delisting concerns intensify and US-China tensions rise, which is particularly relevant now given elevated US-China tensions (as per our US-China Relations Barometer GSSRUSCN), uncertainty over Chinese ADR delistings/audit inspections, geopolitical risks centering around Taiwan, and lingering bilateral trade/technology frictions that are weighing on sentiment and valuations. These issues are arguably more influential to Offshore equities than A shares from sector composition, direct company revenue exposure, and equity ownership standpoints. And three, the Chinese "National Team"—government-related entities that hold domestic equities on behalf of the State—which could have RMB400bn idle capital to deploy, may be called upon to provide downside support/a confidence boost to A shares. We find that the National Team was likely active in mid-March (according to our National Team activity indicator) when the market was under similar pressure, and it may turn active again in the run-up to the Party Congress.

Credit

Bifurcation between property sector and rest of China credit market likely to continue

Kenneth Ho, Chief Asia Credit Strategist

Q: Do you expect the 20th Party Congress to mark an inflection point for China IG and HY bonds?

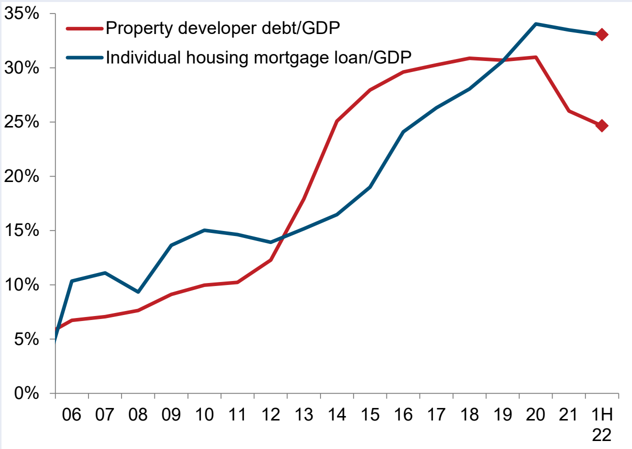
A: No. The past 12 months have seen a bifurcation in how China USD credit has traded. Price action for property sector credits has correlated with news and events surrounding the China real estate sector, while the rest of the China credit market, as well as much of the Asia USD credit market, has been driven more by US rates and the challenging macro backdrop. We do not expect that to significantly change after the Party Congress, for two reasons. One, we believe policymakers' focus on deleveraging the property sector will not change (see pgs. 10-11). We therefore expect property defaults to continue, and forecast a China Property HY default rate of 45% this year (see pgs. 18-19). Two, we expect that inflation, rates, and recession risks will remain the dominant theme affecting global markets—any outcome of the Party Congress will not alter that. As a result, we think it's unlikely that Asia credit spreads will rally, and think the appetite for riskier HY debt is likely to remain muted.

Q: What sectors do you prefer in Chinese USD credit?

A: We believe it's important to stay up-in-quality across IG and HY given the underlying macro uncertainties. Overall, our preference is for shorter-dated carry with a focus on relative value, rather than adopting a strong directional view.

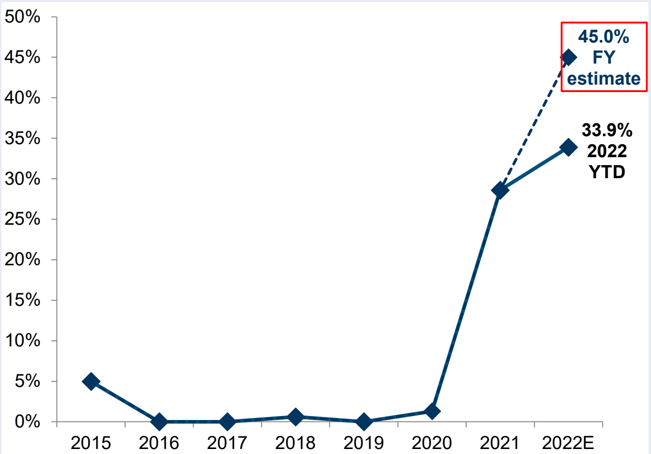
Policymakers' focus on deleveraging the property sector is likely to continue after the Party Congress

Debt-to-GDP ratios for property developers, individual housing mortgage loan-to-GDP ratio



We forecast the China Property HY default rate will rise further to 45% this year

Default ratio of China USD Property HY bond market (weighted by outstanding amount)



Source for exhibits: Bloomberg, Wind, PBOC, China Trustee Association, Asset Management Association of China, Moody's, S&P, GS GIR.

