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Coronavirus: First thoughts on the potential economic impact on China

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Key points

- The escalation of the novel coronavirus (2019-nCoV) outbreak has caused serious concerns among the Chinese public, disrupting both social and economic activity, and putting the country's health system under strain. As the situation is still unfolding, uncertainties abound regarding the duration and severity of the epidemic, and how it will eventually be tackled. There are still considerable challenges ahead and as such, making a call on the outcome at this stage is extremely difficult. This also makes assessing the economic impact challenging, although it is fair to say that the previous consensus outlook of "smoother sailing" for the Chinese economy in 2020 has been significantly called into question.

- There are a number of plausible ways in which the situation could evolve from here. In a quick-resolution scenario, the outbreak could be brought down control in the coming weeks – similar to the Severe Acute Respiratory Syndrome (SARS) in 2003 – confining the negative growth impact to the first quarter of this year. As economic fundamentals remain unscathed, some rebound in pent-up demand, aided by policy stimulus, should drive a strong recovery in the subsequent quarters. The epidemic would, therefore, represents a one-quarter shock – like SARS, but this would still impose downside risk to our growth forecast given that no all lost output can be recouped.

- An intermediate scenario features a slower resolution, which would deepen and prolong the economic downturn during the first half of 2020 and weaken the recovery thereafter. This could see full-year growth slow to below 5%, with rising financial risks and much lower asset prices. A worst-case scenario would consider the virus being uncontainable. Quantifying this risk is difficult, but we would expect severe global repercussions if both China – and the world – fail to prevent a global pandemic.

Current situation: Worst yet to come

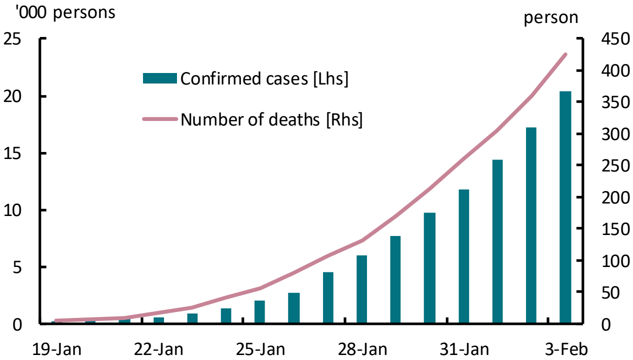
Since the first case was reported to the World Health Organisation (WHO) on 31 December, the 2019-nCoV virus has spread at an exponential rate. As of 3 February, there were 20,438 confirmed cases globally, with China accounting for 99% of all infections, at 20,233 cases, and the remaining 215 spreading across 25 countries (Exhibits 1 and 2). So far, the virus has claimed 425 lives – with a reported mortality rate of just over 2%.

The coronavirus has now surpassed SARS in the number of infections – but not mortality – spreading to all 31 provinces of China within only one month of its discovery (Exhibit 3).

This is partly due to the more infectious nature of the virus, but contagion has also been aided by the mass migration of people during the Lunar New Year (LNY). With the early detection made more difficult by the virus's long incubation period, the upcoming reversal of migration post-LNY could pose risks to a further escalation of the situation.

Exhibit 1: The coronavirus outbreak intensifies

Coronavirus cases - China

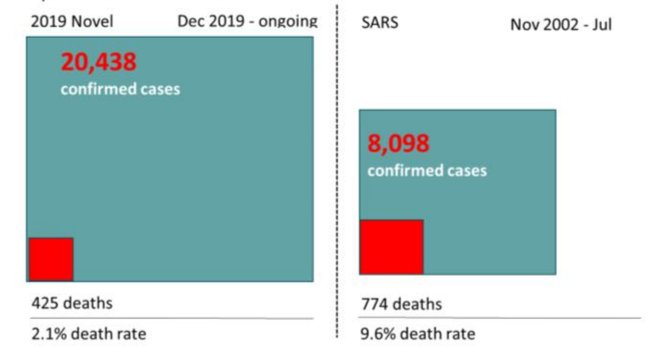


Source: CEIC and AXA-IM Research, as of 3 Feb. 2020

The Chinese authorities have taken drastic measures to contain the virus. At the epicentre of the epidemic, Wuhan, along with its 17 neighbouring cities in the Hubei province, have been in lock-down since 23 January. All 31 provinces and major cities in China have activated their highest level of emergency response by shutting down roads, closing tourist attractions, restricting public gatherings and cancelling LNY celebrations. Many inter/intra-regional highways have been closed, or under partial restrictions, to limit long-haul travel, while the authorities have set up temperature checkpoints at major cross-sections, as well as at airports and train stations.

