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Topics China persists with a zero-COVID policy

China's zero-COVID policy is expected to remain unchanged until the outbreak is under control at home and abroad. As a result, China's economic growth for 2022 is anticipated to be a low rate of +4%. In addition to a downturn in demand, supply constraint risks need to be monitored.

■ China's zero-COVID policy is likely to be continued until the end of the COVID-19 pandemic at home and abroad

China persists with a zero-COVID policy or a zero tolerance toward the pandemic. On February 7, all 3.6 million residents of Baise in Guangxi province were ordered to undergo PCR testing, quarantine at home, and the city was virtually shut down as non-essential business activities were banned, schools and public transport were suspended, and major roads were closed. Following an outbreak of COVID-19, large-scale PCR testing and strict curfews were also implemented in Huludao in Liaoning province.

China's COVID-19 control measures are quite different from the current standard measures taken globally. Other countries are generally easing restrictions on activities, which can be attributed to the fact that with the Omicron variant, the rates of hospitalization, severe illness, and deaths have been lower than infection with prior variants, thus reducing the positive effects of strict restrictions on activities. On the other hand, the negative effects are increasing. Because the Omicron variant is highly contagious, if the government persists with strict control measures, it will be forced to shut down cities frequently and impose a heavy burden on the public. In China, where information is controlled, the public does not necessarily understand such transformation of the virus, and there is a lack of progress in the development and dissemination of vaccines and oral medicines that are effective against the Omicron variant. These factors are thought to be reasons behind China's strict control measures against COVID-19.

In China, some experts have proposed a policy review that takes into account both positive and negative effects, but there has been little momentum for a review. Chinese state media continue to advocate the need for a zero-COVID policy, noting the high death toll in countries around the world and calling for vigilance against variants following the Omicron strain. At a press conference on January 22, the National Health Commission explained the government's decision that "It is cost-effective to maintain production and livelihoods in large areas by sacrificing the normal activities of the few." In response to the spread of the infection in Hong Kong just after the Spring Festival, on February 7, the People's Daily, the official newspaper of the Communist Party of China, strongly criticized Hong Kong's COVID-19 control measures, saying, "coexisting with COVID-19 is a mistake." the Chinese government has stepped up its involvement by sending testing personnel to Hong Kong.

Given this situation, China's zero-COVID policy is likely to be prolonged until the pandemic is clearly under control both at home and abroad. Even if the Omicron outbreak is brought under control in China and overseas in the near future, it is highly likely that a new variant will emerge within the year and the infection will spread again. In such a case, countries around the world are expected to forgo strict activity restrictions against the new variant and take the approach of coexisting with COVID-19, while China will likely impose strict activity restrictions in COVID-19 hotspots. The Chinese government is expected to prioritize the prevention of the spread of infection and an increase in the death toll, by continuing its zero-COVID policy at least until the National Party Congress in the fall, when the composition of the leadership will be decided, including the future of General Secretary Xi Jinping.

■ China's economy is expected to significantly decline due to its zero-COVID policy

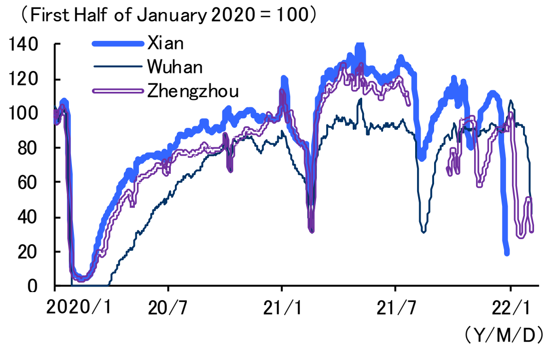
China's prolonged zero-COVID policy is expected to hurt the nation's economy. First of all, the slump in consumer spending is expected to continue for a long period of time. In the wake of the Omicron outbreak around the world since November 2021, the Chinese government has severely restricted economic activities in Xian and Tianjin in Shaanxi province and Zhengzhou in Henan province. People also refrained from going out due to fears of infection. As a result, seasonally adjusted retail sales in December 2021, including those of food services, fell 0.2% from the previous month, recording the first decline in five months. Year-on-year growth in retail sales slowed to +1.7% in December 2021 from +3.9% in November 2021. In particular, service consumption saw a significant decline, with sales of food services decreasing 2.2% year on year. The number of domestic travelers and tourism revenue for the Spring Festival also decreased by 2.0% and 3.9% year on year, respectively. After March 2022, consumer spending is expected to remain sluggish due to restrictions on activities and people's voluntary restraint on going out.

