Careful what you wish for: Scrapping China's zero-COVID restrictions could be inflationary

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Highlights

- Following the Chinese Communist Party's congress last week, Xi Jinping's cemented his status as China's paramount leader for the next five years, including by replacing more than half of the 24-member Politburo with loyalists.
- With little effective opposition, President Xi appears set to continue economic policies that have been unpopular with financial markets, such as a pivot towards more state-directed economic growth and zero-COVID restrictions that have dramatically slowed the economy.
- While zero-COVID is often seen as contributing to global inflation by disrupting supply chains, a reopening of the economy could be a new driver of inflation for the world economy in our view.

Xi Jinping received a third five-year mandate at the conclusion of the Chinese Communist Party's (CCP) congress in mid-October. He also strengthened his political position, by promoting close allies to important government roles and removing former rivals. This suggests a likely continuation of Xi's key economic policies from the last few years: industrial policy geared towards "hard" tech industries like semi-conductor manufacturing, and fiscal policy principally aimed at boosting exports. The CCP congress also provided no indication of a near-term easing in China's zero-COVID policy.

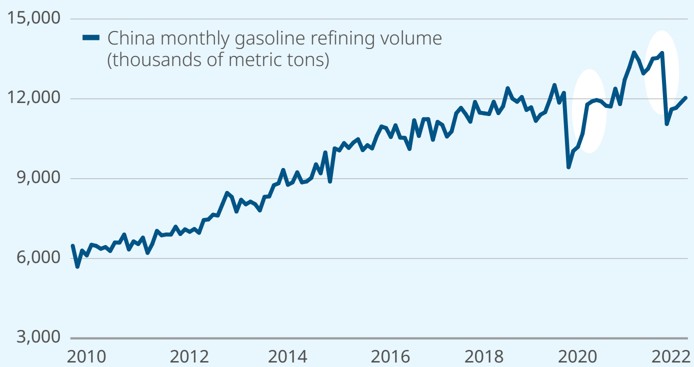
While an easing of COVID restrictions would be beneficial for China's economic outlook, a permanent scrapping of restrictions would likely be inflationary for the global economy in our view. The opposite argument is often made; that the sunsetting of COVID restrictions in China would be disinflationary for the rest of the world by easing supply chain bottlenecks. As western economies import goods from China, lockdowns in China have added to shortages and costs that inflate prices elsewhere.

China is not simply a factory for the world; it is also an important part of global demand. Its growing middle class consumes trillions of dollars in imported goods every year, ranging from German cars to American soybeans. Import growth has slumped this year amid lockdowns and slower economic activity. As Chinese consumers cut down on driving, gasoline refining has dropped by 20% in April 2022 and remains 12% below its March peak (Figure 1). With rebounding Chinese demand in a world of energy scarcity, China could export even greater energy-driven inflation abroad. At the same time, lockdowns barely affected China's exports while imports flatlined as consumers pulled back on spending. The result of slumping imports and resilient exports is a soaring trade surplus closing in on 5% of GDP (Figure 1).

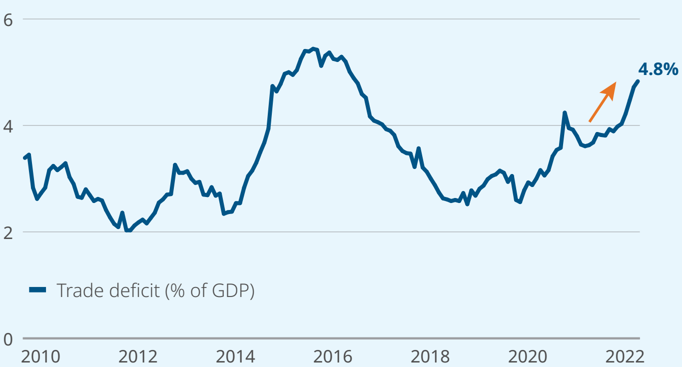
Outside analyses of China often mistakenly transpose Western experience with lockdowns onto China's economy. There are a few key economic differences between China's zero-COVID policy, and the lockdown regimes we saw in the US and Canada in 2020-2021. First, in Western economies, household consumption surged while production slumped, as many businesses paused operations during lockdowns. We are seeing the opposite in China, where household consumption is taking the brunt of the hit from lockdowns, while industrial production remains solid. Second, Western governments' efforts were focused on boosting consumption through direct transfers to households. By contrast, China's government is supporting the economy by propping up exports and public investment, not household consumption.