Exhibit 3: The coronavirus is more contagious but less deadly than SARS

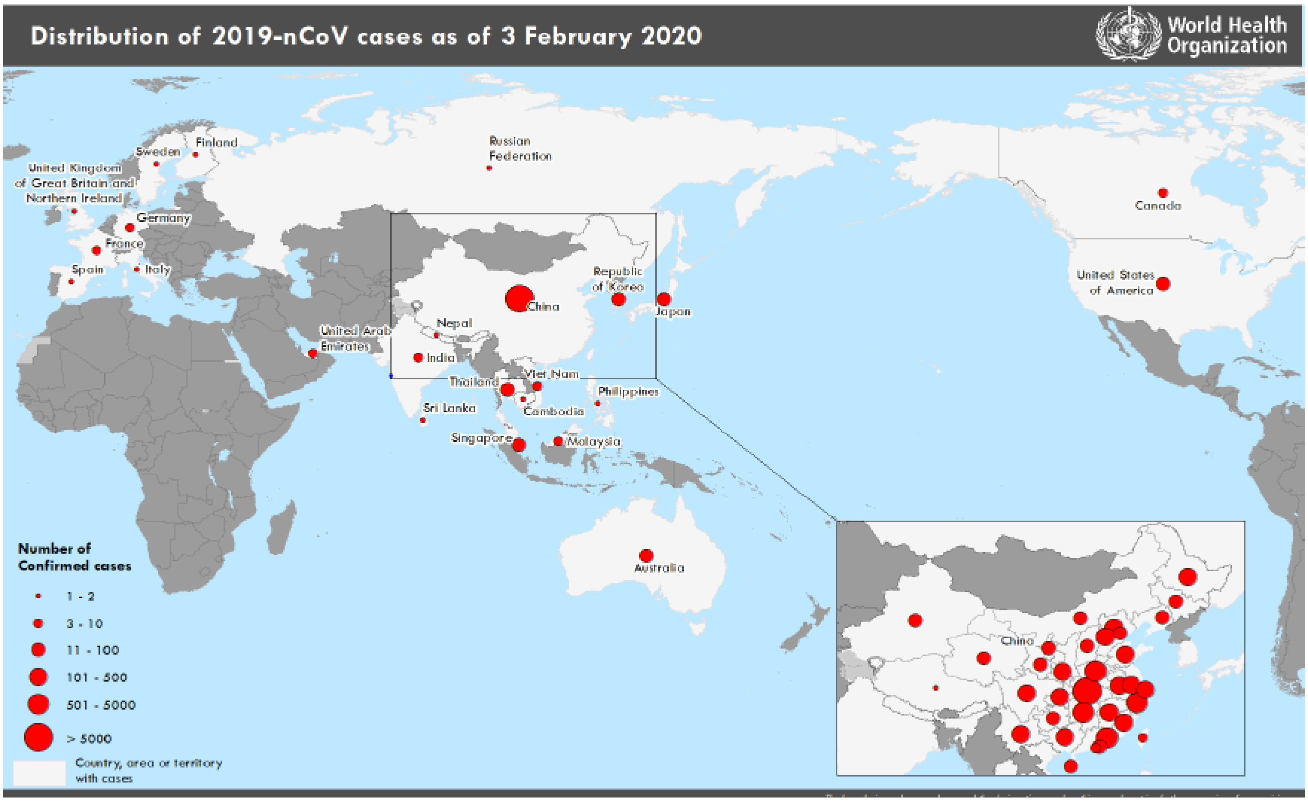
Comparison of the current outbreak with SARS



Source: CEIC and AXA IM Research, as of 3 Feb. 2020

Residents have been advised to stay at home and avoid entertainment gatherings, with the message reinforced by calls and visits from tens of thousands of community workers in cities and village officials in rural areas. The state council also extended the national holiday to 3 February, with some provinces going even further to urge companies not to resume operations until 9 February (13 February in Hubei). The scale and force of these emergency responses are unprecedented. Together with growing precautions taken by individuals, this should help to control the spread of the virus. However, by severely restricting social activities, these measures could

Exhibit 2: The coronavirus spreads fast



Source: World Health Organization

also exacerbate short-term economic weakness, with signs of stress already visible in some sectors.