Q: What are the key areas to watch for after the Party Congress that could lead you to change your views on China credit?

A: Any signs of relaxation in China's zero-Covid policy will be important to watch. The easing of Covid restrictions, and therefore a potentially more optimistic growth outlook, could be important factors in the stabilization and recovery of the property sector. It could also have positive impacts across other segments, such as Macau Gaming, which would be a key beneficiary. A better growth outlook could also lead us to reassess our "up-in-quality" stance on China credit more broadly.

FX

Near-term depreciation pressures; maintaining our constructive medium-to-long term views

Hui Shan, Chief China Economist

Q: Do you expect the Party Congress to mark an inflection point for the CNY?

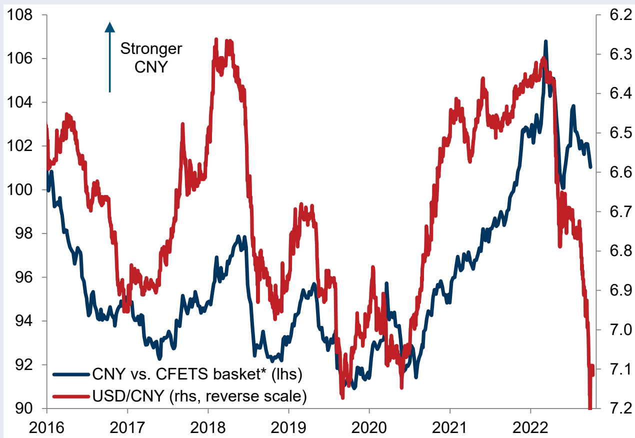
A: We do not expect the Party Congress to mark an inflection point for the CNY. In recent weeks, USD/CNY has climbed above 7.0 and has continued to drift higher on the back of a stronger USD. We expect the widening interest rate differential between the US and China that has driven these shifts to continue as our US team expects the Fed to remain hawkish and deliver more rate hikes in the coming quarters, while interest rates in China will likely remain low as Covid control measures and a sluggish property sector continue to weigh on China's activity growth. We therefore believe that the recent depreciation pressures on the CNY are here to stay, at least until the more comprehensive relaxation in Covid control measures that we expect in 2Q23.

That said, the PBOC's response to further CNY depreciation is worth monitoring. In recent weeks, we observed a strengthening bias in daily CNY fixing as USD/CNY climbed above 7.0, a psychologically important threshold for market participants. The PBOC also reimposed the 20% reserve requirement on FX derivative sales (i.e. increasing the cost of shorting CNY through derivatives), which it last did in August 2018 amid CNY depreciation. Most recently, the PBOC provided verbal guidance against one-way bets on CNY at a meeting with market participants. In the coming weeks, the PBOC might announce more measures aimed at slowing the pace of CNY depreciation should USD/CNY continue to depreciate relatively rapidly, including imposing an even higher reserve requirement ratio (RRR) for FX derivative sales or further cuts to the FX deposit RRR (as it did in early Sept).

Looking ahead, should activity growth rebound in 2H23 as we expect, policymakers may start to normalize the stance of macro policy, potentially narrowing the US-China interest rate differential and sparking risk-on sentiment towards Chinese assets, which we expect would result in CNY appreciation. On net, we forecast USD/CNY of 7.2/7.0/6.8 on a 3/6/12m horizon. And, over the medium-to-long run, we maintain our constructive view on the CNY. Global reserve managers remain under-invested in CNY assets, and we expect them to increase their holdings of CNY assets (in particular bonds) in the next few years, partially for diversification purposes. In addition, China's trade surplus may remain strong on permanently higher market share with some trading partners post-Covid, energy advantages relative to Europe, and structural growth in electric vehicle and renewables production capacity. These would argue for more FX inflows, which in turn would provide support to the CNY.

