THE CHINESE ECONOMIC MODEL AND ITS EFFECTS ON BARCELONA: IMPACTED BY THE PANDEMIC?

THE GEOECONOMIC IMPACT OF CHINA'S COVID POLICY AND WHY IT MATTERS TO THE EUROPEAN UNION

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The COVID pandemic hit China in January 2020. Since then, like the rest of the world, the Chinese economy has gone through huge up and downs. The difference is that China appeared to have recovered from COVID earlier than anybody else, ending 2020 with positive GDP growth (2.3%), while deep recessions were being suffered globally. In fact, China was dubbed "first in, first out".

The problems began in the second half of 2021, as China's recovery turned out to be less spectacular than many expected, and only worsened in the first half of this year, as it continued with draconian lockdowns and closed borders while the rest of the world finalised its opening up. In fact, China might end 2022 with below 3% GDP growth, well below the levels in Southeast Asia and less than half India's rate.

Strict mobility restrictions are not the only problem China is facing. For one thing, the geopolitical landscape is increasingly tense. The Biden administration, which many had expected to change tack on China, has essentially continued with the containment measures implemented under Trump, following years of engagement. As if this were not enough, Russia's invasion of Ukraine last February 24th brings China's rather close relationship with Russia into play, even though it has officially remained neutral with regard to the ongoing military conflict.

In this paper, I will first review the impact of the pandemic on the Chinese economy and its geopolitical implications. Then, I will analyse how the war in Ukraine has complicated matters further and what to expect in the future on the geopolitical front. Finally, I look into China's medium-term growth, which will suffer structural deceleration.

1. The impact of the COVID pandemic on the Chinese economy

In January 2020 the Chinese city of Wuhan was the first to declare a full-scale lockdown in response to the virus later named COVID-19. Soon after Wuhan, China deployed large-scale lockdown measures across the country, which lead to a sharp reduction in people's mobility nationwide with massive economic impact. Vehicle navigation data suggests that national inter-city mobility fell by 66% in February 2020 compared to the 2019 average. That said, mobility soon recovered, as the outbreak was successfully contained rather quickly and tight border controls were imposed as the rest of the world was hit by the pandemic. The reduction in people's mobility moderated in March, falling only 10% and even turning positive in April (+26%). Since then, mobility had been relatively stable until the novel Delta variant stepped in and led mobility in China to slow from the second half of 2021.

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Worse than that, in the first few months of 2022, China introduced more widespread lockdowns in response to Omicron, a much milder but more contagious variant of COVID-19. Drastic mobility restrictions were imposed on cities that in total accounted for 40% of China's gross domestic product, including Shanghai, the renowned international financial centre. In addition, half of China's highways were not functioning and ports were operating inefficiently as a result of large mobility restrictions[1].

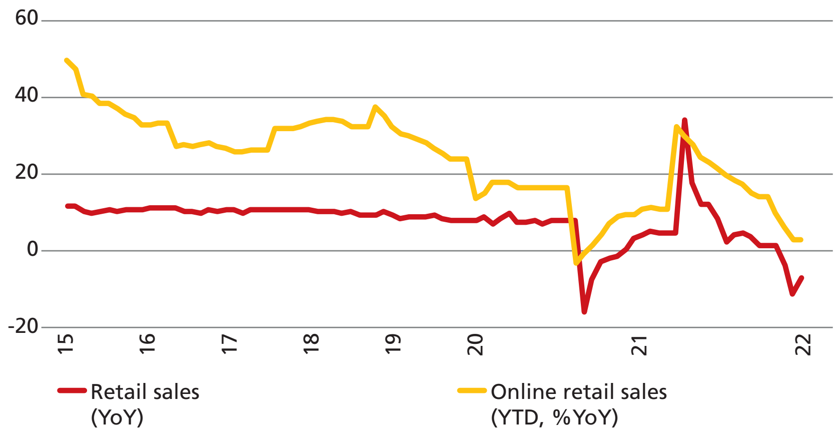
The sharp fall in people's mobility took a toll on household consumption but also disrupted manufacturing production, with a slight recovery since June as some of the most severe lockdowns were lifted. Still, sentiment has remained at a record low throughout 2022 as the Chinese economy has been coping with another massive shock since the second half of 2021, namely the demise of the real estate sector. This started with the collapse of China's largest real estate developer, Evergrande, followed by several others and which extended, in the second half of 2022, to mortgage boycotts by Chinese households who had not received the housing units they had paid for, as developers left them incomplete. The only bright spot has been the strength of external demand throughout 2021 and the first half of 2022, although this has slowed more recently as the world moves into synchronised deceleration.

