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China: Navigating its way out of 'Zero-Covid'

Mounting economic and social stress to force a policy recalibration

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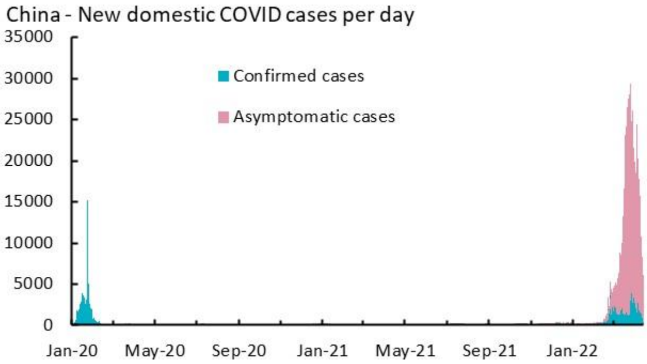
Key points

- A vicious Omicron flareup is giving Beijing's 'Zero-Covid' policy its toughest test since the onset of the pandemic. Although the strategy has proven effective to date in confining infections to a few places, the enormous economic and social costs have raised doubts about its sustainability
- The prospects of continuing economic and social disruption may have shaken Beijing's confidence in the strategy and could, in our view, prompt tangible changes as soon as Shanghai's situation stabilises
- The adjustment won't be a sudden leap to full liberalisation – due to health and political considerations – but a gradual and managed shift away from draconian lockdowns to more targeted containment, vaccines, self-testing and protecting the vulnerable
- While conceptually possible, striking the right balance will be difficult in practice. Doing too little may not help the economy, while going too far could risk losing control of the pandemic, incurring vast damages on the social and macro system
- Beijing therefore has to walk a fine line to seek a viable solution. Our base case assumes the right balance will be achieved and growth recovers in the second half of the year. Failure to do so could see the economy struggle more than it did in 2020

Déjà vu – 2020 all over again?

China has been battling its worst COVID-19 outbreak since the start of the pandemic. Total case counts – including those confirmed and asymptomatic – have risen to over 730,000 since early March, almost nine times the accumulated caseloads in the initial wave (Exhibit 1). Infection numbers in Shanghai – the epicentre of the current outbreak – have remained stubbornly high despite the citywide lockdown surpassing its one-month mark. At the time of writing, there are 14 districts nationwide labelled as high risk, and 104 labelled as medium risk. Together they account for about a fifth of China's population and GDP.

Exhibit 1: The worst outbreak in the pandemic



Source: CEIC and AXA IM Research, as of April 2022

The economic costs of strictly adhering to the 'Zero-Covid' strategy are mounting. Mobility indices have fallen sharply, reflecting broad-based declines in traffic congestion, railway passenger flows, and domestic air travel. Disruptions to the logistic networks are adding pressure to supply chains which are already stretched by a shortage of workers. Cargo shipment turnover has fallen by double digits, while road freight truck flows are averaging half of their normal levels at this time of the year.

On the production side, automakers have been hit hard by factory shutdowns in Shanghai and Jilin, while anecdotal evidence suggests that spring planting in major agricultural regions is hindered by a lack of farmers who are stuck in cities under COVID-19 controls. The latter may exacerbate food price inflation which has already been pushed higher by rising global prices in the wake of the Ukraine crisis. On the demand side, consumer spending is now limited to bare essentials in places like Shanghai, services activity has contracted, and part of the recent weakness in the property market – despite policy relaxations – may be due to lockdowns keeping prospective buyers away.

The notable deterioration in March's activity data gave a glimpse of the growth shock. But that merely scratches the surface given Shanghai's lockdown started in April. The current outbreak, combined with Beijing's insistence on the 'Zero-Covid' policy, has turned hitting the 5.5% growth target from challenging to impossible, even with an aggressive stimulus package. We recently downgraded our growth forecast to 4.5% from 5% and see the balance of risks still tilted to the downside.

Zero-Covid policy runs its course?