Figure 1. China's zero-COVID policy is restricting imports, not exports

Weak demand for gasoline is a symptom of lockdowns



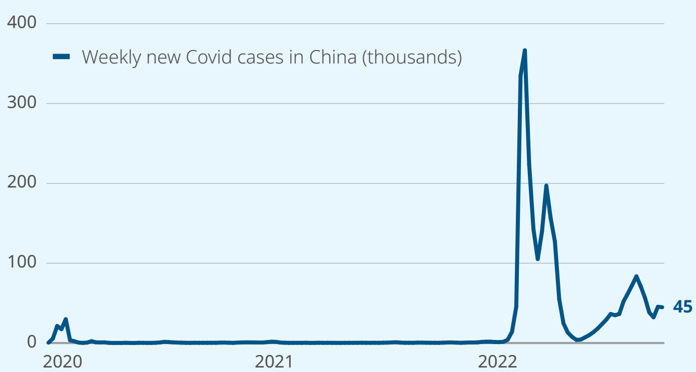
Resilient exports and slumping imports drive the soaring trade surplus



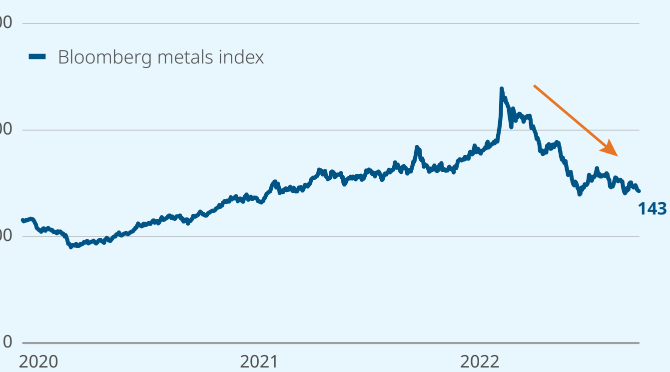
Notes: Via Bloomberg as of October 19, 2022.

Figure 2. Global inflation would likely have been higher without China's zero-COVID

Lockdowns succeeded in controlling cases, but consumption suffered



China's slowdown likely contributed to commodity weakness in Q2 and Q3



Notes: Via Bloomberg as of October 19, 2022.

If COVID lockdowns and associated policy responses in 2020-2021 clearly caused inflation to surge in Canada, the US and most other countries, the same cannot be said for China in 2022. Weak Chinese consumption due to lockdowns and timid demand-side stimulus curbed inflation both in China and globally. Commodity prices soared following the invasion of Ukraine last winter. But they quickly reversed in the spring, partly due to low imports from China, the largest consumer of commodities globally (Figure 2). Without Chinese lockdowns, we can speculate that inflation would have been even higher in the US and Canada this summer.

An eventual scrapping of China's zero-COVID policy would likely contribute inflationary pressures in the world. The risk of pent-up consumer spending roaring back in China in 2023, if restrictions are permanently eased, is one of the reasons we expect underlying inflation in Canada and the US to stick above 4% for much of 2023.

