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The Covid–19 Pandemic and China's Economic Slowdown

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The Chinese economy has been undergoing a structural slowdown during the past decade, due to aging, decelerating productivity, and lower returns on assets. The Covid-19 pandemic, coupled with China's dynamic Zero-Covid policies, have worsened that trend, together with two other important factors, namely the demise of China's real estate sector as well as the much more difficult external environment stemming from growing U.S.-China strategic rivalry and the war in Ukraine. China's Covid experience started well but it is ending poorly. With much better economic performance in 2020 compared to the rest of the world, China managed to attract large amounts of capital while keeping its borders closed. However, doubling down on the Zero-Covid strategy with a much more contagious virus, while the rest of the world was opening, changed China's fortunes for the worse. In fact, China is bound to grow barely half of what the government promised for 2022 (5.5 percent). Moving forward, as the Chinese government starts to show some signs of opening-up, the question remains whether a strong recovery should be expected. The answer is "no." The factors behind China's structural deceleration are still intact. In addition, Covid-related scarring effects are bound to hurt the Chinese economy in terms of human capital and innovation. Finally, the 20th Party Congress has made it crystal clear that the role of the state – and the party – in the economy is bound to increase. All in all, even if the Covid restrictions are lifted, China might see a temporary recovery but the structural deceleration will still lead to growth at around 2 percent by 2030. This implies that any convergence with the U.S. economy will not continue for long.

The Covid-19 pandemic hit China in January 2020, but the Chinese economy had already been in a decelerating trend for years, especially since the 2018 U.S.-China trade war. After the Covid pandemic hit the Chinese economy in early 2020, the trend intensified.

The first impact of Covid-19 in 2020 was rather muted when compared to that in the rest of the world, as China appeared to have recovered from Covid-19 earlier than elsewhere, an idea which is summarized in the concept "first in and first out." In the same vein, the gap between U.S. economic performance in 2020 and that in China was even larger than during the global financial crisis, thus leading many analysts to think that China would be able to leapfrog its convergence with the U.S., and its economy will become larger than that of the U.S. even earlier than expected, namely by 2028.[1] Today, well into the fourth quarter of 2022, that expectation seems utterly optimistic. In fact, the Chinese economy has decelerated very rapidly after a rather moderate recovery in 2021 when China grew 8.1 percent, not too far from the 5.7 percent in the U.S. The dynamic Zero-Covid policy, introduced in the summer of 2021 and leading to draconian mobility restrictions, is a very important reason for China's underwhelming economic outcome, but it is not the only reason. The demise of the real estate sector, which began in earnest with the default of China's largest real estate developer,

[1] https://www.reuters.com/article/us-health-coronavirus-china-economy-idUSKBN29000C

Evergrande, has led to a collapse in sentiment and much lower fixed asset investment. Finally, since coming to power the Biden administration has hardly changed its tough-minded policy on China, and even less so since Russia's invasion of Ukraine and China's tacit support for Russia. Beyond the dynamic Zero-Covid policy and the real estate woes, this is clearly another important source of economic difficulties facing China.

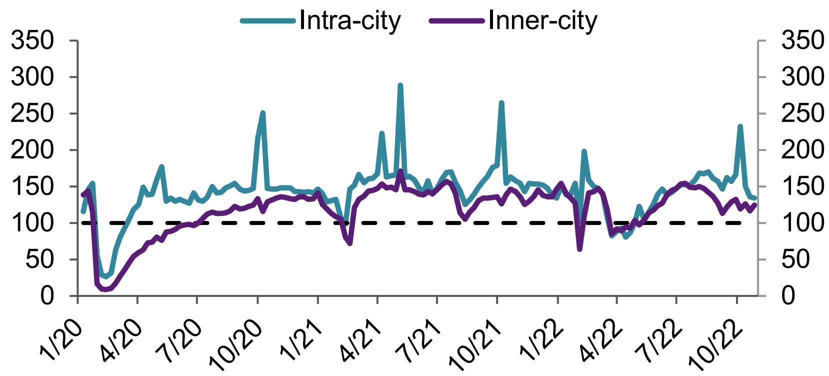
In this essay, I first review how the impact of the Covid-19 pandemic on the Chinese economy has evolved from being rather positive in 2020, at least compared to the rest of the world, to being very negative since the beginning of 2022. I then investigate the geopolitical implications of China's Zero-Covid policies and move to exploring why any lifting of the Zero-Covid policies might not help China's growth. After a short account of its real estate sector woes, I briefly review the structural factors that will weigh down on China's growth in the years to come and what this will mean for Sino-U.S. strategic competition.