Moving ahead, two important questions remain, first and foremost whether zero-COVID policies will be ended. The Party Congress, which confirmed President Xi in an unusual third term, has offered no clues in this regard but the very negative market reaction to the conclusion of the congress and the continuing poor economic data might lead to some targeted re-opening. In any event, this decision – like many others in China today – is highly political and hinges on President Xi's conviction that China's response to COVID should be different than that of the United States. This will be explored in more detail in the next section. The second key question is the handling of the real estate crisis, which has so far been rather ineffective and mainly based on setting up fiscal resources – especially by local governments already cash-strapped by COVID-related expenses – to support developers and help them finalise the millions of housing units which remain under construction.

Given China's size and how much it has contributed to the global economy over the last decades, this is extremely important for the global economy and could not come at a worse time. China's lower economic growth is bound to affect the rest of the world via two key channels. First, China is the largest importer of most commodities, so commodity importers are bound to see their exports fall. Secondly, it has become the centre of global value chains, so any renewed lockdown in important cities for the production/assembly of manufactured goods, as well as ports and railways, will create bottlenecks in other parts of the world, feeding supply-related inflationary pressures.

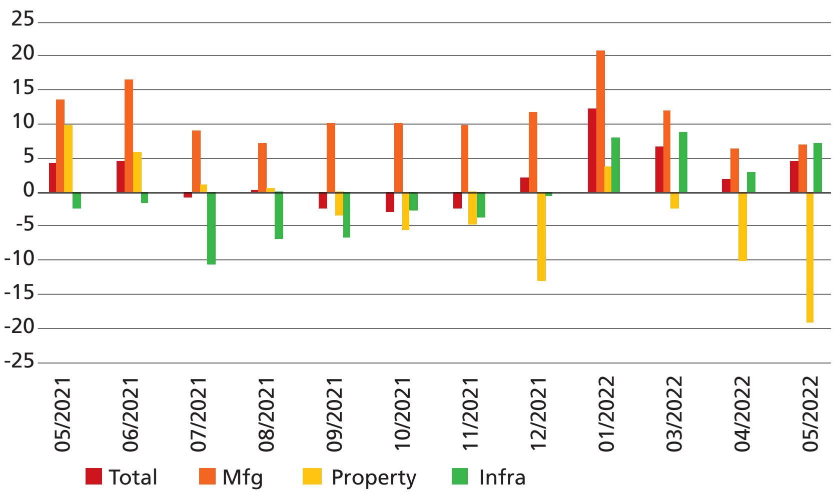
1. For a full account of China's economic future after the October 2022 Party Congress, see: https://jamestown.org/program/the-economic-outlook-for-xis-third-term-mounting-challenges-dwindling-fiscal-and-monetary-options/