CNY has weakened materially against the USD in recent weeks, but remained strong on a trade-weighted basis

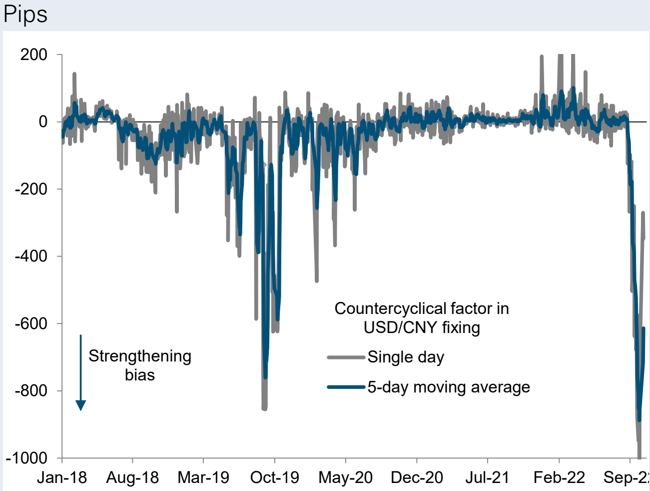
Index (lhs, end-2014=100), USD/CNY (rhs)



*Using expanded CFETS basket starting from 2017

PBOC has recently leaned against CNY depreciation through stronger daily fixing

Pips



Source for exhibits: Bloomberg, Goldman Sachs GIR.

Q: What potential policy shift would have the biggest implication for the CNY?

A: The major policy shifts that would have the biggest near-term implications for the CNY, in our view, are: 1) any shift in the Fed's hawkish stance, and 2) changes to China's dynamic zero-Covid policy. At the risk of stating the obvious, the broad USD path matters for the CNY—USD/CNY has weakened by around 6% since mid-August, but by much less against a basket of currencies (the CNY CFETS index). Any material shift by the Fed and consequent changes in the broad USD path would therefore affect the path of USD/CNY.

On the domestic front, the property sector and Covid control are the major drags on overall growth and key reasons why Chinese policymakers need to maintain an accommodative policy stance and relatively low interest rates. We expect policymakers to stick to the conservative property policy stance that "housing is for living in, not for speculation", and therefore expect the property sector to remain a drag on overall growth next year. A sooner-than-expected relaxation of the dynamic zero-Covid policy would therefore be the one major tailwind to activity growth, and, in turn CNY, in the near term.

Rates

Gradual normalization in short-term rates; range-bound long-term rates, with upside risks

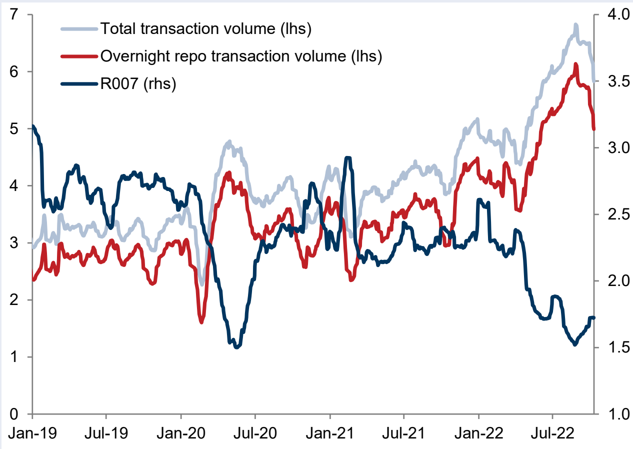
Xinquan Chen, China Economist

Q: How will the changing environment after China's 20th Party Congress impact China's short-term rates?