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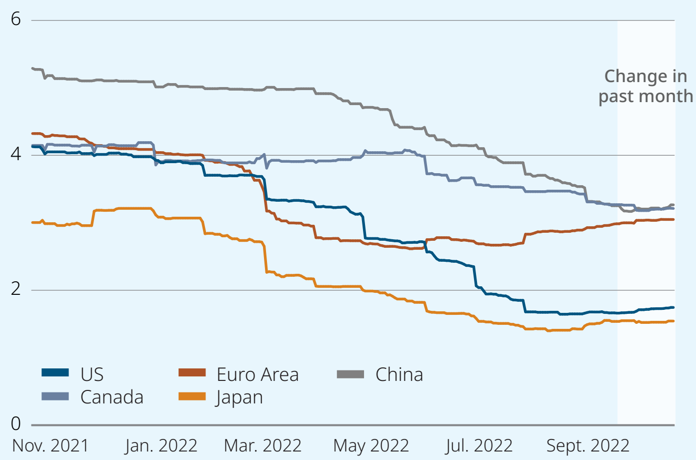
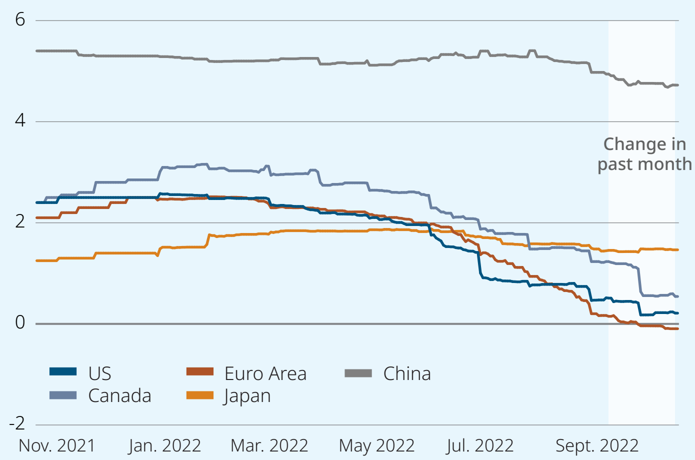
Global macro update

- Forecasters now expect to see **Japan's annual CPI inflation** for 2022 to come in above 2%. Japan has only seen annual inflation above 2% once over the past 30 years, when consumer prices rose 2.7% back in 2014. This was mostly due to a temporary effect from the introduction of a new sales tax, and inflation immediately cratered below 1% the following year. The average forecaster still expects to see inflation below 2% in 2023, supporting the Bank of Japan's decision of keeping rates low to bring inflation sustainably to its 2% target.
- The 2023 consensus forecast for **Eurozone inflation** exploded higher in October, and now sits comfortably above the average forecast for US inflation. This should worry the European Central Bank. After the invasion of Ukraine in February, Eurozone inflation forecasts for 2022 rose much faster than forecasts for 2023, as the disruption to energy markets was expected to cause a one-off increase in prices rather than persistent inflation. With governments reacting to the energy shortages with deficit-financed support programs for households, the temporary price shock could turn into a persistent mismatch between demand and supply.

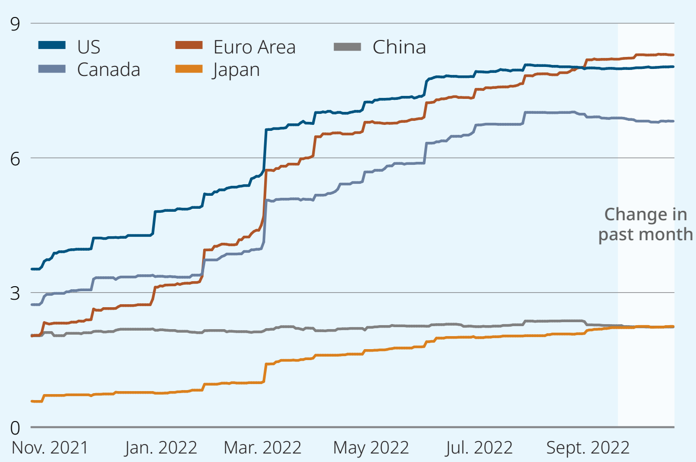
2022 real GDP growth forecast (%, consensus)