The Impact of the Covid-19 Pandemic on the Chinese Economy

Wuhan was the first city to declare a full-scale lockdown in January 2020 due to the virus. which was referred to at that time as SARS-CoV-2. Thereafter, the Chinese government was to deploy large-scale lockdowns across the country, which led to a sharp reduction in nationwide mobility. In addition, Chinese borders were closed and, even when they reopened, travelers were subject to draconian quarantines.

The massive reduction in domestic mobility can be captured by calculating the national inter-city mobility, based on auto navigation data, which fell by 66 percent in February 2020 compared to the 2019 average. That said, mobility recovered very quickly as soon as the outbreak was contained and turned highly positive by April (+26%) (Figure 1).

Figure 1: Mobility Index of Major Chinese Cities (Jan 2020=100)

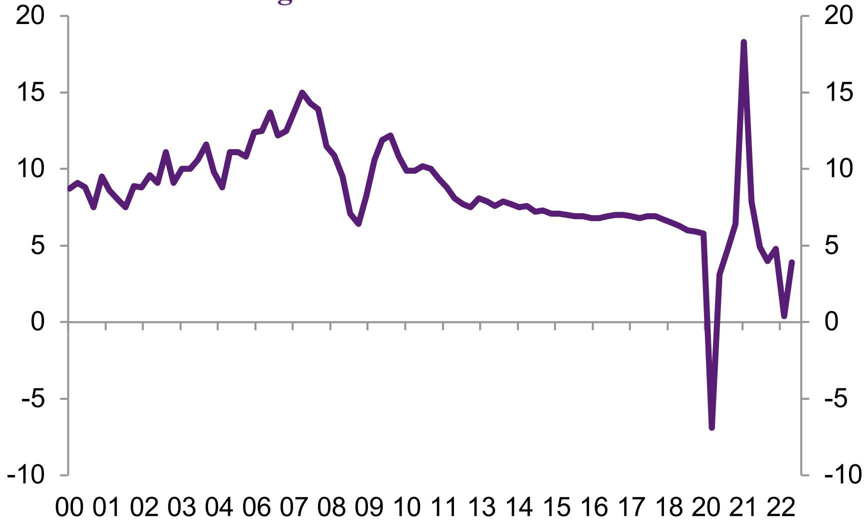


Source: Natixis, AutoNovi, CEIC, WIND. Intra-city index calculated based on highway traffic between 32 provincial regions. Inner-city index calculated based on volume of metro passengers in 24 major Chinese cities. Average of the first 5 weeks of 2020 in the U.S. used as a base.

The lifting of the lockdowns and other mobility restrictions led to a recovery of consumption and sentiment indicators as early as April 2020, even while the rest of the world was either in lockdown or still facing major mobility restrictions. This meant that China's GDP growth managed to end 2020 with a positive rate of 2.3 percent, while growth in the U.S. and the other major economies plummeted into highly negative territory (Figure 2). Such a large growth differential between China and the rest of the world as early as the second quarter of 2020 are encapsulated in China's highly positive mantra – "first in, first out" – as far as

Covid was concerned. A reflection of this success came from the huge amount of FDI destined to China in 2020, thus allowing China to displace the U.S. as the largest recipient of FDI for the first time ever, according to UNCTAD data.[2]