A: We do not expect immediate changes in short-term rates after the 20th Party Congress. That said, we maintain our view that short-term rates, such as the 7-day repo rate (currently around 1.5%), will gradually converge towards the policy rate (i.e., the 7-day reverse repo OMO rate, which is currently at 2%), for two reasons. One, persistently low front-end rates will raise concerns over financial leverage in the bond market. And two, fading fiscal policy support will reduce interbank liquidity (reflected in repo rates). Indeed, we believe that a large stimulus package after the 20th Party Congress is unlikely and expect China's augmented fiscal deficit to narrow by 2pp next year. That said, we expect rate convergence to be gradual, as a sharp rise in short-term rates would generate concerns about growth and financial risks. Policymakers are therefore likely to aim for a gradual normalization that reduces financial leverage while mitigating the potential negative impact on activity growth and financial risks from higher rates.

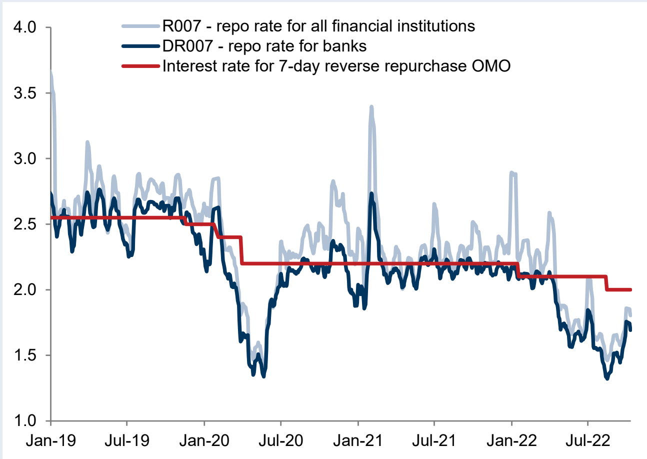
Financial leverage has historically increased sharply on the back of lower short-term rates

20-day moving average, RMBtn (lhs), % (rhs)



Front-end funding rates remain well below policy rates

10-day moving average, percent



Source for exhibits: Wind, Goldman Sachs GIR.

Q: What is the likely trajectory of long-term bond yields, and what role will the 20th Party Congress play in that trajectory?

A: Given that we don't expect immediate policy changes after the Party Congress, we expect long-term bond yields to remain range-bound in the coming months, though we see risks in both directions. On the one hand, ongoing economic challenges around Covid controls, the property sector downturn, and a potential further moderation in export growth as DM economies slow could push yields lower. On the other hand, more growth-supportive measures to ensure stability could bolster market sentiment and drive yields higher. The potential for improved policy coordination and implementation after the Party Congress could also boost the economic recovery and, in turn, bond yields. Further ahead, we see risks around long-term bond yields increasingly skewed to the upside on expectations of a broader relaxation of Covid control measures and a reopening of China's economy in 2Q23 that supports growth and paves the way for a normalization of macro policy in 2H23. All that said, a stronger-than-expected growth recovery and earlier reopening may cause liquidity conditions to normalize sooner, which would see earlier increases in bond yields. We are therefore closely watching for early signs of reopening and recovery of credit demand.

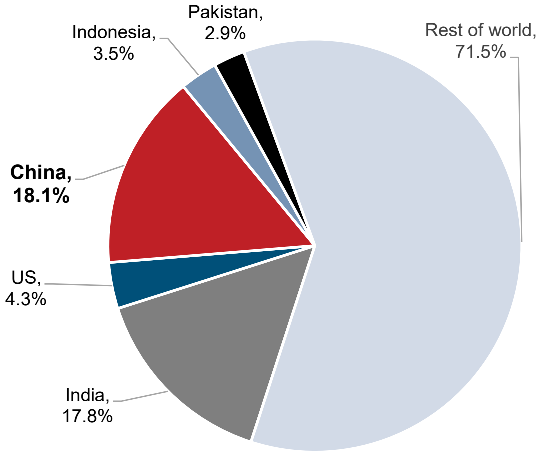
Q: Will foreign outflows in the bond market disrupt the opening-up of China's bond market?