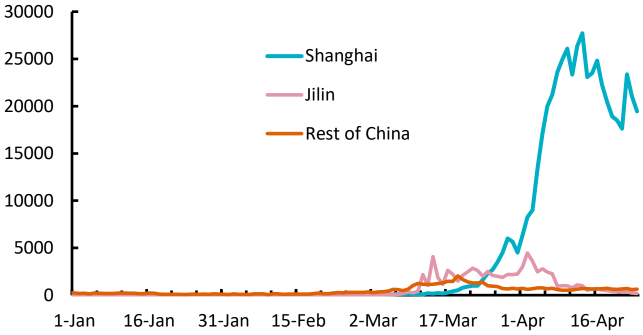
Despite its insistence, we think Beijing's confidence in its COVID-19 policy is waning in light of recent events. This is not because the strategy has lost its effectiveness in containing the virus – the quick resolution to Shenzhen's outbreak and the successful isolation of the rest of country from Shanghai's debacle (Exhibit 2) are evidence that it remains effective in cutting off contagion of a highly infectious disease. The problem, in our view, lies more with the sustainability of the approach, which involves balancing social and economic costs against the benefit of suppressing infections of what's increasingly seen as an endemic.

Given time, Shanghai's situation will stabilize. But what is worrying is what happens to the city after it exits from COVID-19 controls. Given the high transmissibility of this virus, it is very likely that Omicron could come back, resulting in repeated flare-ups. And without changing the overarching policy from the top, the city – and the nation as a whole – could experience repeated lockdowns, leading to prolonged economic and social paralysis.

Beijing clearly understands this risk, and has hence, ordered the 'Zero-Covid' policy to be implemented with "minimal economic impacts". That, however, has been proven to be easier said than done. With several local officials removed from office due to COVID-19 mismanagement, the incentives for prioritizing virus control over economic growth are clear. Such an inability to strike the right balance between fighting the pandemic and preserving economic stability will, in our view, force Beijing to reconsider its policies soon.

Exhibit 2: "Zero Covid" is effective at confining virus

New confirmed COVID-19 cases in 2022



Source: CEIC and AXA IM Research, as of April 2022

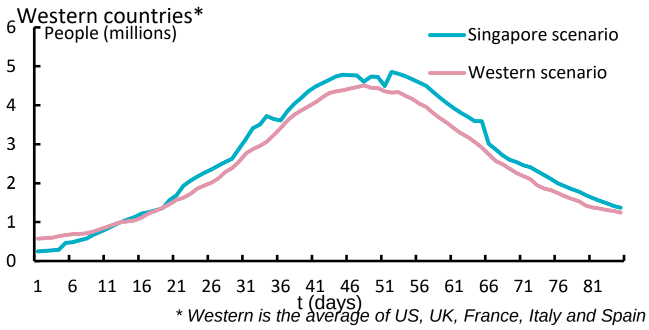
Risks of premature liberalization

So what is holding Beijing back from pursuing a 'living with COVID' strategy, which has become mainstream globally? Apart from political considerations (to be discussed later), China is not as prepared – from a medical standpoint – as many western countries were before they adopted this approach.

While an early mover on vaccination, less than 60% of the population has completed three shots so far. Concerns over vaccine efficacy have subsided following recent studies[1] – indicating comparable results between Sinovac and BioNTech vaccines after booster shots – but the low vaccination rates, particularly among the elderly, are disconcerting. The latter is reinforced by Hong Kong's experience during its fifth COVID-19 wave, where people over the age of 60 accounted for over 95% of deaths and close to 90% of them were not fully vaccinated. With a 264 million elderly population and less than 60% having completed three shots,[2] it's understandable why Beijing is cautious about opening up.

Exhibit 3: COVID cases to surge on relaxed controls

Scenarios of daily new cases if China replicates Singapore and Western countries*



Source: Our world in data and AXA IM Research, as of April 2022

Besides low vaccination rates, Beijing has only just started rolling out antigen test kits and antiviral drugs. Medical infrastructure –

[1] Sinovac Boosters Provide key Protection for Older People, New Study Finds

[2] As of mid-April, around 80% of the elderly population was fully vaccinated and 57% have received the third vaccine dose.

measured by hospital beds per capita – could also fall sharply short of what's required to treat severe cases if the virus is let loose. Using Singapore and western countries as a guide, Exhibit 3 shows that China could see its daily cases rise to close to five million, with hospital admittances at 60,000 to 80,000 at the peak. The total death toll could reach 150,000 based on the experiences of Hong Kong, Singapore and Vietnam, applied to China's current vaccination rates across demographic cohorts. Without proper management and preparations, these numbers could overwhelm the public health system and destabilize society.

