CHINA ECONOMICS FOCUS

The economic impact of the new coronavirus in China

- **China's economy is likely to contract sharply in the first quarter, as a result of the measures that have been taken to limit the spread of the new coronavirus. The apparent slowdown in new infections in the last few days should raise hopes that output will bounce back quickly, leaving no lasting economic damage. But a slower recovery that would have larger and more prolonged effects cannot be ruled out until activity has started to return to normal. The daily data that we are monitoring give no signal that this is happening yet.**
- With much of China's economy, from manufacturing to services, at a standstill nearly two weeks after the Lunar New Year holiday was originally due to end, a contraction in output is very likely this quarter.
- There is still a great deal of uncertainty about what will happen over the coming weeks, not least because it depends on the course taken by an infectious disease that is still poorly understood. Using some fairly benign assumptions, we expect a decline in y/y growth from 6% at the end of last year to around 2% in Q1. That would be only a little bigger than the three percentage point slowdown during SARS. But **in q/q terms, we think output is likely to contract 2.5% (10% at an annualised rate)**.
- Our benign assumptions are that firms restart over the next couple of weeks, that wages continue to be paid, and that jobs aren't lost. If these hold, **the economy should rebound sharply in Q2. This remains the most likely outcome. If so, growth across 2020 as a whole may not be much lower than it was in 2019**.
- Policymakers are clearly trying to ensure this happens. The leadership in Beijing is now encouraging workers to return and firms to reopen (some local governments appear less keen), has offered bridging finance to help firms meet wage and other obligations, and has ordered firms not lay off workers in response to virus containment measures. The government also appears to be gearing up for fiscal stimulus; more monetary easing is likely too.
- **But there is still a plausible malign scenario**, in which these measures don't work. Smaller firms may fall through the net of the government support measures. The self-employed, and the many migrant workers who were between jobs at the Lunar New Year, are already experiencing a collapse in income. **If firms don't reopen soon and household incomes fall more broadly, there would be a more lasting impact, with annual growth a couple of percentage points lower**.
- (As ever, we're talking here about actual growth rather than published GDP. Xi Jinping said yesterday that China would still meet its economic targets this year despite the outbreak. The most important of these is the Party's longstanding target to double 2010 GDP by 2020. To do that, the government will need to publish annual growth this year of at least 5.7%. It is likely to do that come what may.)
- **In order to track which path China is on, we are following – and publishing on our website every day – a set of daily indicators** covering traffic congestion, passenger numbers, property sales, energy consumption and prices. Taken together these should give a good signal of whether economic activity is returning to normal (although the lack of decent labour market data is a blindspot). Looking at the data for Tuesday 11th, while provinces that had an extended Lunar New Year holiday last week had already formally returned to work, these data series suggest that activity remained extremely depressed.

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This Focus *is a transcript of a presentation given at the Capital Economics Emerging Markets Forecast Forum in London on 12th February 2020. A companion piece looking at the impact on the rest of the emerging world will be published on our coronavirus page shortly.*

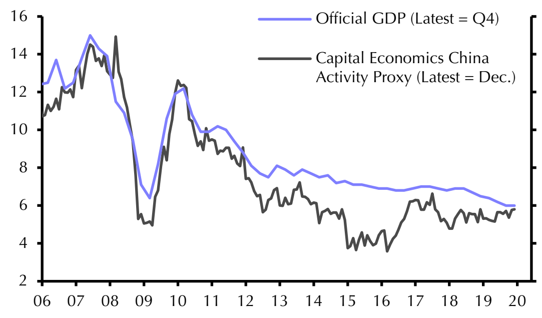
This *Focus* starts by setting the scene for how China's economy was performing before the coronavirus epidemic took hold. The main goal is then to offer some early estimates of the scale of the impact of the coronavirus on China's economy, and some pointers to how this is likely to play out in terms of growth and the policy response both if the outbreak is brought under control soon and if it is not.

China before the outbreak

The Chinese authorities announced to the WHO on 31st December that there was a new flu-like but still unidentified virus spreading in the city of Wuhan.

At that point, economic trends were looking fairly positive. Unusually, both our China Activity Proxy and the official GDP figures were roughly consistent in the fourth quarter of last year, pointing to growth of 6%. (See Chart 1.)

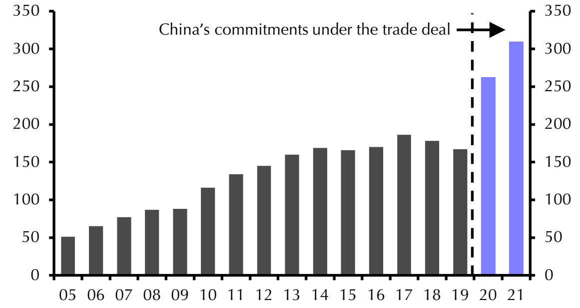
Chart 1: China GDP & CE China Activity Proxy (% y/y)



Sources: CEIC, Capital Economics

The Phase One trade deal was then signed on 15th January, less than a month ago. The centrepiece was a Chinese commitment to significant purchases from the US this year and next. The targets were unrealistically high, even before the disruption around the virus outbreak materialised. (See Chart 2.) But that probably doesn't matter to whether the deal will hold: as long as China increased its purchases significantly, President Trump would be able to claim success. In signing the deal, China won a reprieve from further tariff increases at least until the US election and bought itself time. With global trade turning a corner, the export sector's prospects looked reasonably good.

