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Independent Thinking

Recession Watch: is ‘zero COVID’ on the way out?

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Headlines

- China’s ‘dynamic zero COVID’ policy was never sustainable for the long run
- Recent events mean that its endpoint is looking increasingly close
- The big question now is whether China’s exit will be orderly or not
- Elsewhere, investors continue to seek signs of a pivot on rate rises from central bankers, with more reason to expect one in the US than in the UK

In China, daily new COVID-19 cases have increased sharply in recent days, surpassing the previous peak seen in April when there was a large outbreak in Shanghai. The news highlights the unsustainability of the country’s ‘dynamic zero COVID’ policy. Much discussion has focused on when the authorities will change tack, but even the CCP is not all-powerful in this regard. As cases spread, the past couple of years have shown that China now faces an increasing risk of an extremely large wave, perhaps crossing a tipping point where case rates go vertical. This risk is particularly acute as the Chinese population has almost no hybrid immunity. Indeed, estimates suggest that 1.5 million people could die in such an ‘exit wave’, highlighting why the authorities do not wish to allow this to happen.

The most obvious option, then, is for China to vaccinate its elderly as fast as possible. That has been our baseline view, and reports this week suggest that this plan will soon be put into action. Given lacklustre vaccine take up so far, both carrots and sticks may be required to maximise coverage. The vaccination drive will be a race against time before the virus gets out of control or public dissatisfaction boils over. The upshot is that China’s COVID policy is unlikely to be in place by Q2 or Q3 next year after an exit wave (either disorderly or not). China’s consumption of crude oil and liquid fuels is back in positive territory on a year-on-year percentage basis after falling sharply through its spring lockdowns. A full reopening would be likely to lift this further, putting upward pressure on global commodities prices, and adding another layer of uncertainty to the outlook for headline inflation in 2023.

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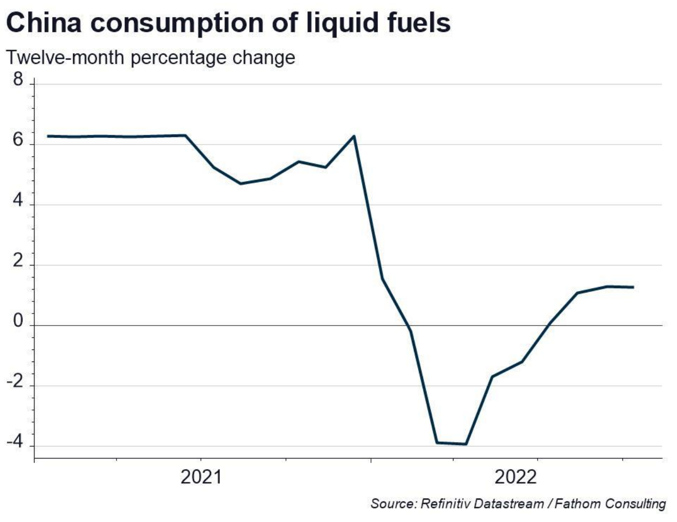
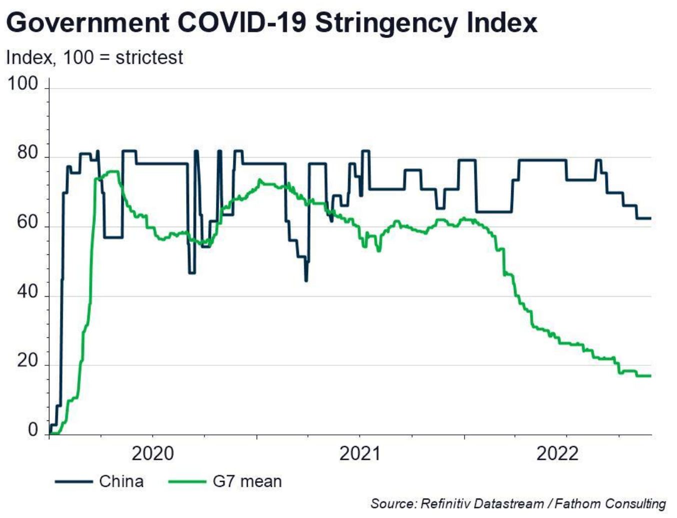


There have been protests across China as public dissatisfaction with ‘dynamic zero COVID’ has increased. China is unique in still maintaining such a harsh approach to managing COVID, and that seems to be wearing on the public. A measure of the stringency of COVID restrictions, produced by researchers at Oxford University, shows that Beijing has loosened some recently. However, the gap between China and the average G7 nation remains extremely wide. The authorities are likely to face increasing pressure for looser restrictions, helping to explain the pivot towards a more ambitious vaccination campaign.



Fresh off President Xi’s coronation at the 20th Party Congress, the protests raise questions about the enduring legitimacy of the CCP. A new database from Freedom House has been tracking protests in China since the middle of the year. It shows that they increased sharply from May before easing more recently, at least based on provisional data from September onwards. Dissatisfaction was seen to be mainly economic, and linked to trouble in the housing market. The authorities have been able to placate this by ensuring retail buyers are protected from losses, even if construction companies and their professional creditors