A: Although foreign investors have sold CNY bonds for an unprecedented seven consecutive months as of August 2022, the outflows could be cyclical while structural inflows could continue on the back of the government's financial opening efforts. We expect foreign investors to play a more important role in China's rates markets over the medium-to-long run despite near-term uncertainties, and see potential for Chinese policymakers to announce more opening-up policies akin to Swap Connect (a scheme to allow overseas investors to access China's onshore interest rate swap market) that help foreign investors better hedge rate risks in the future.

China's demographic woes

China accounts for over one-sixth of the world's population…

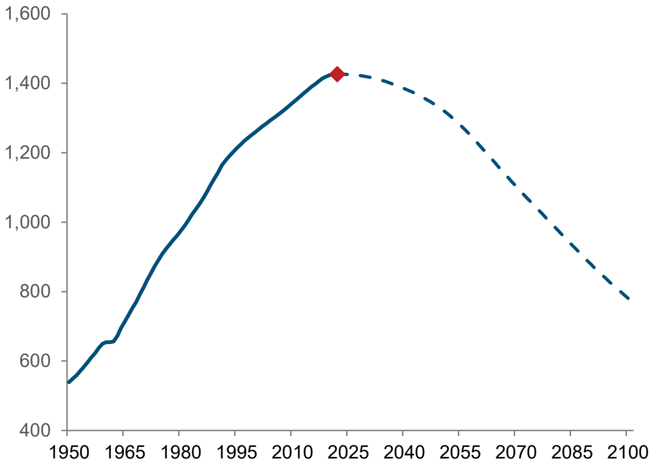
Five most populous countries, % of total world population



Note: Total population as of January 1, 2021 (latest data available).

…but China's population is projected to decline after this year

Population, millions of people



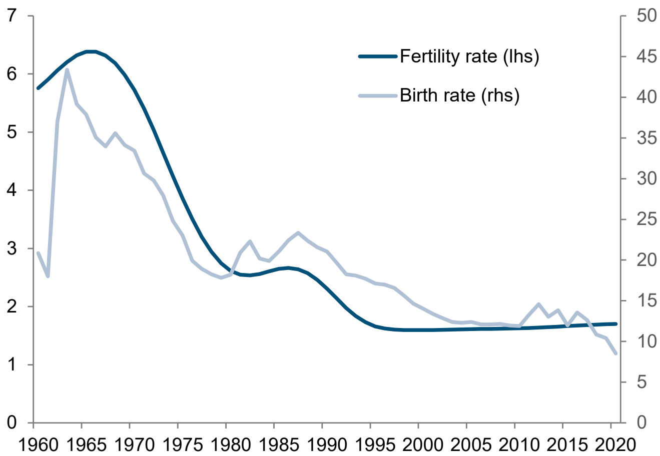
Note: Dashed line represents UN medium-variant projections, which assume a decline of fertility for countries where large families are still prevalent, a slight increase of fertility in several countries where women have fewer than two live births on avg over a lifetime, and continued reductions in mortality at all ages.

A history of population planning policies in China…

Policy	Announced/ Implemented	Abolished	Background/Description
Later, Longer, Fewer	Early 1970s	--	Promoted later marriage, longer gaps between children, and fewer children to control the country's population
One-child policy	1979	2015	Designed to put a brake on population growth amid severe shortages of natural resources, capital, and goods
Two-child policy	2016	2021	Enacted in the face of slowing population growth, an ageing population, and a shrinking workforce
Three-child policy	May 2021	July 2021	Designed to boost the country's birth rate and slow population decline after the two-child limit failed to do so
All family size limits removed	July 2021		All family size limits and corresponding penalties removed

