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The UKNCC Guest Contributor Programme offers contrasting 'short, sharp reads' for those seeking a fuller exploration of key questions. This March 2023 edition explores the question:

"***What are the main opportunities and challenges for China as it emerges from zero-Covid?"***

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What are the main opportunities and challenges for China as it emerges from zero-Covid?

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February 2023

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Estimates of travel during the recent Spring Festival holiday show that the volume of domestic travel in China was nearly double what it was a year ago when zero-Covid policies were in place, but still about half of what it had been in 2019, before Covid-19 struck. For many this symbolises more optimism about the Chinese economy. China's economy will most probably snap back in the next 6-9 months, turning the economic mood superficially much brighter. The key issues are <u>whether</u> this shift has any staying power, <u>when</u> the systemic headwinds that were gathering before 2020 will become more noticeable again, and <u>what</u> the political legacy of zero-Covid might be.

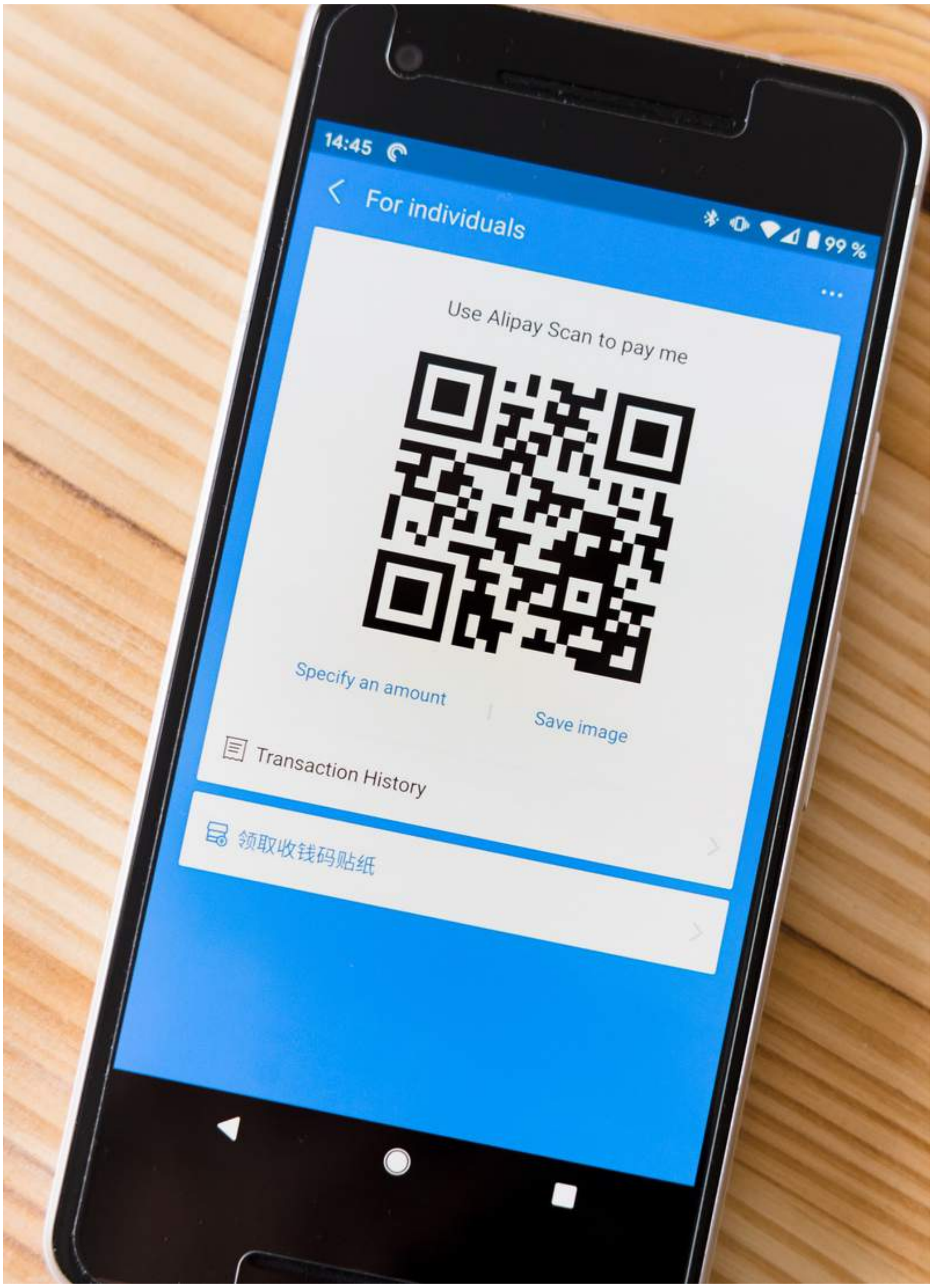
Rebound and reversion

It is the case that the new year celebrations and increased travel may well have resulted in more widespread infection in smaller towns and rural areas, and deaths across the country. However, a rebound in the economy was already apparent in January in the wake of the rapid spread of infection in large urban agglomerations accounting for most of GDP.

It should be noted that the government has adopted an 'all hands on deck' approach to economic cheerleading as it endeavours to get the beaten-up economy back on its feet. Restrictions in the property market have been eased. Blocked credit arteries to property developers have been opened again. Liquidity has been flowing. The so-called 'rectification' campaign against some private firms, data and finance platforms, and entrepreneurs, moreover, looks to have been suspended and reached a point where firms such as Alibaba and Didi are possibly being rehabilitated.

Economic activity levels in January 2023, such as subway traffic, flight departures, transportation of goods, and electricity consumption were up sharply compared to January 2022. Even housing transactions and sales, which suffered significant double digit declines in 2022, perked up sharply in the first 2-3 weeks of January. Business confidence surveys for January showed a sharp rise.

By March or April, the economy should be buzzing again - at least for a while. The failure to get even close to the GDP growth target of 5 per cent in 2022 - officially it rose by 3 per cent but was in all probability significantly lower - should give way this year to a much easier route to nearly 6 per cent.