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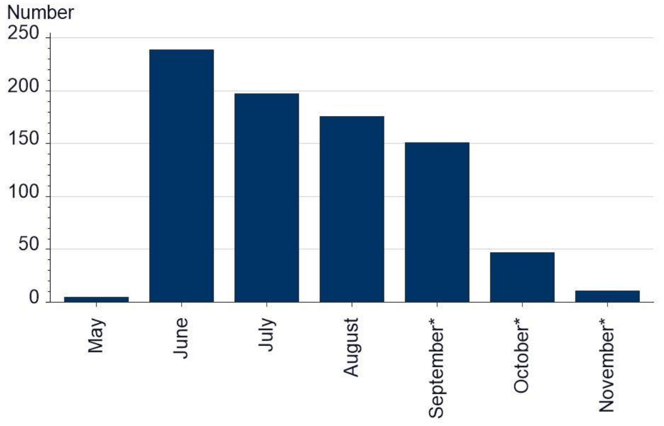
are not. Protests against 'dynamic zero COVID' are not so easy to dissuade. A more forceful crackdown on protestors seems the most likely outcome. The party has weathered unrest before. For the moment, there is no reason to think this time will be different. However, the current unrest highlights the vulnerability of autocratic regimes, whose weaknesses are not always easily identifiable. The Chinese government has made a bargain with its people: leave us alone and we will make you and your family richer. As the country reaches the 'middle income trap' and growths slows, as is our baseline expectation, this deal will become harder and harder to sell. Maintaining power may require even greater levels of control, probably making the growth outlook worse as a result. Such an outcome would make it more difficult to credibly sell its political-economic model to third countries in what is expected to be an increasingly multipolar world.

China protest events in 2022



*Preliminary

Source: Refinitiv Datastream / China Dissent Monitor / Fathom Consulting

Elsewhere, all eyes will be on key European and US inflation data in the coming weeks, ahead of policy decisions by the BoE, ECB and Fed in December. Today's 'flash' euro area figures pointed to a downside surprise in price pressures in November, opening the door for a slowdown in rate hikes by the ECB despite its policy rate being much lower than the Fed's. Indeed, European central banks seem to be partly betting on Fed hikes doing their job for them. There is some validity to this view. The synchronised nature of rate hikes is likely to amplify the effect on demand, compared with any single central bank going on its own. The share of DM central banks that have tightened by 150bps over the previous six months is at highs not seen for several decades. Something similar is true for EM central banks. Synchronised policy tightening should, at the margin, allow each individual central bank to tighten by less than it otherwise would. Moreover, the particularly rapid policy tightening in the US will have larger international spill overs, given the US dollar's important role in global trade and international debt markets. However, each country's inflation outlook will ultimately reflect domestic policy choices, to ensure demand and supply are balanced and inflation expectations remain well-anchored. Policymakers at the Bank of England may find that out the hard way next year.

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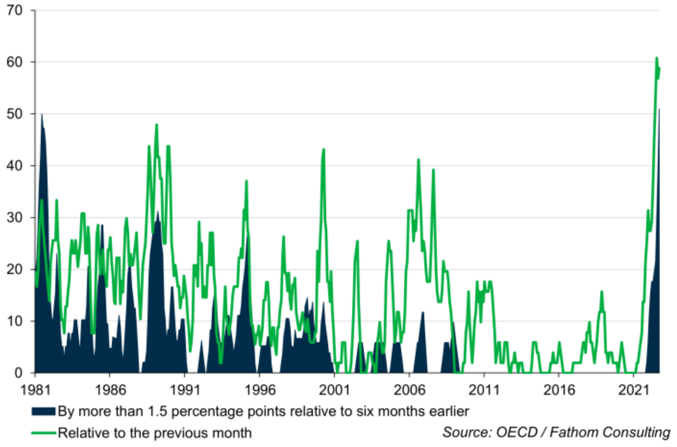
DM central bank policy tightening

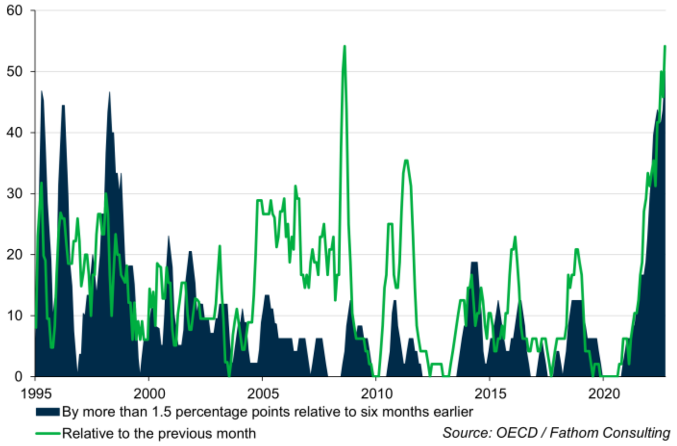
Per cent of total, 3-MMA



Source: OECD / Fathom Consulting

EM central bank policy tightening

Per cent of total, 3-MMA



Source: OECD / Fathom Consulting

Interesting reading

- A China COVID policy pivot? [China Aims to Boost Elderly Covid Vaccination Amid Reopening Pressure - Bloomberg]
- The potentially disastrous consequences from a disorderly end to 'dynamic zero COVID' highlight why Beijing is stepping up its elderly vaccination campaign: [Modeling transmission of SARS-CoV-2 Omicron in China | Nature Medicine]
- *The New York Times* on why China's protests are unlikely to result in regime change https://www.nytimes.com/2022/11/30/world/asia/china-covid-protests-xi-jinping.html

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- The Bundesbank on how the recent bout of inflation was driven by both demand and supply factors: *What drives inflation? Disentangling demand and supply factors (bundesbank.de)*
- An alternative source that measures strikes in China suggests that labour unrest has eased since peaking in 2015/16: *https://maps.clb.org.hk/?i18n_language=en_US&map=1&startDate=2022-10&endDate=2022-11&eventId=&keyword=&addressId=&parentAddressId=&address=&parentAddress=&industry=&parentIndustry=&industryName=*

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