In addition, private fixed asset investment is also expected to slow down due to uncertainty associated with China's zero-COVID policy. Chinese business owners are reportedly intimidated by the strict restrictions imposed by the zero-COVID policy. It is likely that business investment sentiment has deteriorated amid the situation where capacity utilization may be limited immediately when an outbreak is detected in the areas where the business is conducted.

The government will significantly expand infrastructure investment to stabilize the economy and employment, but will not be able to fully offset the downward pressure on the economy caused by its zero-COVID policy. While activity restrictions imposed by the zero-COVID policy were tightened at the end of last year, many local governments said they would aim for growth of more than +5.5% in 2022 through increased investment. For example, Henan, a province with a population of 100 million, is poised for 7% growth in 2022 by increasing fixed asset investment by +10% from the previous year, with a focus on high-speed rail, power plants, water supply and industry. At the March meeting of the National People's Congress, many observers expect the national growth rate target to be set at +5.0% or higher. However, while personal consumption and private fixed asset investment account for 38% and 24% of GDP, respectively, infrastructure investment accounts for only 12% of GDP. Therefore, even if the government significantly expands infrastructure investment through policy measures, it will be difficult to offset the downturn in consumer spending and private fixed asset investment.

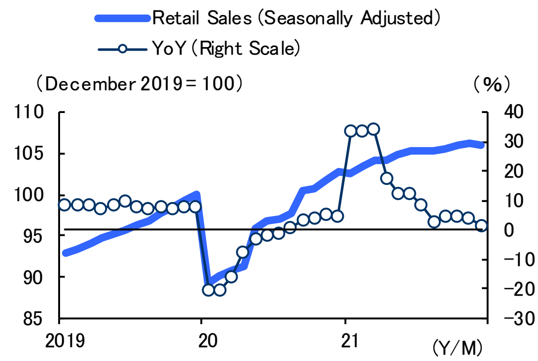
Based on the above, the real GDP growth rate forecast for 2022 will be +4.9%, down 0.3% from the previous forecast. In 2023, on the assumption that the COVID-19 pandemic is brought under control both in China and abroad, the lifting of China's zero-COVID policy is expected to bring the nation's economy back to its potential growth rate of +5.5%.

＜Number of Subway Passengers by City＞



Source: Prepared by The Japan Research Institute, Limited based on Wind Database "Subway Passenger Volume"
Note: Moving average for the last seven days. The announcement of Xian data was suspended on December 27, 2021.

＜China's Retail Sales＞



Source: "Total Retail Sales of Consumer Goods" by the National Bureau of Statistics of China
Note: Seasonally-adjusted values are calculated based on seasonally-adjusted monthly figures (published figures).

■ China's zero-COVID policy could be a major supply risk to the global economy

For the global economy, the continuation of China's zero-COVID policy means that the risk of Chinese factories shutting down remains. The suspension of plant operations in China caused disruption to the global supply chain, mainly in the first half of 2020, and had a major impact on manufacturing industry around the world. For example, auto manufacturers in Japan, South Korea and Europe were forced to suspend production due to a slowdown in auto parts exports. There were also delays in shipments of IT products, such as smartphones and wireless earphones, by global companies that subcontract production to China. The delay in the export of medical supplies such as masks also caused global confusion.

It will also have a major impact if an outbreak occurs in a Chinese port city. China has the largest maritime shipping volume in the world. Although global demand for goods recovered sharply in the second half of 2021, the decline in port capacity as a result of China's COVID-19 control measures has had a major impact on the shipping, wholesale and manufacturing industries around the world.