The main economic focus is on what happens to consumption, which fell by perhaps 0.25-0.5 percent in 2022. For a long time, the Chinese government has spoken about rebalancing the economy away from investment to a more consumption-oriented structure but it has never really embraced measures to make it happen. At less than 40 percent of the economy, consumption in China is far below levels in developed economies and in other emerging market peer group countries. Now, as China emerges from zero-Covid, some political leaders and academics are stressing the need to boost consumption.

This year, though, the bar is set low as a build-up in household deposits is likely to fuel a decent recovery in household spending. Early year consumer confidence readings by the People's Bank of China make a recovery in bigger ticket items like homes a more uncertain call, but there certainly could be a bounce in new home sales, which fell by a quarter in 2022.

The enduring problem in China, though, is that consumption in the economy is low because wages and salaries and other forms of personal income are also low. The government needs to find ways to redistribute income and wealth to middle or low income groups which are more likely to spend, and to acknowledge that if these groups gain, someone else - wealthy Chinese, and local governments - has to lose. This is a political bridge too far for the Communist Party.

While the CCP has somewhat acknowledged such a problem by launching its Common Prosperity agenda to boost social equality, there are few substantive policies that suggest China is willing and able to take the steps necessary to fix the core issues in its economy, such as inequality.

Sooner or later in 2023, this cyclical post-zero-Covid bounce back will fade, as familiar headwinds return. These include slow growth resulting from China's over-indebtedness, reduced credit availability, the weakness of local government finances, the structural downturn in the property sector, and high levels of income inequality. Poor productivity, low incomes for graduates, and a shift from high to low wage/skill jobs in the structure of employment have been continuing problems for several years. Exports are likely to be weak, reflecting the softness of global demand. The government's attitudes to, and demand for, control and influence over private firms and entrepreneurs, moreover, haven't really changed.

The caveat in this rather downbeat view is that the government seems ever more determined to get firms, especially state firms, to invest and innovate as fast as possible in a range of technologies that the US and others have identified as national security risks and made subject to export controls. Semiconductors, in particular. It's questionable whether all the government's lofty aims for core advanced technologies and indeed for sanction-proofing China are realisable, but it would be churlish not to imagine that the government won't try, and this might be an area for foreign investors to monitor and exploit.

Political scarring

It is self-evidently hard to measure trust and confidence in China. Yet in the regular surveys published by the EU and American Chambers of Commerce, there has been a notable rise in the proportion of their members indicating a loss of confidence in China and in its political governance.