Figure 1. China: Retail Sales and Online Retail Sales



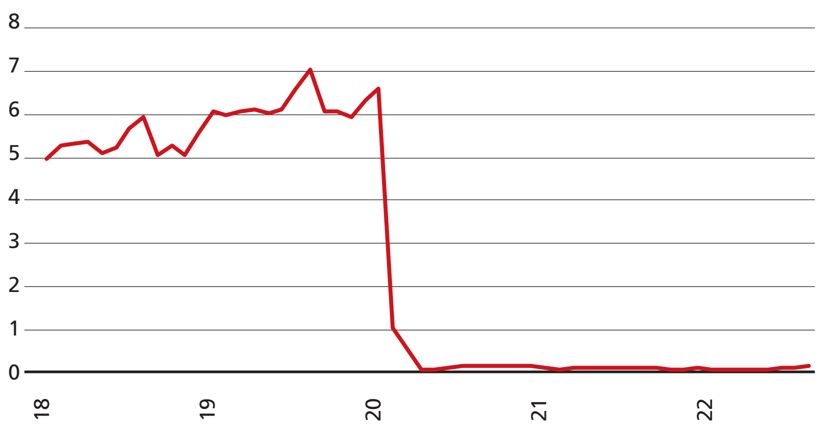
Source: NBS, Natixis.

Figure 2. Retail sales (YOY)



Source: Natixis, AACC.

Figure 3. China's International Air Passengers (million persons)



N.B. Data as of February 2022.
Source: Natixis, Civil Aviation Administration of China, CEIC.

2. Geopolitical consequences of the pandemic

Trust between China and the rest of the world, especially the West, is at a record low. Beyond the economic impact, anti-Chinese sentiment has been growing in many parts of the world.

The fact that China's leadership, and especially President Xi, has remained fully committed to "dynamic zero-COVID" policies has political as well as economic consequences. The sharp decline in imports China has experienced is not only due to lack of demand (in fact imports have grown much less than retail sales), but rather the push for self-reliance. As such, Chinese exports grew 10% year-on-year in the third quarter, while imports rose by only 0.6%, per the data from China Customs. All in all, the substitution of foreign inputs for domestic ones is in full swing and is bound to continue with or without zero-COVID restrictions.

The lack of people-to-people exchanges also related to the closed borders clearly adds to the decoupling push stemming from the pandemic, as trust between China and the rest of the world, especially the West, is at a record low. Curbs on Chinese citizens traveling abroad have wreaked havoc on the economies of several countries that were major tourist destinations for Chinese travellers before the pandemic, particularly Thailand and others in Southeast Asia, but also Hong Kong. Beyond the economic impact, anti-Chinese sentiment has been growing in many parts as the lack of exchange continues, and the same is true for Chinese citizens' attitudes towards foreigners.

Without physical exchanges, Chinese overseas investment has also plummeted and we see no signs of recovery yet. This has led to increased scrutiny of Chinese companies' potential acquisitions by target countries. In other words, the pandemic has clearly increased the speed of bifurcation between China and the United States but, also more generally, as China has been closed to the rest of the world as whole and not only the United States. In fact, the recent position paper from the EU Chamber of Commerce in Beijing is probably the most negative of the past few decades[2].

The lack of mutual understanding between China and the rest of the world is also clearly shown in the much more reduced number of high-level summits between the United States and China but clearly also between China and the EU (European Union) or even its member states. The most recent high-level economic dialogue between the EU and China took place digitally, on April 1st 2022, and was a "dialogue of the deaf", according to the High Commissioner, Josep Borrell. In addition, although China and the EU in principle concluded the long-disputed Comprehensive Agreement on Investment in 2020, the deal has not yet taken effect due to the European sanctions.

The increasing perception of a growing political and social divide between the West and China obviously does not bode well for future scientific or business collaboration between China and the broader international community, although it is difficult to measure the immediate impact of this on the global economy.

3. Economic impact of the war in Ukraine on China

The war in Ukraine and the unprecedented sanctions imposed on Russia by Western allies in response to Russia's invasion are having a very large negative impact on the global economy well beyond Russia and Ukraine.

2. https://www.europeanchamber.com.cn/en/publications-position-paper

The European economy is being hit hard not only due to its dependence on Russian energy.