As China's zero-COVID policy is expected to continue for a long period of time, it is necessary to be cautious not only about a downturn in demand in China but also about the risk of supply constraints engulfing the world.

(Shinichi Seki)

Topics *Soaring crude oil prices and the Indian economy*

India has an economic structure that is susceptible to the impact of crude oil prices, and the recent rise in crude oil prices brings negative pressure on the Indian economy through accelerated inflation, depreciation of the currency, and expansion of the fiscal deficit.

■ India is on high alert for soaring crude oil prices

Crude oil prices continue to rise. West Texas Intermediate (WTI) futures, a key price indicator, hit a seven-year high of 93 dollars per barrel in early February 2022. Crude oil prices are rising against the backdrop of 1) countries shifting to a coexisting with COVID-19 approach and expectations for increased energy demand in the future, 2) heightened tensions over the Ukraine situation, and 3) an upswing in heating demand in the United States due to unusually cold weather.

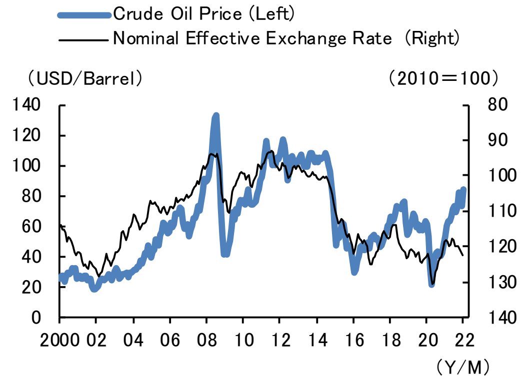
Considering the relationship between the nominal effective U.S. dollar exchange rate and crude oil prices over the past 20 years or so, it is suggested that appreciation of the dollar triggered by U.S. interest rate hikes may exert downward pressure on crude oil prices in the future. However, some predict that crude oil prices will remain high or rise further even if the dollar rises, citing the growing tensions in Ukraine and the Middle East. As the outlook remains uncertain, the economies of many countries, especially those that depend heavily on imports of energy resources, are expected to continue to be sensitive to the trends in crude oil prices.

The Indian economy is expected to face downward pressure from high oil prices through the following three main channels.

The first is the acceleration of inflation. Inflation reduces the purchasing power of households and slows the growth of consumption, which accounts for about 60% of GDP. The price of gasoline in the Delhi metropolitan area has increased by about 30% in the past year, and the year-on-year increases in wholesale prices have soared to the +10% level due to the rise in transportation costs. Wholesale price increases are likely to be passed on to retail prices, and consumer prices are expected to exceed the Reserve Bank of India's monetary policy target of +4±2% sooner rather than later. Incidentally, consumer prices remained high in the first half of 2020 despite the decrease in wholesale prices on a year-on-year basis due to the following two reasons: supply shortages were caused by supply chain disruptions in the wake of COVID-19 lockdowns in India and abroad; and food supplies decreased due to a locust plague (agricultural damage caused by a large outbreak of grasshoppers) in the northwestern part of India. For this reason, when forecasting inflation in India, attention should be paid not only to the trends in crude oil prices, but also to developments in China's zero-COVID policy, which could destabilize global supply chains, and to weather conditions during the monsoon season (June-September), which would have a major impact on agricultural production in India.

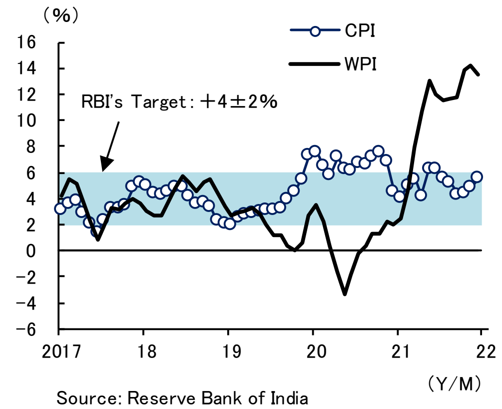
Second, the rupee has weakened due to the widening trade deficit. Since 2020, the rupee has remained resilient amid the current account surplus, but the recent current account surplus has been driven by a temporary drop in imports due to the strict COVID-19 lockdown. With the gradual easing of restrictions