Figure 2: China: Real GDP



Source: Natixis, CEIC

Ironically, though, the perception of China's Covid successful containment policies ended up being a curse. China doubled down on containment policies when the Delta variant hit the country in August 2021 by formally introducing the concept of "dynamic Zero-Covid" policies.[3] The same policies remained in place well past the Delta variant all the way to the much milder – but also less lethal variant – Omicron – which entered China on January 15. The rapid transmission of Omicron pushed Chinese local authorities, who had been constrained by Beijing's dynamic Zero-Covid mantra, to introduce lockdowns of entire villages and cities, all the way to forcing 25 million people in Shanghai to shelter at home on February 28, 2022. By April, areas accounting for some 40 percent of China's gross domestic product, including Shanghai and, partially, Beijing, were in lockdown. In addition, half of the highways in China were not functioning and the ports were operating inefficiently due to mobility restrictions.

The negative economic consequences of the sharp fall in mobility during the spring of 2022 are apparent in the extremely low GDP growth rate for the second quarter (0.4 percent). Household consumption plummeted, as can be seen by the collapse of retail sales, which grew negatively during that period and were nearly in the same range as during the Wuhan lockdown, and also with little support from online sales. An important reality to note, on this front, is that retail sales were increasingly weak in China following Wuhan's re-opening and even before the widespread lockdowns in the first half of 2022 (Figure 3). In other words, China's stagnant consumption seems to be a new normal, which may not be due to the lockdowns, implying that lifting the Covid restrictions might not bring as much growth as some expect.

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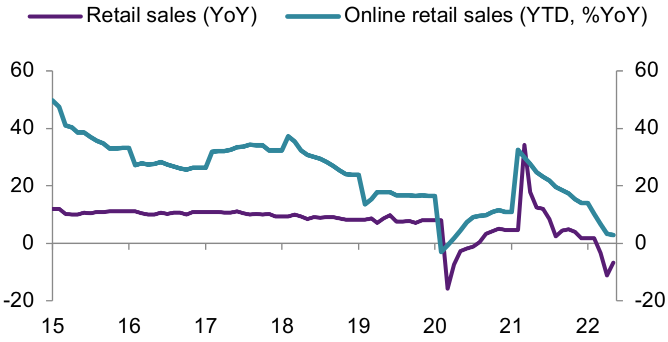
[2] https://www.reuters.com/article/us-china-economy-fdi-idUSKBN29T0TC

[3] https://weekly.chinacdc.cn/en/article/doi/10.46234/ccdcw2022.015

Figure 3:
China: Retail Sales and Online Retail Sales



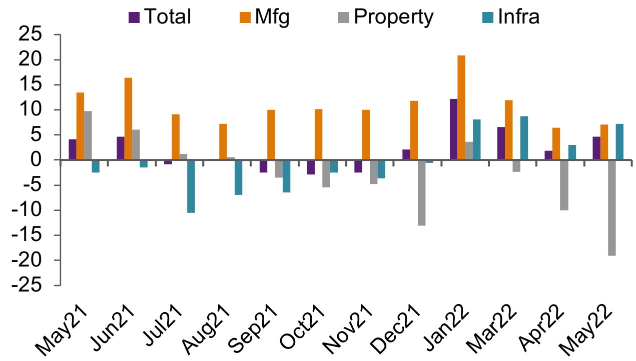
Source: NBS, Natixis

Other than plummeting consumption, the lockdowns in the spring of 2022 also disrupted the supply side of the economy. Manufacturing took a hit, given the central production and the logistics role of Shanghai and the other locked-down cities. This brought renewed pressures on the China-centric global supply chain, and it was accompanied by announcements by large multinationals of a supply chain reshuffling away from China.[4]

