Global Insights

The Economic Cost of China's Zero-COVID Policy

With China's zero-COVID policy limiting efforts to foster renewed growth, it is unlikely that its economy will experience a durable recovery this year. The property-led slowdown shows no signs of abating, and while the regulatory crackdown has softened, it has not been abandoned—posing a risk to the near-term outlook.

Although the People's Bank of China (PBOC) has sufficient runway to remain accommodative given the country's more modest inflation pressures, investors are skeptical that it will be able to provide enough support to meet the ambitious 5.5% growth target set by Premier Li Keqiang at the 13th National People's Congress in March. We see elevated risks of a material economic undershoot this year.

This edition of Global Insights explores China’s economic outlook against a backdrop of weak domestic demand, a property market on life support and a zero-COVID strategy that—depending on the severity and duration of its implementation—could hamstring stimulus efforts.
The economic impact of China’s zero-COVID strategy. China’s zero-COVID strategy, based largely on suppression of the virus, was introduced early in the COVID-19 pandemic to limit its spread. It features aggressive public health measures to reduce transmission. Still, despite China’s 88.1% vaccination rate, the difficult-to-control Omicron variant has led to a spike in new cases.

While many nations have decided to “live with the virus,” China has taken a stricter approach. A deep worry among investors is that China will struggle to contain the virus, making it difficult to achieve the 5.5% growth target set last month at the annual meeting of the National People’s Congress (NPC). We see evidence that consumer confidence may have peaked (see Exhibit 1) and believe that repeated lockdowns, especially in cities like Shanghai—a major financial hub that contributes nearly 4% of the country’s GDP—could put downward pressure on growth.

Repeated lockdowns and other restrictions make China’s zero-COVID strategy one of the world’s strictest, and given the severity of the recent outbreak, we anticipate even tougher lockdowns relative to prior episodes. In fact, China’s track record of curbing outbreaks suggests policymakers are unlikely to roll back public health measures quickly. For example, in the first quarter of 2021, China rolled back restrictions as vaccines became available, only to pivot at the arrival of the Delta variant (see Exhibit 2).

At the moment, China’s zero-tolerance resolve is virtually absolute. In fact, Zheng "Michael" Song, of the Chinese University of Hong Kong, estimates the economic cost of lockdowns to be at least $46 billion per month. Notably, certain measures of economic activity were already in steep decline when the pandemic entered its second year. China’s economy, having benefitted from a pull-forward in demand, has seen highway freight flows, adjusted for each province’s GDP contribution, converge with longer-term averages (see Exhibit 3). With many of the largest manufacturing hubs shuttered, we would not be surprised if the measure fell further in the face of persistent headwinds to near-term demand.

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Zero-COVID policies could hit domestic demand. China’s consumer spending appears poised to soften further amid pandemic-related disruptions (see Exhibit 4). As a result of the latest pandemic lockdowns, Morgan Stanley & Co. Research’s April 7 AlphaWise China Recovery Survey shows that 44% of respondents had changes in working arrangements. Perhaps even more concerning, however, is that respondents that reported changes saw a 12% reduction in income. This, along with aggressive lockdowns, all but guarantees that the consumer will not drive growth in 2022 —leaving the real estate sector, which in the past has been more reliable, to do the heavy lifting.

The property sector is hurting China’s growth trajectory. In our Feb. 9, 2022 Global Insights, “Riding the Tiger: China’s Regulatory Crackdown,” we explored the significant regulatory pressures facing China’s real estate sector. However, at the 2022 NPC, policymakers came to the sector’s aid and declined to expand a trial on property taxes this year. While many China policy observers were surprised by the softer stance, it makes sense given the extraordinary role the sector plays in the nation’s economy.

According to researchers at the National Bureau of Economic Research, real estate and real estate-related services account for 25% of China’s GDP. This compares to 15% to 18% for the US, according to the National Association of Home Builders. China’s property markets are an important growth lever, and a continuation of last year’s strategy would be damaging. That being said, housing market indicators suggest that developers are shying away from fixed investment in the real estate market (see Exhibit 5) amid heightened scrutiny.

