China and COVID-19:
a shock to its economy, a metaphor for its development

GEORGE MAGNUS

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President Xi Jinping has vowed to wage a ‘people’s war’ against the COVID-19 epidemic. Judging by the draconian measures that have been introduced to quarantine tens of millions of people, restrict the return to work after the Chinese New Year, and shutter much of the Chinese economy, he was certainly not understating his determination.

Yet, while this is unquestionably a serious public health issue, there are at least three other important issues related to it. The first is the dire consequences of the government’s containment measures for the economy, at least in the early part of 2020. Second, the government’s conduct unveils significant features about governance in Xi’s China that can be mapped on to China’s development. Third, this crisis is almost certainly the biggest challenge that Xi Jinping has faced since coming to power in 2012. He will survive it and feel emboldened to continue with the contours of governance he has asserted. Yet this will likely prove to be incompatible with China’s economic development goals.

I. Economy in the cross-hairs

In a Strategic Update on China's prospects in the 2020s last September, I explained how China's past performance could not be extrapolated into the future and that it was facing a number of structural headwinds. These comprise over-indebtedness and a more limited capacity to carry and service debt, deteriorating prospects for employment creation, poor demographics or, put simply, the consequences of rapid ageing, a looming middle income trap and a hostile external environment, in particular the many facets of the so-called trade war with the United States.[1]

According to data sourced to Wind Information, provinces accounting for close to 80 per cent of China's GDP and 90 per cent of its exports extended the normal Chinese new year holiday shutdown to 10 February.[2] In the run-up to that date and subsequently, the flow of workers returning to work has been slow, with many either fearful or restricted from doing so. The government clearly wants them to return to normal life as soon as possible, but the reality is that many firms, shops, and transportation systems are continuing to operate health checks and controls that prevent or limit the extent to which workers and visitors can resume normal functions.

The main sector buffeted by the clampdown measures is services, including for example, travel, tourism, restaurants, entertainment and retail outlets. These are sites or environments in which the concentration of people is very high. Yet small businesses have been hit hard, too. Suppliers of components, and even large industrial enterprises, such as those involved in automobile manufacturing, oil and gas, coal and steel, and chemicals, have all succumbed to production delays, cutbacks or closures, and rising levels of inventories because their sales have slumped.

Remember that even before all of these latest shocks, banks were already experiencing stress from rising levels of non-performing loans, a weakening economy, and the cumulative effects of de-risking. Now many of their corporate and household customers will be experiencing additional cash flow problems and income shortfalls, respectively. Private firms, moreover, which had been experiencing more difficult conditions in the wake of the government's policies to favour and champion state enterprises and push the party's influence into the operational management of private as well as state firms, will almost certainly be feeling the brunt of the measures to curtail the infection.

This all begs the question as to how bad the economic situation might become? In this regard most economists are guessing, it is fair to say, aided and abetted by a wealth of bottom-up data from which we can deduce certain trends in transportation volumes, sales in certain sectors, the use of electricity, and imports and prices of oil and copper, for example. These suggest to most forecasters that the effects so far have been quite severe.

Whither growth?

A recent survey of economists by Bloomberg suggested that first quarter GDP growth would drop from 6 per cent at the end of 2019 to about 4-4.5 per cent, but a few were well below 4 per cent.[3] Bear in mind, though, that many economists doubt the official estimates of China's economic growth, with several private forecasters estimating that China's actual economic growth before the coronavirus may have been much closer to 5 than to 6 per cent, and perhaps even a little below that.

If 4.5 per cent in the year to the first quarter proves to be what the government says, the implication would be that there had been no growth at all in China in the March quarter. That itself would be remarkable. Yet, an abundance of anecdote suggests that the impact of the shutdowns and quarantines will have been a fall in output and spending, which would be close to what we would have to call at least a technical recession in China, depending on what happens in the June quarter. If the economy contracted by 1 per cent, or an annual rate of 4 per cent, the more commonly cited annual growth rate would have dropped to 3.5 per cent. The maths then follow: a 2 per cent fall or 8 per cent annualised drop means annual growth falls to 2.5 per cent, and so on.