Similarly, draconian mobility restrictions since early 2022 depressed business sentiment which has remained at record lows throughout the year. This is particularly problematic given the severe difficulties that China's real estate developers have faced since the summer of 2020 when the so-called "three red lines" were introduced by Chinese regulators to stem the excessive leverage of developers. The collapse of China's largest real estate developer, Evergrande, in the summer of 2021 would probably have occurred even without Covid-related mobility restrictions and lockdowns, but these clearly did not help as negative sentiment resulted in plummeting demand for housing units. In fact, the growth of housing transactions has remained highly negative since the spring of 2022 and it is still not improving (Figure 4). The importance of housing transactions for growth stems from the historically very large contribution of the real estate sector to the growth of fixed asset investments in China. After the start of the pandemic, however, fixed asset investments began decelerating, which can mainly be explained by decreasing investments in the real estate sector (Figure 4).

[4] https://techcrunch.com/2022/09/21/apple-to-move-25-iphone-production-to-india-by-2025-20-ipad-and-apple-watch-to-vietnam/#:~:text=In%20a%20report%20they%20sent,of%20all%20iPhones%20by%202025

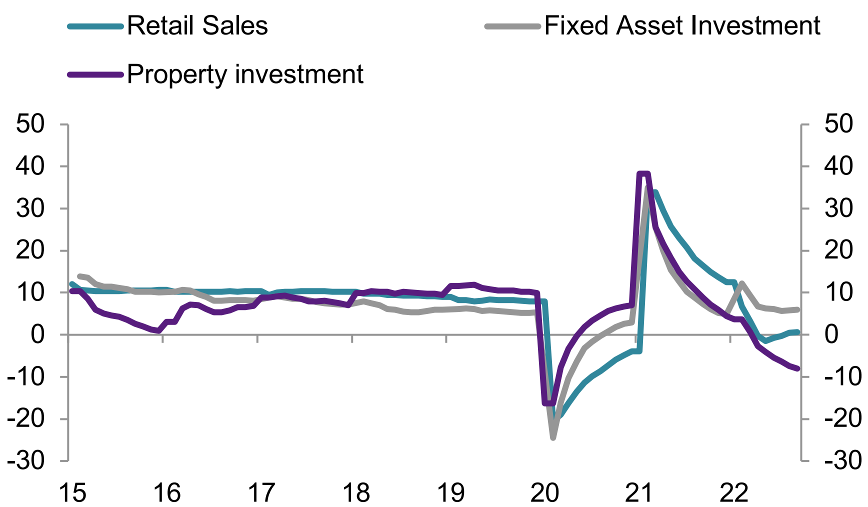
Figure 4:
China's Investment Breakdown (% YoY)



Source: Natixis, CEIC

All in all, the lackluster Covid-hit retail sales and the collapse of fixed asset investments in the real estate sector are behind China's very rapid deceleration of growth (Figure 5).

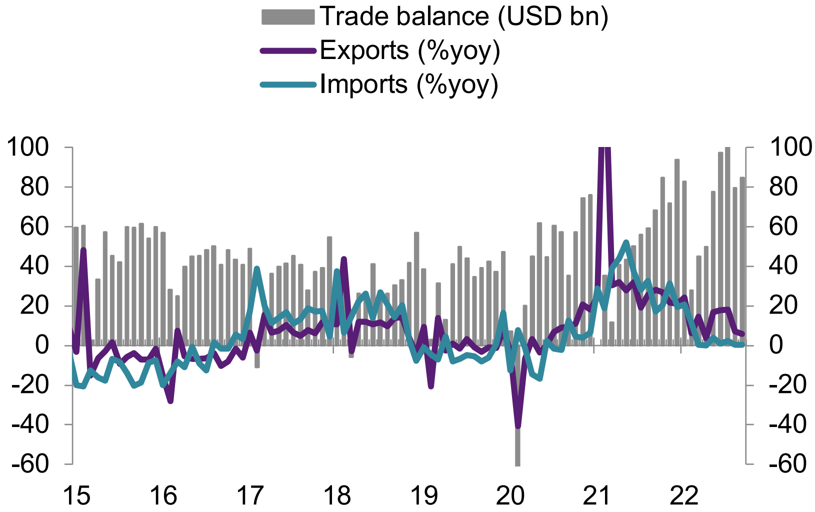
Figure 5:
China: Retail Sales & FAI & Property Investment (YTD %YoY)