Even as China’s policymakers adopt a more dovish regulatory and fiscal framework, it seems unlikely that the property sector is positioned to support growth given weaker home prices and a multi-quarter slowdown in construction business activity (see Exhibit 6). Looking ahead, a disappointing rebound in fixed investment and substantially weaker prices could weigh on both overall economic growth and global commodity markets vis-à-vis steel, cement and lumber.

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Exhibit 7: China Aims to Stimulate Its Economy

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 28, 2022

Favorable inflation dynamics should allow the PBOC to remain accommodative. The latest spike in global prices has largely avoided China. In fact, the most recent 1.5% year-over-year inflation reading looks tame compared to the 8.5% headline rate in the US and the 3.1% average among advanced economies (see Exhibit 8). Although the early stockpiling of key commodities like coal has helped anchor inflation expectations, there are a few reasons why the recent supply shocks have had a more muted impact on prices.

For starters, although food prices, as measured by the UN Food and Agricultural World Food Price Index, are at all-time highs, the impact on China has been limited. This is because wheat—a staple in many other parts of the world and a casualty of the Russia-Ukraine conflict—is a smaller part of China’s consumption basket. Furthermore, China’s coal production reached record levels last year and should provide a buffer against rising energy prices. Taken together, it is unlikely that the recent spike in food and energy prices will constrain accommodative PBOC policies.

Exhibit 8: China Inflation Tame Relative to Advanced Economies

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

Investment Implications

China will struggle to meet its ambitious 5.5% growth target. The latest PMI figures for March indicate underlying economic conditions are weak. An unreliable property sector and the immediate effects of its zero-COVID strategy will likely weigh on the country’s domestic consumption. Morgan Stanley & Co. Research’s price forecast for the MSCI China Index reflects a higher equity risk premium and slower earnings growth.

In fact, profit earned by China’s private industrial enterprises has already started to slow (see Exhibit 9). Although China has access to the tools to stimulate growth, it may be too little and too late to correct the negative feedback loop of a less exuberant consumer, a weaker real estate market and potentially slower exports (see Exhibit 13).

Exhibit 9: Profits at China’s Industrial Firms Slid as COVID-19 Cases Surged

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb 28, 2022

Additionally, China’s more accommodative policy stance will create a challenging backdrop for investors. Historically, China has held a substantial yield advantage over the US, but as the Federal Reserve became more hawkish, interest rate differentials between the two countries narrowed (see Exhibit 12). As the balance shifts further, China could see capital outflows accelerate.  

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Charts You Can't Miss

Exhibit 10: China Lockdowns Could Pressure Global Supply Chains

Exhibit 11: China Depends on Coal to Meet Energy Needs

Exhibit 12: US and Chinese Bond Yield Convergence Could Lead to More Outflows

Exhibit 13: China’s Export Gains at Risk

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 28, 2022

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of April 13, 2022

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 21, 2021

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of April 13, 2022
Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

After a nine-month suspension of granting new video game licenses, China recently issued approvals for 45 games. Beijing cracked down on gaming last summer, citing concerns over gaming addiction and undesirable behavior among youths. In addition to a licensing halt, regulators introduced caps on play time and other measures meant to limit video game addiction. Most of the approved titles were for mobile games, as opposed to computer- or console-based games, highlighting the size and scope of the mobile opportunity set. While analysts interpreted the news positively, the absence of some of China’s top developers and relatively limited number of licenses after such a long hiatus still leave the sector well below its recent peak. — Brad Fulton

Exhibit 14: China's Video Game Industry Could Set the Tone for Technology Sector

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of April 14, 2022
Risk Considerations

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets and frontier markets, since these countries may have relatively unstable governments and less established markets and economies. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond’s maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.
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Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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