The abandonment of zero-Covid has certainly given many cause for relief, now that that they, their staff and families can travel freely in and out of China again. However, the idiosyncrasies and sometimes political awkwardness of doing business in China, which so many firms tolerated over many years for the sake of their revenues and business in the country, now seem no longer to be so easy to brush aside. It is clear that firms have not only been thrust into the cross-hairs of conflicting laws and regulations between their home and China, but that they have to protect themselves against the many risks of geopolitical instability and of vulnerable supply chains.

An accurate read on trust and confidence among Chinese citizens and firms is even harder to evaluate. Most of what we have to go on is anecdotal and the sometimes momentary appearance of posts on social media before they are removed.

The Covid protests online and on the streets late last year were notable because they were large and spontaneous.

Now silent, of course, the protesters nevertheless had formative experiences over a couple of years of repression, and of government incompetence. These protests were not unique. There were others in 2022 over bank mismanagement or fraud that led to the freezing of customer deposits by small banks in Henan. As the real estate crisis deepened, several hundreds of thousands of mortgage owners in several provinces withheld payments to banks and property developers over uncompleted properties. Many more, less widely reported, protests occur even now with increasing regularity over grievances such as unpaid wages, dismissal without compensation, and health and safety issues.

If the ultimate goal of the government is to have a compliant citizenry that is beholden to and trusting in the Communist Party, the last few months have had the opposite effect. There is a sense now that the public is more restive, and less confident that the economic and financial outlook for them and their children - many facing high rates of youth unemployment - is a one-way path to everlasting prosperity. The Covid bounce year of 2023 won't be the acid test for the legitimacy and resilience of the social contract between the people and Xi's China, or indeed the support of top party officials for Xi. After that, all bets are off.

About the Author

George Magnus is an independent economist and commentator, and Research Associate at the China Centre, Oxford University, and at the School of Oriental and African Studies, London.

From 1995-2016, he was the Chief Economist, and then Senior Economic Adviser at UBS Investment Bank. He previously held positions at SG Warburg and Bank of America.

George writes and is cited regularly in major UK and global media outlets sand his publicly available work can be found on his website at www.georgemagnus.com

George's current book, *Red Flags: why Xi's China is in Jeopardy* examines China's contemporary economic, commercial and political challenges

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China's approach to the pandemic took an "adventurous leap" at the end of 2022 when it lifted most of the COVID-19 restrictions and the focus shifted to the prevention of serious sickness and death. The capacity of the Omicron variant to spread quickly meant that even though China had raised the number of ICU beds by 140% and equipped medical teams over the past three years, the country's healthcare system still came under great strain. In rural places where the healthcare system is significantly poorer, this was particularly the case.

Despite widespread concerns, Chinese society has mostly stayed stable during this transitional time. Following the adoption of the "10 new measures", the catering and tourism industries quickly recovered during the Chinese New Year. Pictures of large family gatherings also quickly took over social media, and many people started making plans to travel abroad once more. The majority of Chinese people have resumed their normal lifestyles, with the exception of continuing the practice of wearing masks when going out.

Indeed, China has repeatedly demonstrated its resilience to shocks. In 2020, China was the first to suffer from the pandemic, but also the first to restore normality and achieve economic recovery. Looking further back, China's share of world exports has increased despite efforts by the Trump administration to stifle it through trade restrictions.

It is not surprising to learn that Chinese leadership proposed the idea of "prioritising stability and creating progress in the midst of stability" (wenzi dangtou, wenzhong qiujin) during the Central Economic Work Conference held at the end of last year in preparation for China's economic development in 2023.

The justification is straightforward: in a chaotic world with growing geo-economic divisions, whoever can offer stability is most likely to draw resources and talent and establish themselves as nodes in the global network of production and interaction. This decision is extremely logical for China.

Worsening global trends impact China

The external environment has become less favourable for China's development. On the one hand, the global economy is going through a challenging time. According to the IMF, global inflation will peak in 2023 amid weak growth. The future of the Ukraine conflict remains unclear, which might make world food and oil supplies even more scarce. Meanwhile, the United States is still making greater attempts to "strangle" China in the high-tech industry and to remove it from the global supply chain.