Source: Natixis, Bloomberg ,CEIC

This very negative reality contrasts sharply with China's booming external demand. In fact, export growth, beginning in the second half of 2020 until only very recently, has been very strong. The first reason is China's "first in, first out" policy, with its manufacturing capacity opening before elsewhere in the second of 2020 opening , which led to a massive increase in exports, pushing up China's already high share of global exports. As we advanced into 2022, though, the situation became more complex, first because of Covid-related restrictions on manufacturing capacity in the first half of the year and then because of the synchronized global deceleration (Figure 6). Still, given the increasingly weak imports from China, which turned even negative in October 2022 (–0.8 percent), China continues to maintain its large trade surplus, which, in turn, continues to support growth.

Figure 6: China: Exports and Imports



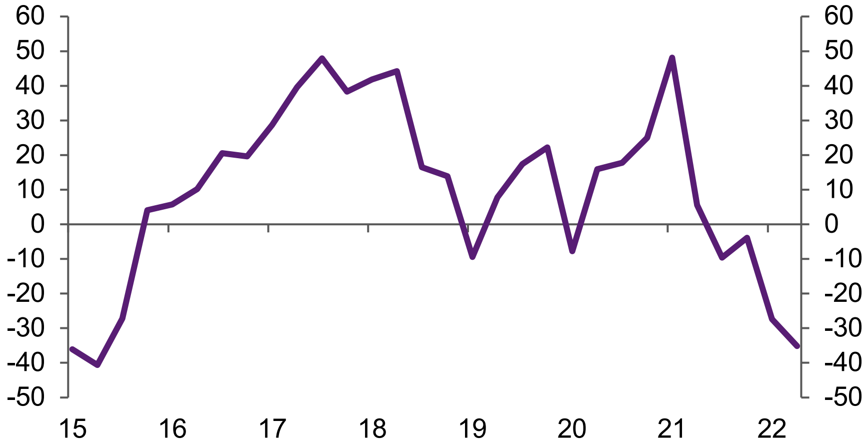
Source: Natixis, NBS

Since the summer, lockdowns have been more targeted, contributing to the recovery of economic activity, and, thereby, a recovering much higher GDP growth in the third quarter (3.9 percent). However, activity indicators for the month of October point to a renewed slowdown in the fourth quarter, and it is very likely that China's GDP growth for the whole of 2022 will be below 3 percent. This will amount to barely half of the 5.5 percent growth target established by the Chinese leadership during the "Two Sessions" in March 2022.[5]

Considering that 2022 is a crucial political year for China and for its leader, President Xi Jinping, one might wonder why there have not been more fiscal and monetary stimuli so that the official growth target can be reached. Some analysts argue that President Xi's personal commitment to deleveraging is simply too important. However, a cursory look at China's rapidly worsening public finances, on the one hand, and the increasingly large capital outflows, on the other, point to an alternative explanation. China does not seem to have enough room to carry out a large stimulus, whether it is fiscal or monetary. On the fiscal side, China's fiscal deficit, when measured comprehensively, including local governments and also local government financial vehicles (LGFVs), hovers at around 13 percent of GDP, according to my estimations, and when one includes the debt of state-owned enterprises (more than half of total corporate debt), public debt is larger than that in any other developed country (other than Japan). Furthermore, local governments are facing a collapse of land sales, which are their major source of revenue (Figure 7).

