CHINA: New lockdowns raise doubts about zero-Covid exit plan

- A new wave of Covid-19 lockdowns will further damage household consumption, but recent adjustments to "dynamic zero" will minimize the impact on manufacturing supply chains.
- Contrary to earlier forecasts, it now appears increasingly doubtful that authorities will move immediately to exit from zero-Covid following the 20th Party Congress in October.
- Once an exit finally begins, a spike in infections is probably inevitable, given the lack of a viable middle-road strategy between strict zero-Covid and full coexistence.

Amid a new wave of Covid-19 infections, 49 cities accounting 21% of China's population and 25% of GDP were under some degree of Covid-lockdown as of 6 September, up from 11% and 16%, respectively, a week earlier. The mega cities of Chengdu and Shenzhen are among the affected regions.

As previously discussed, adjustments to the implementation of "dynamic zero" following the Shanghai lockdown in March and April have minimized the impact of subsequent lockdowns on manufacturing and logistics. Still, the impact on household consumption from the current wave of lockdowns will be severe, and many economists now forecast that full-year GDP growth will drop below 3%. Lockdowns will also deal another blow to the struggling housing market, as restrictions on movement impede sales activity.

Beyond its immediate economic impact, the current lockdown wave also affects the outlook for an eventual exit from dynamic zero. In March, we outlined the conditions required for Beijing to begin a formal exit and forecast how this policy change might unfold. While the basics of that analysis remain relevant, subsequent developments suggest some changes.

Timeline for exit

Contrary to earlier forecasts, an immediate exit from dynamic zero following the 20th Party Congress, which will convene from 16 to 24 October, now appears increasingly doubtful. First, given the enormous political and propaganda resources devoted to defending the policy, a sudden change after the congress would still be viewed as a sign that President Xi Jinping is yielding to pressure or reversing a policy error.

Second, the political transition that begins at the party congress will not be complete until after the National People's Congress, the annual parliament session, in March 2023. The parliament will formally approve senior appointments to government positions after the Party Congress approves a new slate of leaders to parallel positions in the Communist Party apparatus.

Third, Covid-19 infections may surge over the winter months, prompting policymakers to delay a policy shift until the spring.

The vaccination factor

We previously forecast that a rollout of mRNA vaccines was a key condition for exiting dynamic zero, but this assessment has changed. It is now obvious that Chinese authorities do not intend to approve foreign vaccines. Several Chinesedeveloped mRNA vaccines are in various stages of clinical trials and regulatory approval, but recent data indicates that Chinese inactivated vaccines still provide significant protection against severe illness and death. While mRNA jabs would be an improvement, the lack of such vaccines is probably not a significant factor inhibiting China's exit from dynamic zero.

More important than introducing mRNA is boosting the vaccination rate among the elderly, which remains far below the overall rate. But the challenge is significant: in July, the city of Beijing rescinded the country's first-ever vaccine mandate in response to public criticism less than two days after announcing the policy. The government's reluctance to deploy the coercive power of the state to increase vaccinations – even as authorities readily use coercion to enforce other elements of dynamic zero – hints at the depth of vaccine hesitancy among the Chinese public.

The coming storm

Following the Shanghai lockdown, policymakers adopted a new containment strategy based on regular, mandatory PCR testing. The hope was that by detecting outbreaks early and quickly imposing targeted lockdowns, cities could prevent large-scale community spread that would necessitate citywide restrictions. For a while this approach succeeded, raising hopes that mass testing could serve as a middle-ground strategy between zero-Covid and a coexistence strategy. But the recent outbreak in Shenzhen, which had implemented a strict testing program, casts doubt on whether this strategy is viable against newer, more infectious variants.

The lack of a viable middle-ground strategy implies that when China's exit from dynamic zero does finally begin, a sharp spike in infections is probably inevitable. Low vaccination rates among the elderly; the lower efficacy of Chinese vaccines; and the low rate of natural immunity from previous infections will combine to make an infection surge difficult to avoid. The concern for policymakers is that China's health care system remains ill-prepared to absorb such a surge, and temporary field hospitals will probably be required.

Once the construction of field hospitals and other preparations for the inevitable surge begins, these moves will offer the clearest signal that an exit from dynamic zero is imminent. But even with ample preparations, the transition to full coexistence is likely to be messy.

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