The worsening Sino-US relationship has caused broader reverberations. Consider the ties between China and the UK. Then-prime minister David Cameron called for a "golden age" in Sino-UK relations in 2015 and led the charge for the UK to join the Chinese-led Asian Infrastructure Investment Bank.

The two nations' collaboration in trade, finance, research, technology, and intercultural exchanges had reached new heights.

However, since 2019, the UK's China policy has prioritised ideological and national security over economic and strategic interests. According to China, the UK's meddling in Hong Kong, disapproval of Huawei's technology, and pressure on China over human rights issues are more motivated by an unfounded fear of China than by legitimate national interests.

“Putting our own needs first and doing our best.” (zuohao ziji de shi.) This phrase reflects a significant change in perspective. China has reaped significant benefits from active involvement in economic globalisation ever since its reform and opening-up. Globalisation still exists today, although disruptions have grown, at least temporarily. Major nations are now paying more attention to supply chain security as a result of the epidemic and the conflict in Ukraine; economic efficiency is no longer the sole factor to be taken into account.

China's political system and economic foundation give it the capacity to remain stable.

First and foremost, China has a stable political system and distinct development objectives. The government is devoted to modernisation and to raising people's standards of living. Long-term policy planning is a strength of the Chinese government, as is the capacity to control the pace of reform and advance gradually toward its objectives without inciting violent confrontations in society.

Second, it places value on the growth of the real economy and has a manufacturing system that is reasonably well-established. Following the COVID-19 breakout, the Chinese government has given even higher priority to improving the supply chain and filling gaps.

Third, China's enormous population meams it has a sizeable market. In fact, since 2016, local revenues for international businesses in China have increased and surpassed exports. This helps to explain why China still appeals to global investors even after the United States started a trade war with China. The amount of money saved by Chinese households increased by about 26 trillion yuan in 2022. Consumption and investment will pick up steam as the pandemic eases and stimulus initiatives are implemented.

The decoupling approach will not be simple to implement for as long as China accomplishes its objective of stable development. China still has advantages over Mexico, Vietnam, and India, which are the primary alternatives for manufacturing locations, in terms of a skilled labour force, infrastructure, and business environment.

Additionally, China can broaden its advantages by lifting restrictions on foreign investment and joining international trade and economic agreements like the Digital Economic Partnership Agreement (DEPA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This means that over time, those that favour the path of decoupling will have to pay a higher price, defeating their original intention of retaining power.

Having said that, China must increase public confidence in itself by demonstrating its ability to be stable. This calls for ongoing work to make its policy consistent and predictable and to prevent significant risks.

To achieve uniformity in policy at home, rule by law will be essential. Lockdowns will no longer be the main response to COVID-19 now that China has decided to manage it with measures against Class-B infectious diseases under the Law on the Prevention and Treatment of Infectious Diseases.

Legal and institutional measures will also be taken to protect China's stance of support for the private economy, the nationwide treatment of foreign-funded businesses, and greater liberalisation of the service sector.

Risks must be managed within specific bounds though they cannot be completely predicted or avoided. Particular focus has been placed on the risks associated with the housing and financial markets, as well as the problem of local government debt. Making advance preparations and remaining watchful is crucial for China. Risk management might even occasionally present chances to advance domestic reforms.

It is important not to undervalue the global challenges. Due to the need for stability and ongoing development, China must base its foreign policy on practical national interests, including maintaining food and energy security and fostering an environment that is conducive to domestic development. China's diplomacy will continue to focus on fostering cordial ties and reducing uncertainty in the global order.

The main topic of discussion remains Sino-American ties. Positively, there is still opportunity for collaboration in areas such crisis management, economic and trade cooperation, and global governance even though the US strategy frames its strategy towards China as one of competition. 2023 may see a shift towards some cooperation between the two countries as the US midterm elections and China's 20th National Congress of the CPC have come to a close. A reasonable expectation for the bilateral partnership should be to establish some mechanisms for dialogue.

Conclusion

Although the twin storms of the pandemic and counter-globalisation have not totally abated, the future sea appears to be getting a lot calmer. The hull of the enormous Chinese ship is still in decent shape; which is very good news. When the ship's speed slows, however, the captain must maintain the crew's confidence and be vigilant for any risky undercurrents.

About the Author

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