…has resulted in a sharp decline in fertility and birth rates…

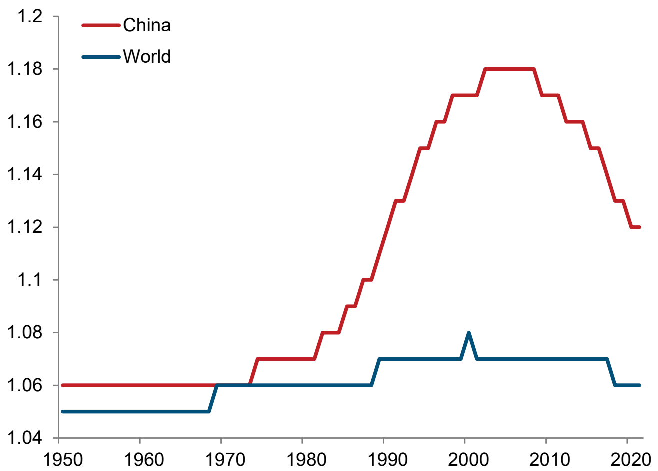
Fertility rate (lhs), live births per 1,000 population (rhs)



Note: Fertility rate represents the number of children that would be born to a woman if she were to live to the end of her childbearing years and bear children in accordance with age-specific fertility rates of the specified year.

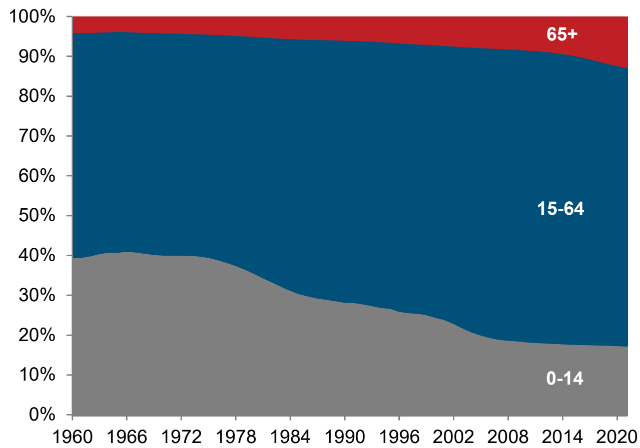
…a more distorted sex ratio than the rest of the world…

Sex ratio at birth (male births to female births)



…and a shrinking share of the population under 14 years old

Share of total population by age group, %



Source for all exhibits: United Nations, Department of Economic and Social Affairs, Population Division (2022), various news sources, Goldman Sachs GIR.