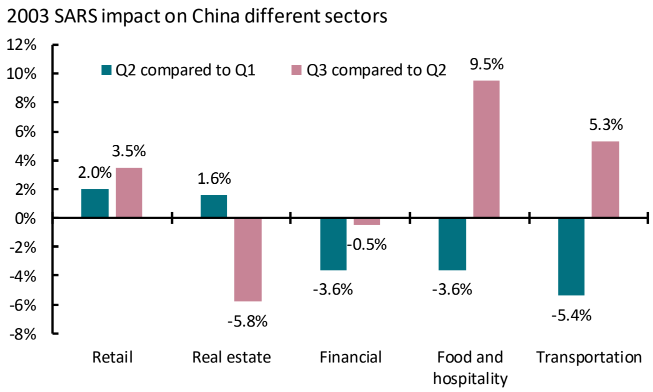
Economic impact: All depends on the path to crisis-resolution

Gauging the economic impact of the 2019-nCoV is not easy at this stage. As the situation is still unfolding, there are considerable uncertainties around how long and severe the outbreak will be, how effective the government's responses are, and what remedies can be applied to soften the economic blow. In the absence of any hard data, a comparison to previous epidemics, like SARS, is our best starting point. However, mindful of different characteristics of the viruses and the increased complexity of the Chinese economy – along with its closer integration to the rest of the world – such a comparison can serve only as an illustrative guide. The risk of a more severe and contagious shock than SARS cannot be ruled out.

The lesson of SARS

The outbreak of SARS in 2003 dealt a heavy blow to the Chinese economy. Following a slow start in late-2002, the virus spread quickly in the first half of 2003, with the peak of contagion between March and May. Public emergencies were enacted, and the spread of infections dramatically reduced economic activity. Real GDP growth fell to 9.1% in the second quarter (Q2) from 11.1%, driven by weakness in the tertiary sector, such as transportation (-5.4ppt) and hotel/catering services (-3.6ppt). Higher frequency data showed passenger traffic volumes plummeted by 41% and 22% in May and June respectively, while retail sales growth tumbled by 6ppt to 4.3%. However, as the outbreak passed its peak in June, the negative impact faded allowing growth to rebound to 10% in Q3 and Q4 (Exhibit 4). In retrospect, SARS was a one-quarter shock for the Chinese economy.

Exhibit 4: Growth changes during and after SARS



Sources: CEIC and AXA-IM Research, as of 3 Feb. 2020

The experience of the SARS shows that services and retail sectors are the most vulnerable to outbreaks of epidemics. And history is repeating itself now. Rising fears of the coronavirus and tough restrictions imposed by the government have significantly curtailed people's travel and spending during this year's LNY. Data from the Ministry of Transportation shows that overall travel shrank by more than 70% in recent days, compared to the same period last year. The cancelation of blockbuster movies and shutdowns of cinemas mean that this year's box office sales would be dismal compared to the RMB5.9bn recorded in 2019. Offline retail sales, which brought in more than RMB1trn revenue last year, would also fall dramatically as shopping malls are closed and people are refraining from going out.

More damaging than SARS?

There are several reasons to expect the 2019-nCoV outbreak to be more economically damaging than SARS. First, the services sector is now a bigger part of the economy (54% vs. 42% in 2003) and consumption is a more important driver of growth. A similar scale of slowdown in these sectors would therefore have a larger impact on the economy than in 2003. Second, the LNY is one of the three "Golden Week" holidays, during which sales can account for up to 10% of annual revenue in some industries. For some businesses, the lost LNY sales will not be reclaimed even if the situation returns to normal. Finally, the overall macro backdrop has become less accommodating, given the Chinese economy is in the middle of a structural slowdown driven by both internal imbalances and external headwinds. This contrasts to 2003 when China just entered the WTO and was on a fast-track to industrialisation and globalisation.

Two mitigating factors are worth highlighting too. First, household spending patterns have changed dramatically given the rise of e-commerce. Online retailing, which now accounts for more than 20% of total retail sales, should be less affected by the epidemic and can help to soften the blow to overall consumption[1]. Second, while Beijing's heavy-handed response has exacerbated short-term economic pains, it could help to shorten the duration of the outbreak. A quicker resolution can limit the spillover of the initial shock, allowing the economy to find its feet quickly. With some added stimulus to aid the recovery, growth could bounce back swiftly once the epidemic fades, like it did in 2003.

Three scenarios: From bad to worst

Given there is little visibility on when and how the outbreak will end, below we outline three possible outcomes and assess their impacts on the economy. The growth estimates in these scenarios are constructed with our best effort given

[1] To be clear, we only expect some partial offsets from online sales, which too face the uncertainty of disruptions to logistics that would make delivery difficult during the epidemic.

the current information. We will monitor the situation closely and recalibrate the numbers once conditions change.

