

China's lockdown crisis ups the stakes

Jeremy Weltman Thursday, May 12, 2022

The country's zero-Covid policy worsens the operating environment for investors concerned by an agglomeration of negative risks.



A resident looks through a gap in a barrier at a Shanghai residential area during the Covid lockdown. Photo: Reuters

Lauded as one of the world's fastest-growing emerging markets (EMs), and one that was opening up to the world for trade and investment, China had seemed to be a one-way bet a decade ago as an EM that could not be ignored.

In 2010, China was the safest of the Brics and Mints groupings of the world's largest EMs, and that remains true today, based on the metrics compiled from Euromoney's crowd-sourcing country-risk survey of around 300 experts.

Yet China is now 47th out of 174 countries in the global risk rankings, when 10 years ago it was 10 places higher. [Its failure to make further ground is a concern.](#)

Burdened by slowing economic growth, debateable policymaking choices and rising debts that have recently manifested in property-sector defaults – plus a raft of top-down regulatory interference – many have started to question China's credentials.

Its human-rights failings were always a concern, but the internment of the predominantly Muslim Uyghur ethnic group in Xinjiang and the throttling of democracy in Hong Kong have only increased that unease, worsened by Beijing's cross-strait belligerence and its failure to condemn [Russia's actions in Ukraine.](#)

And yet for all these drawbacks, China is always relied upon for its strong trade and fiscal-fuelled economic growth, making it the pulsating economic engine of the world and an abundant source of low-cost goods and crucial supplies. It also has one of the world's largest consumer markets.

Now the pandemic appears to be the catalyst for one of its greatest failings: an inability to adapt by imposing draconian lockdowns and mass testing with no modifications that take into account vaccinations, herd immunity or less virulent mutations.

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This says much about how the Communist state operates, and equally as much about its sub-optimal vaccine programme. Only less-efficient Chinese manufactured vials are permitted to be used, and there are still too many of its elderly citizens without the recommended number of jabs.

Dual problem

With no Plan B, the government risks harming the economy and the China Communist Party's (CCP) legitimacy by inflaming social instability, as the vociferous responses directed towards local party officials from Shanghai's fenced-in apartment blocks underline.

Towns and cities are still routinely locked down even if only a handful of Covid-19 cases emerge. Contrast that with other countries in the region that have moved towards a more practical living-with-Covid policy, which takes a sensible approach towards protecting the more vulnerable segments of the population and healthcare resources, while enabling the economy to function as normally as possible.

Even Chinese citizens are now questioning the competency of its authorities to carry out such actions, not least in ensuring that local populations can access food and essential services.

Such questions come at a time when president Xi Jinping is aiming for a positive public mood domestically, and stability, as he seeks an expected re-election at the 20th Party Congress later in the year.

Economic impact

The downfall of China's approach is borne out on one level by the bare economic facts.

Take mandatory testing. This is likely to cost in the region of RMB1.7 trillion per year, given China's enormous population size. This is around 1.5% or more of GDP, piling pressure on municipal and local authority finances that are already undermined by having to spend their way out of a slump.

Shanghai is China's economic hub, and is home to its busiest port, and that alone is sufficient to downgrade the country's economic growth prospects, which with lockdowns in other towns and cities suggest the government's 5.5% target for real GDP growth this year will be difficult to meet.

In April, the IMF was predicting just 4.4%. Private-sector bank Nomura has gone out on a limb, forecasting 3.9%, as the supply shock manifests in lower demand for goods. Others are beginning to adopt a similar view.

And the impact is becoming crystal clear.

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- Chien Szu-Min”

ECR survey contributor and ABN Amro senior economist Arjen van Dijkhuizen notes that China's purchasing managers' index (PMI) readings have fallen further below the neutral 50 mark, to the lowest levels since the initial Covid-19 shock in Q12020.

"The official manufacturing PMI fell to 47.4 in April (from 49.5 in March) and the non-manufacturing PMI to 41.9 (from 48.4)," he says. "This brought the official composite PMI down to 42.7 (from 48.8), while Caixin's manufacturing PMI fell to 46.0 (from 48.1).

"These developments were more or less in line with expectations, as we anticipate April to be the weakest month in China's current pandemic-driven cycle, both for manufacturing and services."

Van Dijkhuizen adds: "All this clearly reflects the impact of the broadening of lockdowns seen since the second half of March, on the back of the spread of Omicron. This has created heavy headwinds to China's economic growth and added to domestic supply bottlenecks spilling over to global supply chains."

Milos Vulanovic, associate professor of finance at the EDHEC Business school, is another of Euromoney's survey contributors who monitors China's risks.

With the Covid policy prioritizing health stability in the short term over economic stability, it will negatively impact supply chains and increase the prices of manufactured goods, he believes.

There may be some increasing inflation, says Vulanovic, but adds that the [inflationary policies](#) of the US Federal Reserve and European Central Bank (ECB) – and the dollar-peg policy of the People's Bank of China – make Chinese manufacturing goods relatively cheap.

He also agrees that shutting down the Shanghai main economic zone will have implications for the overall levels of GDP this year and significantly decrease growth in the short term, with internal seasonal migrations also altered.

Holistic view

Vulanovic goes on to consider China's risks more holistically and takes a measured view that is largely reflected in its risk ranking.

He notes the fact that China, as one of the leading world economies with a relatively high stock of capital, would have enough investors willing to take the risks.