<Crude Oil Price and US Dollar's Nominal Effective Exchange Rate>



Source: World Bank、Bank for International Settlement

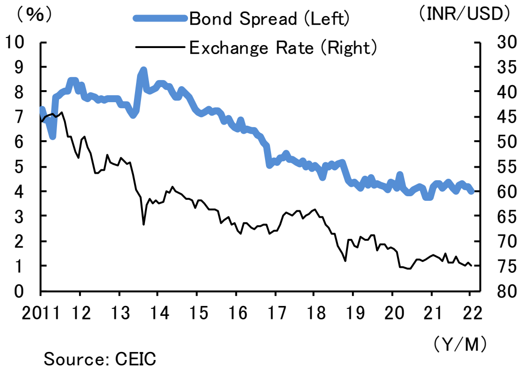
<CPI and WPI (YoY)>



Source: Reserve Bank of India

on activities, imports are gradually picking up and the current account balance has dropped into deficit again. If crude oil prices remain high, the current account deficit will widen further and downward pressure on the rupee will intensify. India's imports as a percentage of GDP tend to increase by 0.1% when crude oil prices rise by 1 dollar per barrel. Given this trend, if crude oil prices remain at a high level of 90 dollars per barrel, India’s trade deficit as a percentage of GDP for fiscal 2022 will increase by approximately 2% on a year-on-year basis.

＜Inida-US 2 Year Government Bond Spread and Exchange Rate between Rupee and US Dollar＞



Source: CEIC

This, combined with the downward pressure on the rupee from the interest rate side due to U.S. interest rate hikes, could lead to a vicious cycle of depreciation of the rupee and inflation. In fact, in the 2010s, it was observed that there was a correlation between the depreciation of the rupee and the narrowing of the interest rate gap between India and the United States. Given this correlation, the Reserve Bank of India may follow the lead of the United States in raising interest rates to stabilize exchange rates and prices. In this case, inflationary pressure through the depreciation of the rupee will be reduced, while the lending rates of financial institutions will rise, putting downward pressure on domestic demand.

The third is the expansion of the fiscal deficit. The government has indicated that it will try to rebuild its finances, which have been badly damaged by the COVID-19 pandemic, but it may find it difficult to rebuild its finances because of the need for additional fiscal spending to cope with inflation caused by soaring crude oil prices. In 2014, a drastic reform of the fuel subsidy system was implemented in order to reduce the subsidy expenditure, and thereafter the fuel subsidy expenditure by the central government decreased to around 0.1% of nominal GDP. Therefore, the immediate fiscal impact of increased fuel subsidies will be limited. However, the impact cannot be ignored if the inflation-fighting measures that have been talked about add up, such as 1) lowering the gasoline-related tax rate to control fuel prices, 2) increasing subsidies for food and fertilizer, and 3) increasing support for low-income earners and small- and medium-sized enterprises.

■ India must make efforts to overcome economic vulnerabilities

In order to prevent the economy from deteriorating due to soaring crude oil prices, India needs to promote structural reforms in various fields. First of all, it is necessary to reduce the dependence on crude oil imports by expanding renewable energy sources and improving energy efficiency. It is also important to reduce the trade deficit by improving the international competitiveness of its manufacturing industry through infrastructure development and reform of labor laws. Furthermore, for fiscal consolidation, it is also necessary to 1) improve expenditure efficiency through the digitization of public administration, 2) privatize state enterprises, and 3) simplify the tax system and raise the tax collection rate by leveraging the practical capabilities of tax authorities.

When the government announced the budget for fiscal 2022 (April 2022 to March 2023), it announced a policy to carry out structural reforms including the aforementioned measures. However, these efforts cannot be carried out overnight. Given the lack of progress in the revision of the Land Acquisition Act, which is essential for infrastructure development and facilitation of plant construction, it is unlikely that structural reforms will be accelerated in line with the government's expectations. Therefore, it is necessary to assume that the Indian economy will remain vulnerable to crude oil price rises.

(Shotaro Kumagai)