Summary of our key forecasts

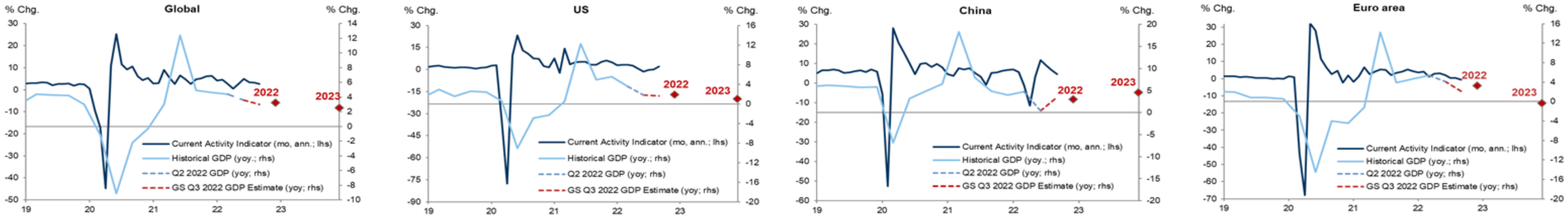
GS GIR: Macro at a glance

Watching

- **Globally,** we expect below-trend Q4/Q4 real GDP growth of 1.9% in 2022 as the sizable growth drags from the Russia-Ukraine conflict, tighter financial conditions, weak real income growth, and a substantial slowdown in housing activity more than offset medical improvements and a consumption boost from pent-up savings. We expect the global inflation surge to peak in the coming months, and think the combination of a moderation in demand growth, improvements in goods supply, and tighter monetary policy will be sufficient to bring inflation back toward DM central banks' targets over the next two years.
- **In the US,** we expect Q4/Q4 growth to slow to 0.2% in 2022, reflecting a large fiscal drag and a negative impulse from tighter financial conditions. We see a 35% probability of entering a recession over the next year, although we think any recession would likely be mild. We expect core PCE inflation to decline to 4.5% by end-2022, although further supply chain disruptions, stronger wage growth, or firmer shelter inflation could keep inflation somewhat higher for longer. We expect the unemployment rate to rise to 3.6% by end-2022, 4.1% by end-2023, and 4.2% by end-2024.
- **We expect the Fed** to deliver a 75bp hike in November, followed by a 50bp hike in December and a 25bp hike in February, for a peak funds rate of 4.5-4.75%, though we see risk that a higher peak rate will be needed to reverse overheating enough to bring inflation down. On the fiscal policy front, we would expect additional fiscal legislation if Democrats maintain control of Congress after the midterm election, but a divided or Republican-majority Congress would likely pass a limited fiscal package in the event of a recession.
- **In the Euro area,** we expect a moderate recession in 2H22, driven by continued significant gas supply disruptions owing to the war in Ukraine and slowing growth momentum. We expect headline inflation to peak at 11.7%yoy in January before falling back to 4.6% in December 2023.
- **We expect the ECB** to hike by 75bp in October and December, followed by a 50bp hike in February for a terminal rate of 2.75%, though we see risks skewed towards a higher terminal rate in the event of more persistent inflationary pressures and stronger second-round effects.
- **In China,** we expect full-year real GDP growth of 3.0% in 2022. On a sequential basis, we expect a sharp rebound of 14.0% qoq ann. growth in Q3 after very weak growth in Q2, during the 20th Party Congress in mid-October. We see the risks to our baseline as broadly balanced, with upside risks from stronger-than-expected policy stimulus and downside risks from uncertainty associated with Covid, housing, and external demand.
- **WATCH INFLATION AND EUROPEAN NATURAL GAS.** On the inflation front, more persistent inflationary pressures could lead to extended central bank hiking cycles, which could raise the risk of recession in several major economies. Tensions in the European natural gas market also continue to loom large, with Russia suspending gas flows through the Nord Stream gas pipeline indefinitely, skewing risk towards a more severe and protracted downturn in Europe.

Goldman Sachs Global Investment Research.

Growth



Source: Haver Analytics and Goldman Sachs Global Investment Research.
Note: GS CAI is a measure of current growth. For more information on the methodology of the CAI please see "Lessons Learned: Re-engineering Our CAIs in Light of the Pandemic Recession," Global Economics Analyst, Sep. 29, 2020.

Forecasts

Economics

GDP growth (%)	2022 GS (Q4/Q4)	2022 GS (CY)	2022 Cons. (CY)	2023 GS (CY)	2023 Cons. (CY)
Global	1.9	3.2	2.9	2.5	2.5
US	0.2	1.8	1.6	1.0	0.7
China	3.3	3.0	3.3	4.5	5.0
Euro area	1.2	3.2	3.0	-0.4	0.2

Policy rates (%)	2022 GS	2022 Mkt.	2023 GS	2023 Mkt.
US	4.38	4.42	4.63	4.02
Euro area	2.25	2.94	2.75	3.09
China	2.00	2.49	2.00	2.67
Japan	-0.10	0.09	-0.10	0.15

Markets

Interest rates 10Yr (%)	Last	E2022	E2023	FX	Last	3m	12m
US	3.89	3.75	4.00	EUR/$	0.97	0.97	1.05
Germany	2.33	2.00	2.10	GBP/$	1.10	1.05	1.19
Japan	0.25	0.25	0.50	$/JPY	146	145	125
UK	4.49	3.50	4.00	$/CNY	7.1	7.20	6.80

Commodities	Last	3m	12m	Credit (bp)		Last	4Q22	2Q23
Crude Oil, Brent ($/bbl)	96	115	110	USD	IG	154	175	140
Nat Gas ($/mmBtu)	6.44	7.95	4.15		HY	498	625	465
Copper ($/mt)	7,639	6,700	9,000	EUR	IG	237	229	175
Gold ($/troy oz)	1,677	1,850	1,950		HY	607	655	491

