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CHINA: COVID SITUATION AND ITS IMPACT ON ECONOMY

DETERIORATING OUTLOOK CALLS FOR POLICY ADJUSTMENT

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SUMMARY

› The covid situation in China has deteriorated significantly since the start of this year. In response, the government has doubled down on its zero-covid policy by imposing aggressive containment measures in several regions.

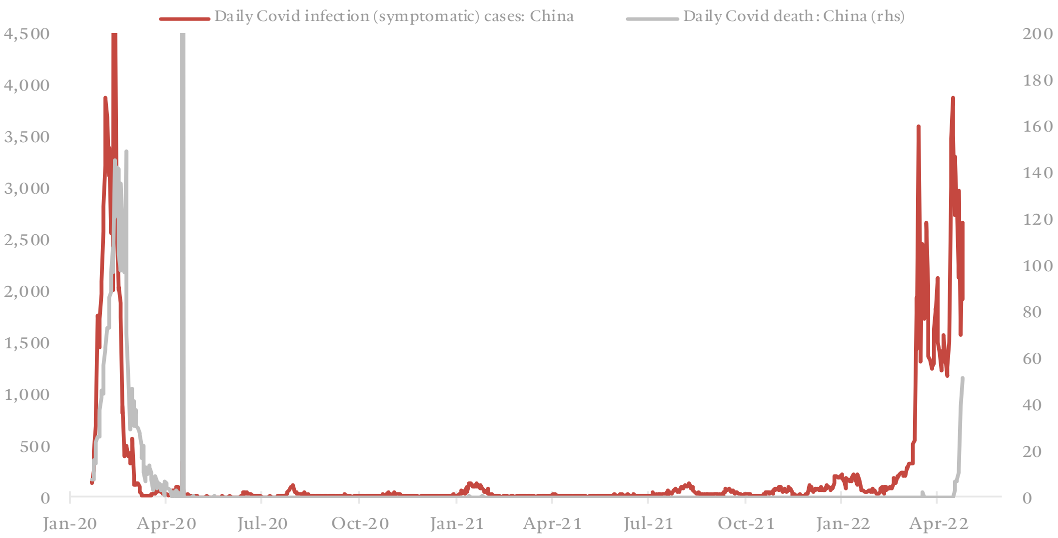
› The escalated control measures have become the dominant near-term growth headwind in China. We estimate that the current containment measures could shave 55bps off Chinese GDP per month compared to our previous base case.

› We expect more concrete macro policy support to mitigate the downward pressure on growth, especially in the form of fiscal stimulus for infrastructure investment. But adjustment to China's 'zero covid' policy is needed for any sustainable recovery.

Covid outbreaks prompt tightened containment measures

China is currently fighting its largest wave of covid infections since the beginning of the pandemic. Whereas daily new cases averaged 200 from April 2020 to February 2022, China's daily new (symptomatic) cases currently hover around a few thousand, spread across widely across regions *(Chart 1)*. In response, the Chinese authorities have adopted aggressive containment measures in accordance with their zero-covid policy (ZCP).

CHART 1: NEW DAILY COVID CASES IN CHINA



Source: PWM - AA&MR, China National Health Commission, Wind, 25 April 2022

Local covid outbreaks have become more frequent in China since the second half of last year when the Delta variant started to spread. The Chinese government resorted to

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aggressive mass testing, contact tracing and targeted isolation in the early stage of the outbreaks (the so-called "dynamic clearing strategy") and successfully contained the spread of the virus with limited social and economic costs. This approach also enjoyed reasonable popular support.

However, these targeted measures have been overwhelmed by the arrival of the highly transmissible Omicron variant. To achieve their "dynamic-clearing" objective, local governments have had to significantly step up containment efforts, which has ultimately led to full lockdowns in many localities. For example, following the full lockdown of the Jilin province on 6 March, Shenzhen and Shanghai, the two most important manufacturing and financing hubs in China, which jointly account for around 6% of China's GDP, also announced full lockdowns in March.

The dominant growth headwinds in the near term

Although a vast majority of the detected cases are asymptomatic and reported mortality rates are low, the economic damage stemming from the recent covid outbreaks and the stringent containment measures they provoked is huge. In our view, the current wave of covid infections and the government's ZCP (mainly the latter) have become the dominant growth headwinds for China in the near term.