[5] https://www.scmp.com/news/china/politics/article/3169210/two-sessions-2022-chinas-lawmakers-meet-under-ukraine-conflict

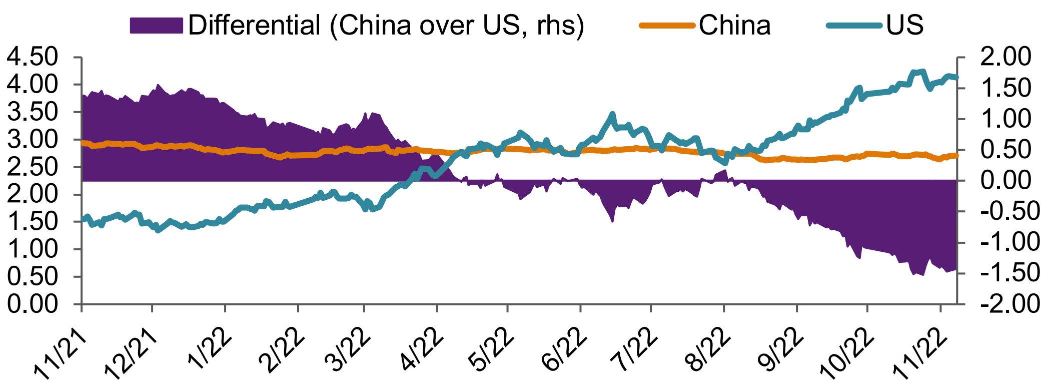
Figure 7: Government Land Sales Revenue (%YoY)



Source: Natixis, CEIC. N.B. Data as of Q2 2022.

On the monetary side, the rapid increase in interest rates globally but especially by the U.S. Federal Reserve, is making it increasingly difficult for the People's Bank of China to cut interest rates. In fact, the once positive yield differential between China and the U.S. is now highly negative, which is pushing portfolio flows out of China and into the U.S. This puts additional depreciation pressures on the RMB, discouraging portfolio investors from entering China (Figure 8).

Figure 8: 10-yr Government Bond Yield Differential (%)



Source: Natixis, Bloomberg. Data as of November 7, 2022.

One important issue that comes to mind is the effect of the Covid restrictions on China's missing of its GDP growth target for 2022. According to my estimates, the reduction in mobility stemming from China's dynamic Zero-Covid policies has shaved off at least 2.3 percentage points from GDP growth. This means that, without such restrictions, the official target might have been achieved.[6]

[6] https://research.natixis.com/Site/en/publication/sHXkXavoUcrYc40-HXXURg%3D%3D?from=share

Beyond Covid Restrictions, What is Wrong with the Chinese Economy

The fact that China might have reached its growth target in 2022 if such draconian Covid restrictions had not been introduced may lead some in the U.S. to think that after its dynamic Zero-Covid policies are abandoned, the Chinese economy will again become very strong. This inference is not correct.

First, China's official GDP growth target for 2022 was set at a rather low level compared to that in the past, as even before the Omicron wave hit in mid-January 2022 Premier Li Keqiang was fully aware of the several headwinds that the Chinese economy was facing. During the annual Central Economic Work Conference in December 2021, Premier Li gave hints at a much lower growth target, possibly around 5.5 percent, which, only a few months later, ended up being the official target.[7] This was lower than the GDP growth of 6.1 percent achieved in 2019, which in fact had been pushed down by the Sino-U.S. trade war as well as the unavoidable structural deceleration of the Chinese economy. Since then, Premier Li has had to add other headwinds, notably the Zero-Covid restrictions and Russia's invasion of Ukraine, which led to an increase in energy and food prices as well as to fears of secondary sanctions on China.

In other words, China might have been able to reach the 5.5 percent GDP growth target set by Premier Li if the Covid-19 restrictions had been lifted. But Premier Li was wise enough to lower that target, given the increasing cyclical and structural headwinds facing the Chinese economy.

What to Expect Next?