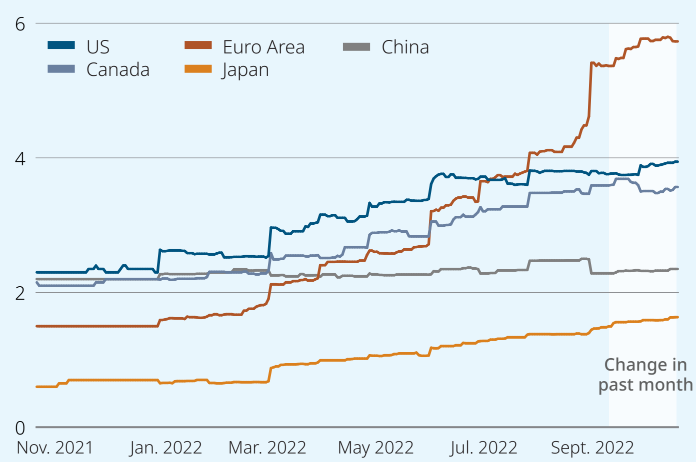
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



Notes: Average growth and inflation forecasts from Consensus Economics as of October 31, 2022.

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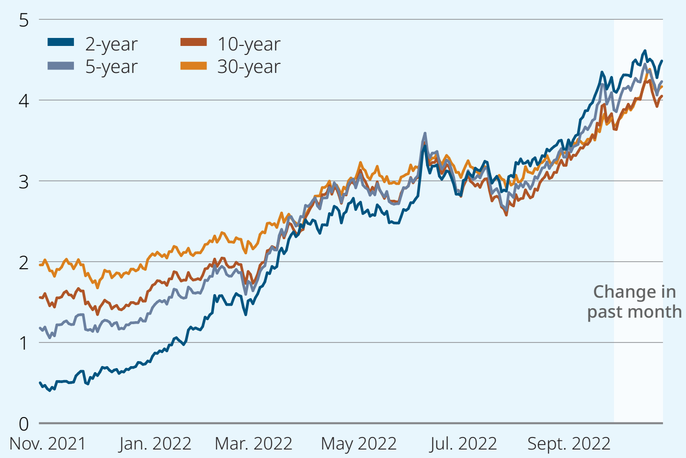
Capital markets update

- The **S&P 500** declined below its June lows in September and remained weak in the first half of October as the hawkish Fed, rising Treasury yields and global macro uncertainty softened sentiment. Equities bounced in the second half of October as earnings appeared stronger than many investors had feared and expectations by some that the Fed had reached peak hawkishness.
- **US Treasury yields** spiked in September and continued rising through most of October, as the Fed reiterated its commitment to hike rates until inflation returns to 2%. In October, market-implied expectations of US inflation also rose sharply while poor liquidity conditions remain a concern.
- **The British pound** recovered in October following the UK's disastrous mini-budget in September that led to sharp losses in sterling and gilts. The **Japanese yen** breached the key threshold of 150 to the US dollar in October, bringing its total depreciation this year to over 25% vs. the US dollar.

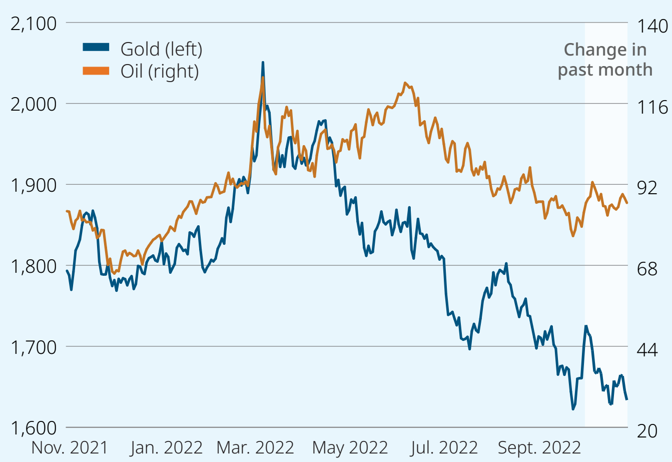
Equity indices (one year ago=100)