Equities

S&P 500	E2022 GS	E2022 Cons.	E2023 GS	E2023 Cons.	Returns (%)	12m	YTD	E2022 P/E
Price	3,600	--	--	--	S&P500	12.0	-25.0	16.3x
EPS	$226	$225	$234	$241	MXAPJ	13.0	-28.0	12.0x
Growth	8%	8%	3%	7%	Topix	12.0	-6.0	13.7x
					STOXX 600	6.0	-21.0	10.8x

Consumer	2022 CPI (%, yoy)	2022 Unemp. Rate	2023 CPI (%, yoy)	2023 Unemp. Rate	Wage Tracker 2022 (%) Q1	Q2	Q3	Q4
US	7.9	3.6	3.5	4.1	5.8	5.8	5.7	--
Euro area	8.5	6.6	7.8	6.5	--	--	--	--
China	2.1	--	2.0	--	--	--	--	--

Source: Bloomberg, Goldman Sachs Global Investment Research. For important disclosures, see the Disclosure Appendix or go to www.gs.com/research/hedge.html.

Market pricing as of October 10, 2022.

Glossary of GS proprietary indices

Current Activity Indicator (CAI)

GS CAIs measure the growth signal in a broad range of weekly and monthly indicators, offering an alternative to Gross Domestic Product (GDP). GDP is an imperfect guide to current activity: In most countries, it is only available quarterly and is released with a substantial delay, and its initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs aim to address GDP's shortcomings and provide a timelier read on the pace of growth.

For more, see our CAI page and Global Economics Analyst: Trackin' All Over the World – Our New Global CAI, 25 February 2017.

Dynamic Equilibrium Exchange Rates (DEER)

The GSDEER framework establishes an equilibrium (or "fair") value of the real exchange rate based on relative productivity and terms-of-trade differentials.

For more, see our GSDEER page, Global Economics Paper No. 227: Finding Fair Value in EM FX, 26 January 2016, and Global Markets Analyst: A Look at Valuation Across G10 FX, 29 June 2017.

Financial Conditions Index (FCI)

GS FCIs gauge the "looseness" or "tightness" of financial conditions across the world's major economies, incorporating variables that directly affect spending on domestically produced goods and services. FCIs can provide valuable information about the economic growth outlook and the direct and indirect effects of monetary policy on real economic activity.

FCIs for the G10 economies are calculated as a weighted average of a policy rate, a long-term risk-free bond yield, a corporate credit spread, an equity price variable, and a trade-weighted exchange rate; the Euro area FCI also includes a sovereign credit spread. The weights mirror the effects of the financial variables on real GDP growth in our models over a one-year horizon. FCIs for emerging markets are calculated as a weighted average of a short-term interest rate, a long-term swap rate, a CDS spread, an equity price variable, a trade-weighted exchange rate, and—in economies with large foreign-currency-denominated debt stocks—a debt-weighted exchange rate index.

For more, see our FCI page, Global Economics Analyst: Our New G10 Financial Conditions Indices, 20 April 2017, and Global Economics Analyst: Tracking EM Financial Conditions – Our New FCIs, 6 October 2017.

Goldman Sachs Analyst Index (GSAI)

The US GSAI is based on a monthly survey of GS equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on analysts' responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

Macro-Data Assessment Platform (MAP)

GS MAP scores facilitate rapid interpretation of new data releases for economic indicators worldwide. MAP summarizes the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. The sign on the degree of surprise characterizes underperformance with a negative number and outperformance with a positive number. Each of these two components is ranked on a scale from 0 to 5, with the MAP score being the product of the two, i.e., from -25 to +25. For example, a MAP score of +20 (5; +4) would indicate that the data has a very high correlation to GDP (5) and that it came out well above consensus expectations (+4), for a total MAP value of +20.

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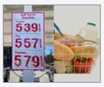
September 13, 2022



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July 28, 2022

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Equity bear market: a paradigm shift?
June 14, 2022

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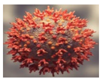

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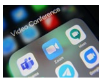

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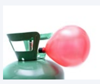

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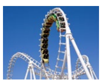

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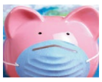

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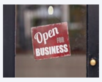

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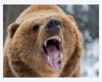

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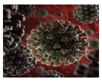

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