There are two important issues that will affect China's growth in the future. The first is whether its Zero-Covid policy will end completely, and, if so, how soon. President Xi's report to the 20th National Congress of Chinese Communist Party (CCP) did not announce an imminent lifting of Covid-related restrictions. Instead, it focused on the success of its Covid policy as compared to that elsewhere.[8] However, the very negative market reaction when the Party Congress concluded and the continuously poor economic data since the Congress seem to have pushed the Chinese government in the direction of some targeted re-opening. In fact, on November 10, the National Health Commission announced a shortening of its quarantine rules for incoming passengers and the lifting of some domestic restrictions on contact tracing, but there still was no clear message that the speed of such liftings will be pre-determined.[9] In fact, the size of any such re-opening is still open to question. So far, the re-opening seems to be focused more on cross-border mobility rather than on domestic mobility, thus raising questions about the possibility of improving growth.

Moving forward, the second question relates to China's remaining headwinds – such as the still unresolved problems in the real estate sector as well as the increasingly difficult external environment – and how such problems might impact a tentative lifting of the Covid restrictions. Obviously, one must add to these challenges China's unavoidable structural deceleration as the society ages and productivity continues to decline.

[7] https://www.scmp.com/economy/china-economy/article/3158408/key-china-economic-planning-meeting-said-be-set-next-week

[8] https://www.fmprc.gov.cn/eng/zxxx_662805/202210/t20221025_10791908.html

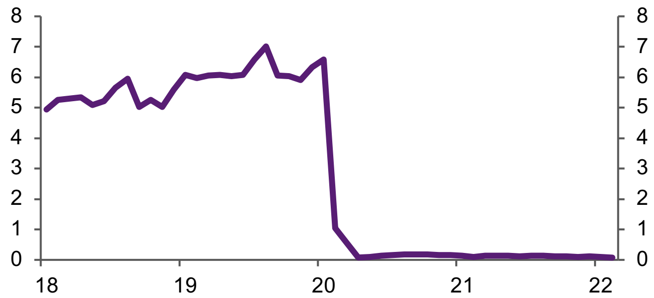
[9] https://english.news.cn/20221110/bbafa428411e4938a3cd0a29fffad844/c.html

The Geopolitics of Covid Policies

There is no doubt that China's dynamic Zero-Covid policy is highly political. The stubbornness with which the Chinese leadership has maintained its draconian lockdowns, notwithstanding the economic costs, cannot be understood without considering the political dimensions. President Xi's commitment to his "dynamic Zero-Covid" policy should be understood as an attempt to highlight the clear difference between China and the U.S. in terms of their respective responses to Covid. In particular, on several occasions President Xi has stated that the lives of the Chinese people are more important than the life of the economy.[10] Even within the recent partial re-opening announced by the National Health Commission there is a reference to China following a different path, compared to that of the West, in its move away from Covid restrictions.

Meanwhile, the fact that Chinese borders have remained practically closed for so long due to the draconian quarantine rules has brought Chinese exchanges with the rest of the world to a halt (Figure 9). This has also increased the mistrust between Westerners and Chinese, which does not bode well for business exchanges (Figure 10).

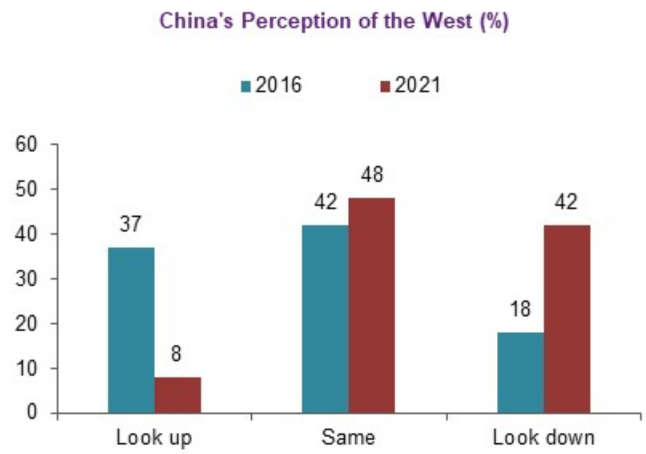
Figure 9:
China's International Air Passenger
(million persons)



N.B. Data as of February 2022.