US Treasury yields (%)



Currencies (relative to USD, one year ago=100)

Commodity prices (in USD)



Notes: Financial data from Bloomberg as of October 31, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

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What we'll be watching in November

November 3: Bank of England rate decision

- UK CPI inflation climbed to 10.1% in September, and the Bank of England is expected to react forcefully. Markets expect a 75bps rate hike at the very least, and a 100bps hike is a real possibility. The Bank of England has been clear that it will not hesitate to tighten rates to fight inflation, even if their actions bring forward an expected recession.

November 16: Canada housing starts for October

- While home sales have slowed in Canada, new construction has remained resilient. In September, housing starts jumped to 300k, the highest number since November 2021 and the fourth highest number in history.
- By some measures, the housing market is slowing more quickly in the US than in Canada, which is somewhat surprising. The latter is more overvalued relative to fundamentals and Canadian homeowners are more sensitive to rate hikes. But the strong housing start print shows that it remains tricky to bet on the demise of the Canadian housing market.

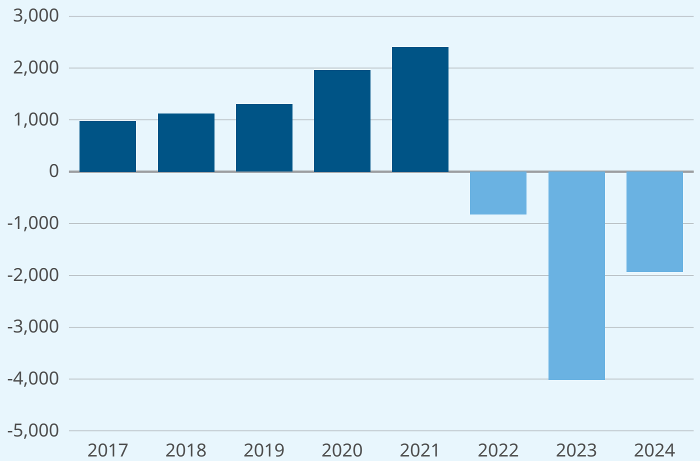
November 16: Canada CPI for October

- After lagging US inflation in August, mainly due to methodological quirks, Canadian inflation for September surprised to the upside. CPI inflation for both Canada and the US came in at +0.4% month-on-month.
- This supports our view that in the short term, the Canadian economy remains at least as hot as the US economy, and inflation will stick above the Bank of Canada's target over the coming quarters.

Emerging theme

- The Bank of Canada will likely generate negative net income for the first time in its history over the next few years. Before the pandemic, it remitted around $1 billion a year to the federal government as seigniorage. But with surging interest rates, its interest payments to financial institutions are about to exceed the fixed interest revenue from its portfolio of assets, mostly made up of Government of Canada bonds.
- Based on our estimates, the total net shortfall over the next three years will amount to around 3% of annual federal government revenues. Because the Bank cannot technically run a sizable deficit, the government of Canada will probably provide an effective loan to the Bank of Canada. This could be a challenge for the optics of central bank independence.
- The Bank of Canada's quantitative easing policies in 2020 and 2021 had a major effect on government finances going forward. When we factor in the Bank of Canada's holdings of Government of Canada bonds, the average weighted maturity of the government's debt drops from 6.7 years to 4.7 years.

Bank of Canada's net income will likely turn negative (million $)



Notes: Data from Bank of Canada and Bloomberg as of October 14, 2022. Authors' calculations.