These are then extraordinary times for Beijing's policymakers and party leaders. Quite whether the government can bring itself to reveal the true sense of economic loss is a moot point. The suspicion is that it won't. The Communist Party's pledge to double GDP and income per head in the decade to 2020 is now on the cusp. Hitting these targets requires GDP to grow by about 5.8 per cent in real terms in 2020, and this might only happen if the infection stabilises soon and economic life normalises in an orderly and steady fashion after March.

If the growth target for this year is not met, and the pledge is unfulfilled, it would not be a political disaster for Beijing, but there would certainly be some reputational damage to add to other sources of pushback and disquiet that have been building up over the last 18 months or so, now including the mishandling of the coronavirus prevention and containment.

Normally we would have expected the party to announce its growth target and strategy for 2020 at the 'two sessions' meetings—of the Chinese People's Political Consultative Conference, and the National People's Congress—in early March. These key meetings have, however, been postponed, following state media announcements that Beijing will remain subject to travel and other restrictions for much longer. It was reported on 14 February that everyone returning to Beijing would have to go into quarantine for 14 days or risk punishment in order to help contain the coronavirus.[4] The government has so far only taken the unusual step of revealing that in 3 normally highly secretive Politburo Standing Committee meetings in the last few weeks President Xi insisted that the COVID-19 outbreak should not stop China from achieving its economic and social goals.[5]

To date, the government has been restrained in trying to offset the economic effects of the virus containment measures, partly because its focus is elsewhere, and significantly, one imagines, because stimulus measures can hardly have traction if people won't go out and workers can't work. Nevertheless, the authorities have not been inactive.

The People's Bank of China has injected several hundred billion dollars of liquidity to try and keep the financial system stable, and ensure orderly funding to other financial institutions and to many borrowers. The 'usual suspects' of lower interest rates, cuts in reserve requirements, targeted lending instructions, and the use of window guidance for lending are all likely to be deployed. New forms of fiscal easing, and more infrastructure spending are also likely policy responses in due course. Local governments have also been authorised to front-load spending for this year, and borrow accordingly.

By mid February, issuance of bonds had already surpassed that for the whole of the year-ago month, and the Ministry of Finance again increased the quota for local government bond issuance in the early part of 2020. It is also likely that the government will allow the Yuan to weaken, even at the risk of causing some angst for its US counterpart, which will doubtless be scrutinising China's compliance with the terms of the phase one trade deal, concluded only last month.

Ultimately, everything depends on how long it takes for the authorities to control and stabilise the spread of infection, enabling it to lift restrictions and allow economic life to normalise. Yet, we would normally expect a public health crisis such as this to have only a temporary impact on demand in the economy, even if it turned out to be severe. Once people return to work, retail outlets reopen, and construction and production resume, spending and lending will resume as well. The veil that has lifted over China's governance structure, on the other hand, has more enduring and perhaps significant implications.

II. Lifting the veil on governance

The government's craving for secrecy, stability and control, especially in the 40 or so days before President Xi went on full alert, and then its determined and draconian measures to combat the spread of infection are in some ways a metaphor for thinking about China's economic development prospects.

In assessing the non-economic issues in the short timeline of COVID-19, two things stand out. First, it certainly appears that in the early days of this crisis, there was a systematic attempt to suppress and control information, including medical information and advice, which several doctors in Wuhan tried to share amongst themselves. Second, once the scale of the problem was allowed to filter up to the top of the government, its response couldn't have been more forceful if the threat had been about national security at the highest level. It was as if the government had been compelled to bring the full force of the state to bear on an existential threat.

However the most striking recent revelation is that President Xi Jinping addressed the Politburo Standing committee on the looming epidemic as early as 7 January, two weeks before he went on the offensive against the virus, and while Wuhan authorities were still turning a blind eye to it.[6] It is a matter of conjecture as to what the government itself knew on 7 January and for how long before that, but it was predictable that Beijing's current—and very traditional—strategy was to hold the local party authorities responsible and present itself as the agent of reassurance and heroism on the people's behalf.