[10] https://www.fmprc.gov.cn/eng/zxxx_662805/202105/t20210522_9133147.html

Figure 10: Chinese Views of the West



Source: *Global Times October 20, 2022 https://www.globaltimes.cn/page/202210/1277550.shtml*

In other words, the pandemic has clearly accelerated the speed of Sino-U.S. decoupling, at least as far as people-to-people exchanges are concerned, but also that of China with other economies more generally, as China has been closed to the whole world. In fact, the recent position paper of the EU Chamber in Beijing, probably the most negative in decades, argues that ideology is trumping the economy in China.[11] The lack of mutual understanding between China and the U.S. is also clear in terms of the much-reduced number of high-level meetings between the U.S. and China as well as between China and the EU or even its member-states. The increasing perception of a growing political, economic, and cultural divide between the West and China obviously does not bode well for future scientific or business collaborations between China and the broader international community, even though it is difficult to measure the immediate impact of this on the Chinese and global economies.

China's Growth Outlook Beyond Covid

Even as Covid hit the Chinese economy quite dramatically, the key question is what to expect once the Covid restrictions are lifted, especially in the medium term. As has been noted, the burst of the real estate bubble is another crucial headwind for the Chinese economy, and it will take years to be resolved. The related excessive accumulation of fixed asset investment and overcapacity are also hurting the country, especially third-tier cities. This big challenge has been simultaneously accompanied by structural headwinds. First, China's fertility rate has been declining and the population is aging rapidly, even more so after Covid, which is one of the most obvious scarring effects of the pandemic. Similarly, the speed of urbanization cannot but slow down as some 60 percent of the Chinese population are already urban residents. Furthermore, the experiences of the developed economies show that, even if incentives are introduced, it is not easy to increase the fertility rate. A large inflow of migrants also seems to be out of the question for Chinese policymakers. There is only one potential silver lining from the shortage of labor, namely the push for a technological

[11] https://www.europeanchamber.com.cn/en/publications-position-paper

upgrading in the direction of capital-intensive activities and the use of robots. However, the actual impact on productivity and thereby on potential growth is difficult to estimate.

Capital accumulation has long accounted for the lion's share of China's potential growth, but this is changing, even more so as business sentiment has plummeted due to Covid. Fixed asset investment, especially by the private sector, has been negatively affected. Another bottleneck for investment growth is the rising debt level, which, by the third quarter of 2022, stood at 287 percent of GDP. The long-term climate targets, such as achieving peaked emissions in 2030 and net-zero emissions in 2060, will also have important implications for China's long-term growth. This is due to the difficult balance between economic growth and de-carbonization initiatives in a country that is both the world's manufacturing hub and the world's largest emitter.

Finally, the increasingly aggressive competition between the U.S. and China already appears to be structural, thus constituting another important headwind for China's potential growth, especially if technological decoupling continues and two separate ecosystems emerge, one that is U.S.-centric and the other that is China-centric. This clearly will not be growth-enhancing, either for the U.S. or for China, but the costs are likely to be higher for China as it has not yet reached technological frontiers in key areas, such as semiconductors. The hope that China can leapfrog its technological upgrading by buying technology overseas seems more difficult than ever as Chinese outbound direct investments face growing restrictions not only in the U.S. but also in Europe.

In sum, there is by now a growing consensus that China's potential growth is decelerating and by 2030 it may well hover at around 2 percent. In other words, even if the Covid restrictions are lifted, with the related temporary boost in growth, the structural deceleration of the Chinese economy will not only be unavoidable but it will probably prevent China from closing its gap with the U.S. economy, at least at the current pace of US potential growth.

About the Contributor

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Photo Credit: Nearly empty duty-free shop at PEK amid the COVID-19 pandemic
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