While the direct impact of the Ukraine crisis on the Chinese economy has been much more muted, it has still been negative. As the largest importer of oil and gas in the world, the huge jump in energy prices is bad news for China, not least because China's carbon reduction goals (as outlined in its Five-Year Plan) require additional gas imports to transition away from coal. However, China has swiftly reacted to this additional headwind buffeting its economic outlook by lifting annual carbon emission targets at the Two Sessions of the National People's Congress and the Chinese People's Political Consultative Conference in early March 2022. In addition, China – as well India and other emerging economies – has stepped up purchases of cheaper oil from Russia due to the wedge created by Europe's reluctance to buy oil from Russia.

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In other words, although China should, in principle, oppose events that increase energy prices, its implicit support for Russia seems to indicate that other objectives, namely weaking the United States global hegemony, are more important. This has been further demonstrated by China's accommodating position on OPEC's recent cut in production, even if that means higher oil prices.

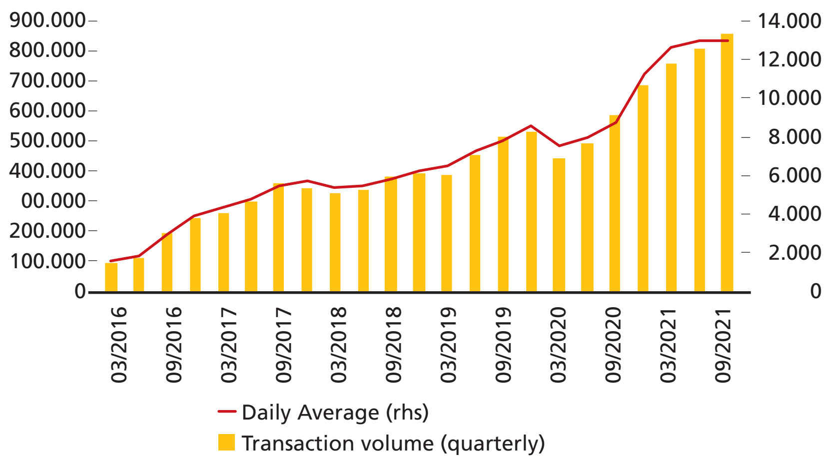
The other immediate downward pressure on the Chinese economy is the slew of Western sanctions imposed on Russia. Chinese banks do not seem to be financing operations with Russia, although evidence remains scarce and Chinese energy companies – including Sinopec – are shelving their projects with Russian counterparts. Still, the impact of such withdrawal from Russia has so far been quite moderate for China, since Russia is ten times smaller. China does not even need to fully cut its ties with Russia, but just avoid hard currency payments and some targeted entities such as the Russian central bank and the ministry of finance. Indeed, China remains the largest exporter of goods to Russia, especially those that are subject to export controls, like semiconductors, and which Russia desperately needs in order to maintain its industrial – as well as military – capacity. This also means that there is a latent risk of China ending up being subject to secondary sanctions, especially as far as exports of dual-use semiconductors are concerned.

Another silver-lining for China from the war in Ukraine is fostering the international role of the renminbi (RMB) as Russia – as well as other sanctioned countries such as North Korea and Iran – steps up its use of the RMB through China's international payment system (CIPS). This is also increasingly the case for Saudi Arabia as well, whose largest export destination is China, and even for India when it comes to coal imports.

All in all, China's rhetoric regarding the war in Ukraine has been anti-US and anti-NATO, while being quite accommodating towards Russia and opposing Western sanctions against the nation. At the same, by complying with Western sanctions, China has so far abided with the letter of the law – or at least no proof exists of the opposite – even if not its spirit[3].In other words, China is using any space available to support Russia and to create a united front against the West with its Global Security Initiative and the expansion of the Shanghai Cooperation Organisation and the BRICS.

3. For more details on the steps China could take to help Russia financially, see: https://www.bruegel.org/blog-post/can-china-bail-out-putin

Figure 4. RMB Cross-border Interbank Payment System (transaction volume)



Source: Natixis, PBoC.