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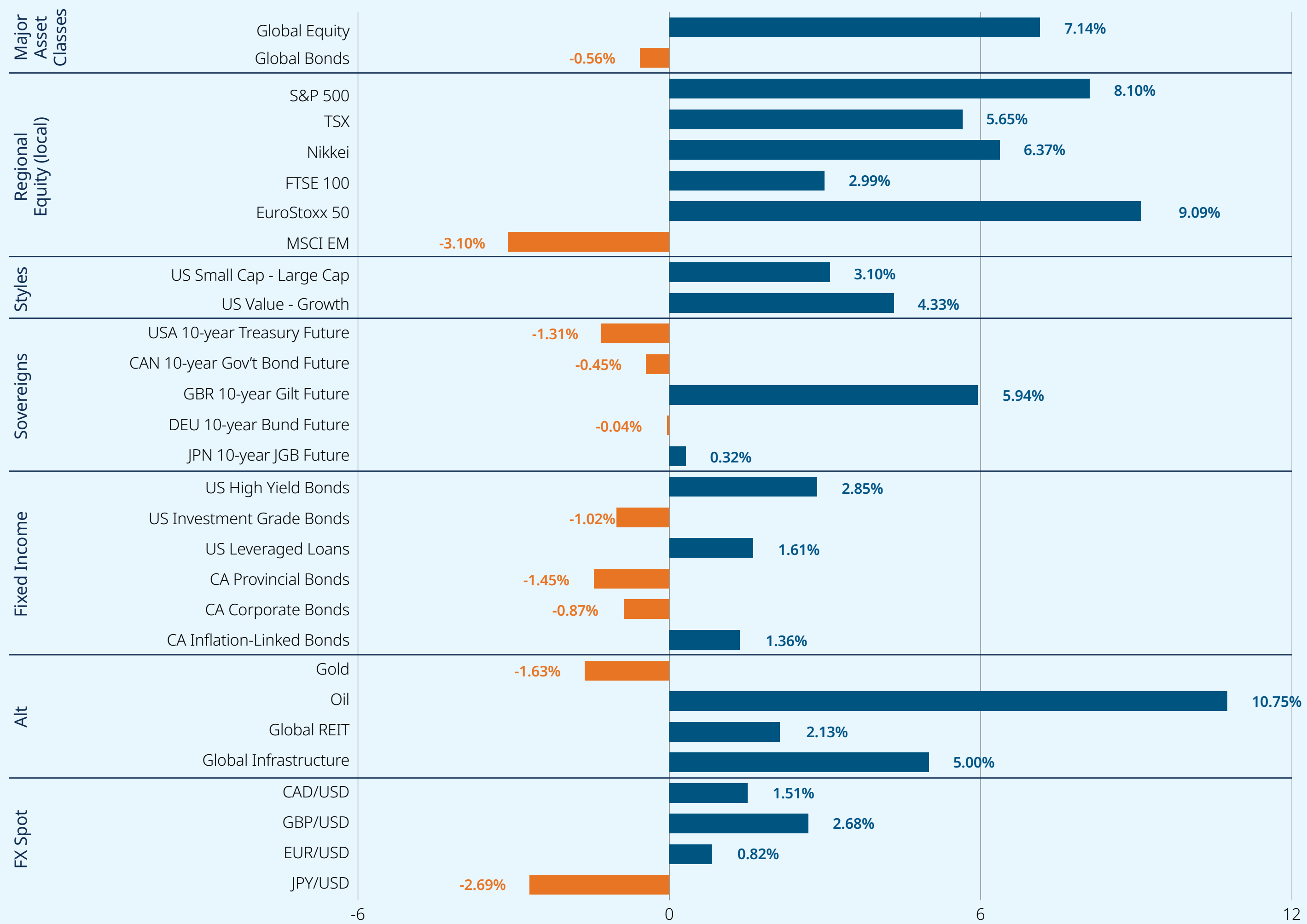
Capital market returns in October



Notes: Market data from Bloomberg as of October 31, 2022. Index returns are for the period: 2022-09-01 to 2022-09-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EURO STOXX 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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