TABLE 1 : CHINA'S CONTAIMENT ZONE CATEGORISATION

Containment category	Control measures	Threshold to lift restrictions	GDP % exposure (as of 28th April)
Contained zone (封控区)	Full lock down Residents grounded at home Services to the door	No new symptomatic and asymptomatic case in 14 days Negative mass testing results for the area, 2 days before measures are eased	~12%
Restricted zone (管控区)	Residents grounded to living area One trip every 2-3 days per family Gathering are prohibited		
Preventive zone (防范区) **and/or mobility controls**	Gathering are prohibited Social restrictions apply	When the entire district or county does not include any contained and restricted area.	~39%

Source: PWM - AA&MR, Chinese Government

According to our estimate, the regions that are currently subject to some sort of restrictions represent about 51% of Chinese GDP (*Table 1*). While this has declined from 60% about two weeks ago, it is still significant (and could rise again as the virus has not been brought fully under control). This has led to broad-based slowdown in economic activity at a national level. In particular, domestic consumption, already weak, deteriorated further in March, especially for services, with the Caixin services purchasing manager index (PMI) reading dropping sharply to 42.0 from 50.2 in February. Retail sales in March contracted by 3.5% year on year (y-o-y), down from an expansion of 6.7% in the first two months of the year. Retail sales data for April will likely be even worse as the March numbers did not fully capture the impact of the lockdowns.

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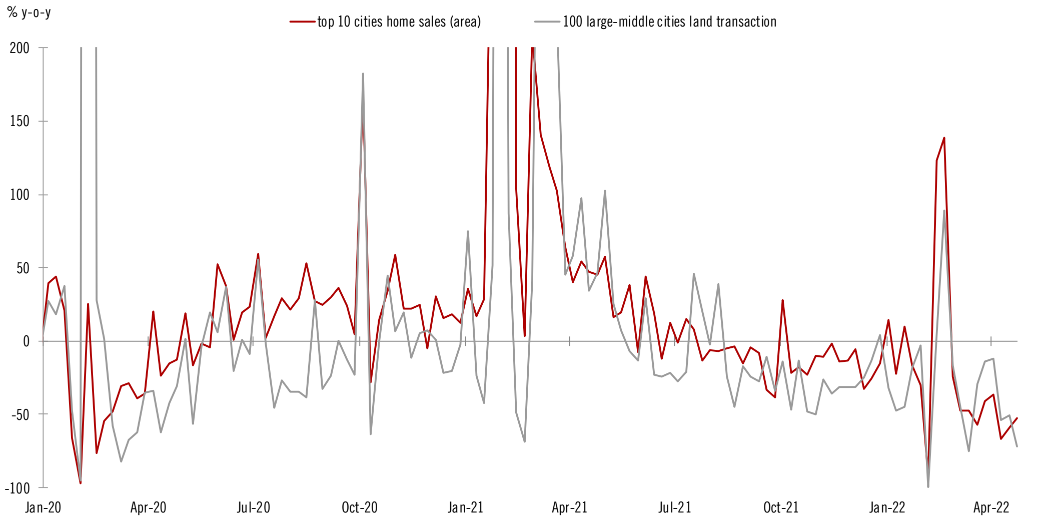
CHART 2: GROWTH IN HOME SALES IN CHINA'S MAJOR CITIES