Scenario 1 assumes fast containment of the virus, similar to that experienced with SARS. This will require the Chinese authorities to bring down the growth of new infections quickly, control the spread of the disease and speed up the treatment of the ill. If this is achieved in the coming weeks, most of the negative effects could be confined to first quarter of 2020. We think the shock to services and retail activities could be worth 1.5~2ppt of GDP growth, with some spillover into secondary-sector activities. This would take Q1 growth down to 4.0-4.5% year-on-year, with a possible contraction of 0.5% on a quarter-on-quarter basis. Beijing would likely announce a bigger stimulus package – centred on fiscal policy – to resuscitate the economy at the National People's Congress in March. Monetary policy would likely also do its part. But with added inflationary pressures and ongoing debt concerns, the People's Bank of China (PBoC) may not want to change its policy stance substantially to deal with a transient, non-economic shock. We think some precautionary liquidity injections, possibly an RRR cut (up to 100 basis points), are likely, along with targeted measures to ease funding constraints of SMEs. These policy supports should help to unleash pent-up demand in the economy, leading to a swift growth rebound – to above 6% – in Q2, followed by a return to moderation in the second half of the year. Such a scenario would lower our full-year growth forecast to around 5.6% with downside risks, but not derail the managed slowdown that Beijing tries to engineer.

Scenario 2 features a more drawn-out battle against the epidemic, leading to a deeper and longer slowdown followed by a more lacklustre recovery. The failure to quickly contain the virus means that the shock to services and consumer sectors would be prolonged, raising the risk of a second-round effect in terms of rising job losses and income reduction. The government would also likely impose tougher restrictions in the workplace, or even postpone production further in some areas to limit virus contagion. These delays will weigh on industrial and manufacturing activities and dampen export growth. The latter could be exacerbated by reduced foreign demand for Chinese products and services due to health concerns, as the WHO has declared the 2019-nCoV a public health emergency of international concern (PHEIC). A deeper and prolonged downturn will see growth drop below 5% and stay there throughout the first half of the year. Assuming the epidemic is eventually brought under control around mid-year, we suspect the subsequent recovery would be less vigorous than in Scenario 1 as prolonged economic pains cause more business failures, disrupt supply-chains and damage bank balance sheets. Beijing would step up policy stimulus, but that support may be too little too late for many. We expect full-year economic growth to fall below 5% in this case, with higher risks of financial instability – e.g. rising defaults – and lower and more volatile asset prices.

Scenario 3 considers the worst outcome of failure to contain the virus. An important feature of the 2019-nCoV is its long incubation period – of up to 14 days, which enables it to be transmitted by people before they present symptoms. This makes early detection more difficult, hindering attempts to contain contagious carriers. Some experts suggest that the vast majority of confirmed cases outside Hubei were a result of encounters with Wuhan residents who showed no symptoms of infections when they left the city before the lockdown. So far, estimates of the 2019-nCoV mortality rate is lower than other recent virus outbreaks (e.g. SARS, MERS[2] and Ebola) and treatable under proper medical care. It is possible that with the help of effective medicines and prevention, both the deadliness and infectiousness of the virus can be lowered to levels that people can live with without excessive fears (e.g. turning it into something more like a seasonal flu). However, getting to that end-point won't be easy as developing new drugs or vaccines will take time. In the interim, the spread of the virus could continue to cause fears and disruptions to economies, markets and societies across the globe. It is impossible to quantify the impact of this scenario, but it is fair to say that China will be in for a much longer and more painful adjustment, with possible collateral damages done to the structure of its economy. This scenario would also bring nasty global ramifications, with other countries potentially struggling to cope with the spillover to their economies. At a time where the world is still vulnerable from weak expansion, this could be something that tips the global economy into recession.

Impact on China's Phase-One deal commitments

On a related note, the coronavirus outbreak would also diminish China's ability to fulfil its commitments to increase exports from the US in line with its commitments to the "Phase One" trade deal – something that we had already been sceptical about. The impact of any such failure would depend on the US reaction to a shortfall of the schedule. A scenario that saw the US recognize the extreme nature of the shock to China and make allowances, would not exacerbate a global downturn. However, if the US were to follow the letter of the trade pact, it could increase tariffs on China, something that would create additional risks to the global economy. With the White House now fully focusing on the end-year elections, we suspect its reaction will tend towards the former for now. But the medium-term path will be dependent on resolution of the US political uncertainties over the coming year.

[2] Middle East respiratory syndrome

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