China lacks an adequate regulatory framework, it is slow in addressing environmental, social and governance (ESG) concerns, and there is the view that possibly insiders have an advantage in its financial markets.

"Yet, overall, informed investors are aware of these, and specialized Western companies would continue to operate at the same pace," says Vulanovic.

He also states that it is hard to say what the increasing bonds between China and Russia will bring.

"Closer relations between the two are causing a lot of consternation in the West, but on the other side it is undeniable that Russia is the wealthiest natural resources country very much needed by China and that closer economic ties in an orderly environment could strengthen both," says Vulanovic.

On the domestic political situation, he feels it is hard to assess the mood of the population, although it is reasonable to expect that there is a high degree of support for the president's policies among various segments of the population.

Party loyalty, a state-backed media and rising standard of living are among the factors that various experts have alluded to that support this.

Still, as others – such as Chien Szu-Min, associate research fellow at the Taiwan Institute of Economic Research – have pointed out, to quell public anger other members of the party elite who are not Xi's supporters may be included in the leadership, and this may lead to policy adjustments.

Investor warning

Chien states that the severe and long-term lockdown “has caused a great warning to domestic and foreign investors”.

“It means that in order to achieve their zero-Covid goal, China can do whatever it can do, even to control and restrict basic needs,” she says.

The zero-Covid policy will continue, says Chien, as domestic vaccines have limited effect on Omicron. The view on GDP under this policy is pessimistic. The GDP estimates from some research institutions are between 3.6% to 4.3%, and the most pessimistic estimate is 1.5%, which is lower than the 5.5% set by the Chinese government.

Export growth in April is the lowest in the past two years, due to staff shortages, difficulties obtaining raw materials, stagnating production and transport supply-chain blockages.

“In addition to the weakening of consumer demand due to the lockdown, the government controls prices,” she says. “However, the blocked areas still need to pay higher-than-expected costs to obtain basic food.”

The upshot, Chien adds, is that a recent survey by the American Chamber of Commerce points out that half the companies that responded plan to reduce or postpone their investments in China.

“At the same time, 60% of companies have lowered their revenue forecasts, and in a survey by the European Union Chamber of Commerce in China, 25% of companies will start to consider withdrawing from China, which is a conservative forecast,” she says.

Image tarnished

Sher Mehta, director of macroeconomic research and country analysis at Virtuoso Economics, believes there are lucrative diversification opportunities that Chinese assets – government bonds and equities – present to investors, but the zero-Covid policy is likely to further tarnish its image and make it less attractive for investors.

“This, in turn, will probably result in investors increasingly trimming their exposure to Chinese government bonds and equities, possibly over the coming months of this year,” he says.

Given the impending National Congress later this year, Mehta believe politics will continue to take precedence over any economic considerations, at least until autumn, and possibly until the end of this year.

This implies a notable hit to growth – despite the recent stimulus measures – with greater business and supply-chain disruptions, and a squeezing of company profit margins, as a result of elevated producer price inflation, and a continuation of weakness in fixed investment vis-à-vis real estate

Mehta says export sectors that are likely to be affected most are electronics, equipment, machinery – including computers – mobile phones, automobiles, textiles and medical-related exports.

He sees further deceleration of domestic demand and a greater build-up of corporate and household debt at a time when China is already reeling under an overload of bad loans and declining returns on investments, particularly in real estate.

"The above-mentioned factors will have medium-term repercussions for growth, too," says Mehta. "This is because China, which has sufficient policy space to ramp-up stimulus, may go in for new measures to bolster growth – notably infrastructure spending – to counter these economic headwinds over the coming months.

"This, in turn, will exacerbate financial imbalances due to greater build-up of debt, lead to more pronounced financial stress, result in a further slowdown of the deleveraging process in China, enhance the possibility of market turmoil and slow down the ongoing structural reform process."

“Its increasingly assertive or truculent foreign-policy stance could result in the US imposing sanctions ... in the near future

- Sher Mehta”

As a consequence, the effectiveness of policy stimulus is likely to be blunted, productivity growth will moderate and GDP growth will be slower during the medium-term.

Looking ahead, China's attractiveness as an investment destination might further erode, Mehta says, due to its strong and [growing ties with Russia](#).

"Its increasingly assertive or truculent foreign-policy stance could result in the US imposing sanctions, including potentially levying additional duties on Chinese exports or import quotas, in the near future," he says.

The US may come out with several legislative measures to protect security threats from China and its interests. Moreover, says Mehta, China's foreign policy stance vis-à-vis Russia is likely to fuel the decoupling momentum between China and the West.

Another risk, he mentions, is the possibility of US-based firms operating in China or firms that are from countries that are allies of the US facing increasing regulatory discrimination and anti-trust investigations during the coming months, compelling them to downsize operations or leave China.

There is the resolve of Chinese policymakers to lower the country's technological dependence on the US.

Mehta says: "It wants to replace foreign technology with domestic IT products rather quickly and encourage domestic production of everything from mobile phones and computers to semiconductors."

As a start, he adds, government agencies and state-backed corporations have been directed to replace foreign-branded personal computers with domestic-branded computers within two years. This will adversely affect sales of foreign technology companies in China.

China's data protection, cybersecurity and anti-competitive practice-related regulations are discriminatory, he states.

"They benefit domestic firms who are at an advantage, relative to foreign companies, because these regulations reduce competition from foreign technology companies that are not able to comply with such regulations."



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