The way forward

The authorities are, therefore, facing a serious dilemma. Continuing with its current approach risks plunging the economy into a deep recession, resulting in wide-spread job losses and social discontent. Moving to the other extreme of 'living with COVID' could inflict a crisis on the health system, leading to social and political disruptions too. Neither outcome is palatable in a year of leadership transition where economic, social and political stability is of paramount importance.

One possible, but highly uncertain, way forward is a gradual and managed transition away from the current policy but far from reaching full liberalisation. Such a gradual adjustment may involve scaling back the use of draconian lockdowns, replaced by more targeted controls and closed-loop operations to lessen the economic shock. Many social restrictions – such as mask wearing, social distancing, and trace and tracking – would remain in place to slow the speed of virus transmission. In the meantime, compulsory PCR testing could be slowly replaced by faster antigen tests, and patients with no/mild symptoms could be allowed to quarantine at home. The latter would free up medical resources for treating those with severe symptoms, with the government building more temporary hospitals in anticipation of a possible surge in patient numbers. But the most important preparation of all is accelerating vaccination for the elderly – a tried-and-tested way to lower death toll.[3]

Timewise, such changes could happen gradually once Shanghai's situation is under control. Waiting another six months for the Party Congress to end could prove too late for saving the economy. At the same time, making hasty changes before the battle in Shanghai is won could send confusing signals to local officials, and be seen as Beijing admitting the failure of its policy. The political consequence of the latter will be dear, so we think Beijing would want to avoid it at all costs.

For the same reason, we also do not expect a high-profile announcement of abandoning the 'Zero Covid' policy. Instead, the adjustments described above could be justified as necessary modifications to the 'Dynamic Zero Covid' approach in light of a changing virus. In other words, the name won't change, but it will be new wine in the old bottle.

For the real economy, softening COVID restrictions should be growth positive, but the degree will be checked by a lack of full liberalization. Combining this with pent-up demand and more forceful policy supports, the economy should rebound in the second half of 2022, with full year growth exceeding 4%. However, there are acute risks both to this projection and the COVID-19 outlook.

Entering the unknown

The greatest risk to our base case lies with the failure to strike a realistic balance between reviving growth and keeping infections low. Easing restrictions too much risks losing control of the pandemic, while tinkering at the edges of the COVID response may not make a sufficient difference to the economy. Getting the balance right will therefore be a challenging feat. Indeed, there is no guarantee such a benign path even exists – few countries have succeeded in lessening the economic impact of COVID-19 while maintaining low case numbers. But the consequences for China to misjudge this could be greater with its larger unimmunised population.

The economic risks of not getting the balance right are squarely to the downside. As explained above, too cautious a move – involving only peripheral changes – will not meaningfully revive the economy. But too drastic a relaxation could spread the virus like wildfire, which would require even more draconian controls to contain further down the line. In both cases, the economy would likely suffer from a prolonged paralysis, resulting in permanent scarring and loss of competitiveness.

The same may also occur if Beijing were to postpone changes until the Party Congress in early Q4. Another six months of rolling lockdowns as the virus flares up randomly across the country could incur the same damage as an unsuccessful COVID strategy change.

Under these scenarios, one could envisage a deeper growth contraction in Q2 than our base case, with the weakness persisting in Q3 before a rebound finally occurs towards the year end. Full year economic growth could fall below 2%[4], worse than 2020's 2.2%. While this may pave the way for a strong growth rebound in 2023, the lasting damage from prolonged economic paralysis and a loss of policy credibility could haunt the Chinese economy and financial markets for many years to come.

[3] Beijing can either implement these changes nationwide in a cautious and gradual fashion or introduce pilot trials in cities with high vaccination rates and good medical infrastructure. If proven feasible, the pilot program can be broadened. This is similar to how major economic and social reforms were carried out in the past.

[4] It is possible that the official activity data will show a much stronger economic picture this year than that conveyed by third party data. We saw such a gap in Q1, and the pattern could well persist as lockdowns deepen the economic pain. Some of this could be driven by the broader coverage of the official data (e.g. medical spending on COVID containment) and data smoothing techniques, but political considerations are also important in the light of a growth target, which didn't exist in 2020. In any case, markets are unlikely to be very sensitive to benign GDP outturns if there is clear evidence of economic struggle.

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