All in all, while the war in Ukraine constitutes a negative shock to the Chinese economy, beyond high commodity prices the direct impact remains limited. The problem is that it is happening at a time when China is beset by a severe Omicron COVID-19 wave on top of a cyclical deceleration and negative market sentiment stemming from a regulatory crackdown. Though China seems keen to abide by the letter of the law and comply with sanctions, the country also seems willing to take risks to maintain its strategic relationship with Russia. This is clearly a razor's edge for China, as it could be caught in the fire not only of Western sanctions, but also of potentially negative decisions by Western companies operating in China. Still, China looks favourably upon Russia's attack on the West, as its ultimate objective is to change the global order towards Chinese dominance. Fully aware of this challenge, the United States is putting renewed pressure on China, most recently with a very broad semiconductor ban that will make it harder for China to move up the technological ladder.

All in all, the growing differences between the Western narrative and that of China – let alone Russia – are clear signs that, following the invasion of Ukraine, the world is more than ever like a chess board on which Biden and Xi are pursuing global hegemony.

4. China's long-term growth prospects

At first sight, China's difficult economic situation may appear temporary, since it is mainly explained by COVID restrictions, real estate woes and, to a lesser extent, the war in Ukraine. However, the reality is that the Chinese economy is also decelerating structurally.

To gauge China's potential growth rate in the future, a straightforward and common way is to make a forecast based on standard convergence theory. Convergence theory is based on the assumption that poorer countries grow relatively faster than richer countries and in the long run growth rates will all converge. Following a similar methodology to Gordon (2014) and implementing a convergence-style estimate for labour productivity by taking the changes in the population growth pattern given by UN population forecasts, the estimated average real GDP growth rate for the period between 2021 and 2025 should be 4.9% and 3.6% from 2026 to 2030, descending to 2.4% from 2030 to 2035 (Table 1). This rather low medium-term growth rate should surprise no one. Many studies have already made use of this framework, and many have pointed to a slowing growth trajectory for China[4].

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Table 1

	Output	Labour productivity
2021-2025	4.9	4.9
2026-2030	3.6	3.8
2031-2035	2.4	3.0

No matter how low this growth rate may look, the reality is that most risks are on the downside. First, is the further worsening demographics, as one key scarring effect of the pandemic. The second is an even lower return on assets, as the state's role in the economy becomes more and more pervasive with continual crackdowns on the private sector and, in particular, China's innovative tech sector. Finally, both climate change and COVID-related harm to human capital and Chinese people's openness to the rest of the world are worrisome issues which make lower potential growth increasingly likely. Finally, both United States–China strategic competition and China's own increasingly totalitarian drive, blessed at the recently concluded Party Congress, are two additional worrying signs for China's potential growth.

5. Conclusions

China's growth has been coming down for both cyclical and structural reasons. The cyclical reasons in 2020 are a redoubling of COVID restrictions while the rest of the world was lifting them, the troubles in China's real estate sector and the war in Ukraine. China's response to the pandemic, like Russia's invasion of Ukraine, is best understood not through an economic prism but rather a geopolitical one. On COVID, the recent mobility restrictions have created havoc for consumption as well as investor sentiment but are framed in President Xi's mantra that China's response to COVID is superior to that of the West. In the same vein, China's narrative favouring Russia's invasion of Ukraine by blaming the US and NATO does not make much economic sense, as Europe is a far bigger market for China than Russia. Still, supporting Russia serves a much more important objective – feeding anti-Western sentiment across the world in a heated system rivalry for world hegemony between the US and China.

This is why Russia's invasion of Ukraine has clearly worsened the world's already shaky geopolitical situation, feeding an even more intense confrontation between the US and China, already heated due to the pandemic.

The result of all this is a world moving in two blocs, with the EU, the United Kingdom, Australia, Japan and South Korea more aligned with the United States than ever. At the same time, and supported

4. See IMF (2020) and World Bank (2019).

by Russia, China is extending its alliances in the Global South with the New Development Paradigm and the Global Security Initiative, as well as expanding the BRICS. The world has clearly become a great power competition between the United States and China. Against this background, China's power – so far mainly economic – seems likely to suffer much worse growth prospects for a few years to come.

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