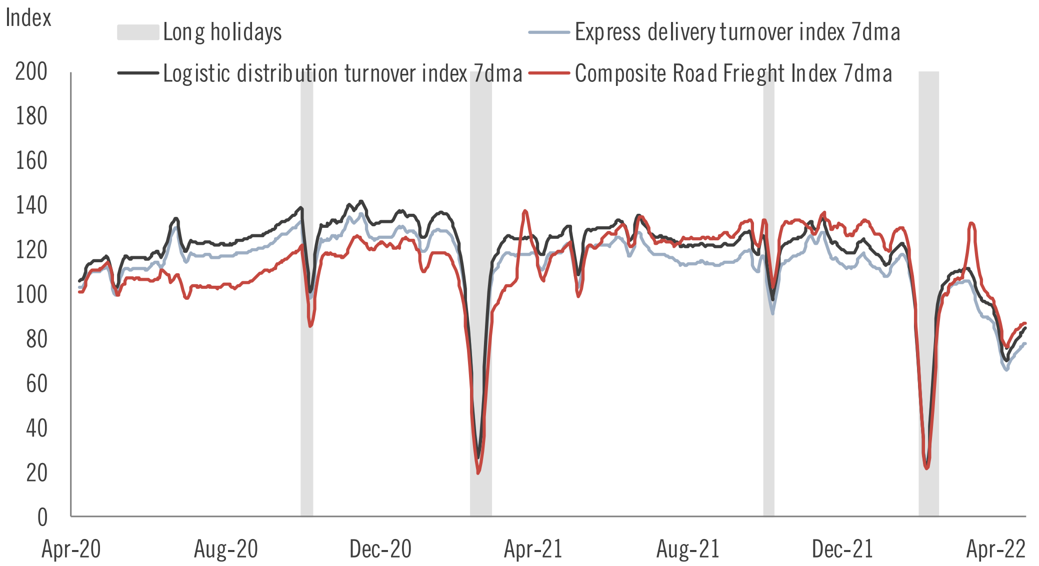


Source: PWM - AA&MR, Wind, 24 April 2022

Restrictions on mobility have exacerbated the downturn in the property sector. Tightened regulations on property developers' indebtedness has led to a liquidity crisis in this sector since last year while worsening sentiment and the economy's slowdown have resulted in lower housing demand. The aggressive mobility restrictions recently introduced in many cities have made housing activity even more difficult. For example, in China's top 10 cities, housing sales (in terms of floor area) contracted by more than 50% y-o-y in the week ending 24 April (*Chart 2*). Weak sales obviously add to the challenge of tight liquidity conditions for developers, who recorded a 19.6% y-o-y drop in total funding available in March, compared with a 17.7% drop in the first two months of 2022.

The impact of strict containment measures is not limited to the retail and the property sectors. While some industrial companies are allowed to operate in a 'closed-loop' (which requires all employees to live in the offices or factories during the lockdown period) to reduce the disruptions to manufacturing, most small- and medium-sized enterprises (SMEs) are not able to satisfy such requirements. In addition, the restrictions on transport and tightened preventive measures at ports have caused serious disruptions to logistics (*Chart 3*). The impact is being felt nationwide, including in many areas that have not seen any fresh covid outbreak, and we could see another round of global supply-chain disruption.

CHART 3: INDICATORS OF CHINESE DOMESTIC LOGISTICS NETWORKS



Source: PWM - AA&MR, Wind, as of 25 April 2022

Persistently weak domestic demand has had an impact on the labour market as well, with the unemployment rate edging up in March for the fourth consecutive month to 5.8%, beyond the 5.5% forecast recently announced in the National People's Congress meeting. Slowing household income growth and declining excess savings also point to weaker spending power ahead.

According to our estimate, the additional containment measures could shave **55bps off Chinese GDP per month compared to our previous base case**. The longer the restriction measures last and/or the wider they are applied, the greater the economic damage.

Policy adjustment is needed for sustained recovery

Despite the surging economic cost and increasingly vocal complaints by residents placed under tight lockdowns, there is no sign that the Chinese government will give up its ZCP anytime soon. Indeed, at a high-level meeting on 17 March, president Xi Jinping reiterated the need to stick to the ZCP, citing the importance of protecting people's lives. While he also called for a balanced and scientific approach to limit the damage to the economy, curbing the spread of the virus obviously is still the top priority.

In our view, the political necessity of keeping covid contained before the Chinese Communist Party's 20th National Congress, which probably will take place in October, suggests that the ZCP could stay in place for some time.

To mitigate the significant downward pressure on growth, we expect more concrete policy support in the near term. Fiscal stimulus will likely play an important role in supporting infrastructure investment, and possibly household consumption as well. Indeed, in the recent meeting of the Financial and Economic Affairs Committee, President

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Xi called for all-out efforts to build modern infrastructure in China. In addition, more targeted monetary policy tools may be deployed to support micro and small businesses and sectors heavily affected by the recent covid outbreaks.

In our view, however, stimulus can only be effective if heavy mobility restrictions are lifted. Hence, to engineer a sustained economic recovery, the Chinese government probably will have to adjust its ZCP, if not abandon it entirely. Whether there will be any progress on this front remains to be seen. In the meantime, forecasts for Chinese growth face downside risk.

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