Not everyone will have been thus placated. Indeed, after the sad death in early February of Dr. Li Wenliang—one of the Wuhan doctors who had been silenced and sanctioned for trying to share medical information with colleagues—an unusual torrent of dissent and anger among citizens erupted on social media, posing perhaps the biggest governance and trust challenge to Xi Jinping since he came to power.

Moreover, a tireless critic of Beijing, Professor Xu Zhangrun, who had been suspended from his Tsinghua University academic post last year, recently wrote a long essay in which he charged that the epidemic had revealed 'the rotten core of Chinese governance'.[7] What Xu lamented was the suppression of China's technocratic system by a new tyranny which, in the absence of checks and balances, produces rule by a clique of trusted lieutenants who are beholden to their leader. He was quite right to say so, but as a result he has been banned from social media and, according to friends, has become uncontactable.[8]

Economic development implications

This is the perfect segue into a deeper look at China's forceful but brittle governance system—which Xu believes is in a state of terminal decay—and its interaction with China's economic development. For once you get to a certain stage of development, typically as a middle-income country which China is, the role of enabling institutions and robust governance becomes increasingly significant.

Whether or not Xu is right about 'terminal', the consequences of a more authoritarian, ideological and controlling governance structure can already be seen. These exist in the stall in structural economic reforms and the debt dependency of the economy, the flagging state of private sector enterprises, which have been the engine of China's economic miracle historically, insecurity about what are in any case limited property rights, and a general lack of confidence in the spending patterns of private individuals and firms. Many foreign firms that have been moving parts of their supply chain operations outside China or who are considering such a move will certainly not have been dissuaded from the appropriateness of their strategy by recent developments.

There is a lively debate about the case for authoritarian governance to propel economic development in a poor country that needs to deploy physical labour, and mobilise savings and capital to industrialise. While China under Mao is remembered for appalling economic and political catastrophes, it was not devoid of economic, social and educational achievements. Yet it was under Deng Xiaoping, who came to power in 1978, that China truly began to change. Economic development after the Mao era was spurred by the party becoming much more pragmatic as Deng pursued the strategy of 'reform and opening up', grand experiment that entailed the grafting of market mechanisms onto the state system, the pursuit of privatisation, entrepreneurship, certain property rights, and more.

By about 2010, China's development model was in need of a reboot and a renewed commitment to 'reform and opening up'. When President Xi Jinping came to power in 2012, though, he quickly orchestrated a political switch back to a Mao-era sort of governance model and ideology that revolves around a high degree of centralisation of personal and party power and authoritarian control, a relentless anti-corruption campaign and political purge, and the return of what Xu calls 'Red Culture'.

At the National People's Congress in 2017, Xi told delegates 'Government, the military, society and schools north, south, east and west—the party leads them all'. He has not flinched from policies and practices designed to demonstrate this in shaping political and institutional arrangements across government, the economy, finance, education, culture, the media and elsewhere.

III. Xi in Crisis

The burning question now is whether the centralisation of power and authority, the obsession with stability and control, and the stifling of dissent and debate are compromising a more sophisticated China's development potential.

The coronavirus epidemic management has revealed all three phenomena. To be fair, it also revealed a still forceful response, which perhaps few if any countries could emulate. Yet, that response reflects a flawed governance system, which is simultaneously the effect and cause of the public health scare. Arguably, the draconian response was necessary only because the same governance system capable of delivering it was also at fault for causing the crisis in the first place.

Instead of containing and suppressing the virus outbreak in the first month or so, the authorities were more concerned to shut down essential information and debate, and threaten those deemed to be passing on 'unauthorised information'. There was no role for the media, civil society institutions, public feedback or personal initiative because Xi Jinping has pretty much outlawed them.

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This has been about a current, major public health scare. In the past, similar governance failures have been perhaps rather less personalised but no less real, and included health scares, food and public safety issues, economic performance and institutional obstacles to better economic management, including as they pertained to the made-in-China financial crisis of 2015-16. Moreover, several academics and intellectuals in China have charged that governance failures also lie at or close to the heart of several foreign policy misjudgements, including the miscalculations over the trade war with the United States, the misjudgements over the Hong Kong protests, the 'loss' of Taiwan to a more independently-minded Tsai Ing-Wen presidency in the recent elections, and its positioning regarding several Belt and Road countries.

To western-trained eyes, the weaknesses of China's governance system seem obvious. As a modern, industrialised and increasingly information-driven state, China's growth and dynamism in the future should be increasingly determined not by top-down diktat, directives and quantitative targets, but by more flexible institutional arrangements that nurture and encourage productivity, efficiency, and, importantly, personal responsibility and initiative. In complex, information-driven societies, in which we strive for the continuous application of advanced technologies across multiple economic sectors, and independent, accountable and professional regulation, the urge to control and suppress information or knowledge is highly likely to retard development.

Yet, there is little to no chance that Xi's China will change tack following the shock of COVID-19. On the contrary, if anything, Xi seems more likely to double down, and demonstrate to Chinese citizens how important his and the party's remedial actions were and that the people's support for the party will always be rewarded. After several days of absence from TV and media coverage, the President re-emerged recently, with state media outlet Xinhua describing him, as the 'commander of the people's war against the epidemic'.[9]

Notwithstanding the broad and passionate outpouring of grief and anger about Dr. Li's death and the mishandling of the epidemic, Chinese politics are not about to be upended. Yet, this is not the first governance failure China has endured, and it won't be the last. Trust is a commodity that can sometimes be resilient to loss, until it isn't. For many, the doubling of income per head in 2020 may or may not happen, and will likely be below the radar. But if China were to finally lapse into a proper recession for the first time or the economic model were to falter in terms of job creation, the brittleness of the governance system would likely become a more contentious matter.

For now, the governance structure that has planted deep roots under Xi is existential to the party. In the coming years of economic development, it is also likely to be its antithesis. This is the biggest contradiction confronting China and President Xi. ■

Endnotes

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THE AUTHOR

George Magnus is Research Associate at the China Centre, Oxford University, and at the School of Oriental and African Studies, London. George was the Chief Economist, and then Senior Economic Adviser at UBS Investment Bank from 1995-2016. He had previously worked as the Chief Economist at SG Warburg (1987-1995), and before that at Laurie Milbank/Chase Securities, Bank of America and Lloyds Bank. His written work and a blog can be found on his website at www.georgemagnus.com. George's current book, *Red Flags: why Xi's China is in Jeopardy* was published in 2018 by Yale University Press, and then in paperback in August 2019 with newly commissioned material.

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lse.ac.uk/ideas/exec

For general enquiries:

LSE IDEAS
Floor 9, Pankhurst House
1 Clement's Inn, London
WC2A 2AZ

+44 (0)20 7849 4918

ideas@lse.ac.uk

lse.ac.uk/ideas

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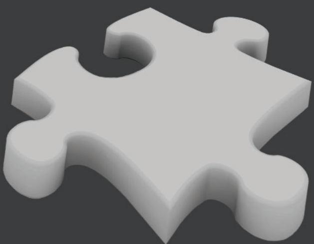

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The Chinese government's draconian actions to control the coronavirus seem to be producing a remarkable economic contraction. As so many are unable to attend or resume work at the moment, the government's palliative economic measures may gain little traction. Although the demand shock will eventually fade, other longer-term issues will surely endure.

The supply shock will be less obvious but more corrosive. The government's questionable conduct in managing the public health crisis has unveiled significant features about governance in Xi's China that can be mapped on to China's development. While this crisis is the biggest challenge Xi has faced, there is little doubt that he will survive it, champion the party's role in the nation's rescue, and feel emboldened to continue with his authoritarian governance. Yet it is this that, in the long run, will prove incompatible with China's economic development ambitions.