Chart 2: US Exports of Goods & Services to China ($bn)

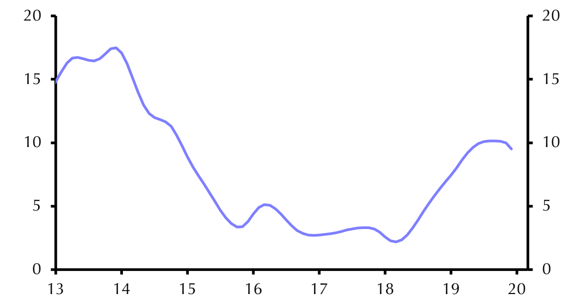


Sources: CEIC, USTR, Capital Economics

There was one major vulnerability though, which was the extent to which China's growth recently had been dependent on property construction.

Property construction accounts for roughly 15% of China's economy and was growing at 10% y/y through most of last year. (See Chart 3.) So this one sector was contributing about 1.5% percentage points of overall growth. That is unsustainable: the sustainable rate of construction growth we think is zero. We thought a slowdown in construction would be a major headwind this year. This is a vulnerability that the coronavirus outbreak makes all the more acute, as I'll explain in a moment.

Chart 3: Floor Space Under Construction (% y/y, sq. metre)

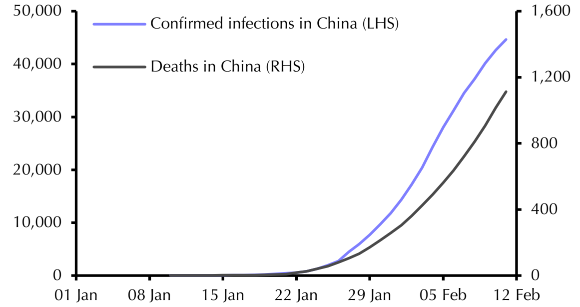


Sources: CEIC, Capital Economics

The outbreak and the initial response

That was the picture as the coronavirus outbreak was taking hold in Wuhan. Chart 4 shows the rise since the turn of the year in the number of people confirmed to be infected with the new coronavirus and the number of confirmed deaths. (See Chart 4.) There are now 45,000 confirmed infections in China (as of the end of Tuesday) on the official figures and 1,100 are known to have died.

Chart 4: Infections & Deaths in China due to New Coronavirus



Sources: CEIC, Capital Economics

These are tragedies playing out across China. The Party was slow to respond in early January and there is evidence of attempts to cover up what was happening in Wuhan. But in the days after President Xi's first comments about the outbreak on 20th January, the Party became much more open and took some aggressive measures to limit contagion. (See Table 1.)

Table 1: The Initial Policy Response to the Outbreak

December 31st	China notifies WHO about new unidentified virus.
January 20th	First public comment from President Xi.
23rd	Wuhan cordoned off. Nearby cities subsequently quarantined too. (Total population 53 million).
24th	Travel restrictions across the rest of the country.
25th	Lunar New Year's Day.
26th	Lunar New Year holiday is extended.

Source: Capital Economics

Wuhan and nearby cities with a total population of more than 50 million have been quarantined. Tens of millions more people are confined to homes and allowed to go out only every couple of days. Transport links across much of the country were curtailed, including long-distance buses and trains. Communities put up barricades to stop outsiders from entering, with the support of local authorities. The Lunar New Year holiday was extended by over a week and many firms and factories have been told to remain closed beyond that.

On top of these official measures, most people in China are doing everything they can to avoid crowded or public spaces.

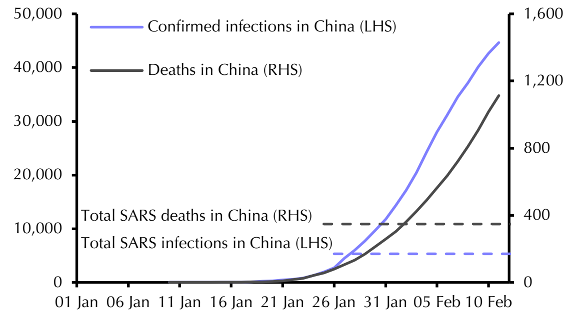
When we think about the economic impact of the outbreak, it is important to note that it is these measures being taken by the public and by officials to limit contagion that are having an impact, not the virus itself. Total infections in China only amount to one in every 30,000 people.

What is the economic impact?

Estimating the economic impact is made hard by the fact that nothing like this has happened in recent times. When we started to analyse the economic impact in early January, before the new virus had been identified, we drew comparisons with SARS, another respiratory disease caused by a coronavirus that appeared in 2003.

Initially, SARS seemed like a plausible worst-case scenario: the worst recent outbreak in China of an infectious disease, and one that initially did significant economic damage. But in public health terms, the new cornonavirus has now gone well beyond the damage caused by SARS. Below is the chart I just showed of infections and deaths from the new coronavirus with the the equivalents in China for SARS added as dashed lines. (See Chart 5.) Already there are three times as many deaths and eight times as many infections.

Chart 5: Infections & Deaths in China due to New Coronavirus



Sources: CEIC, Capital Economics

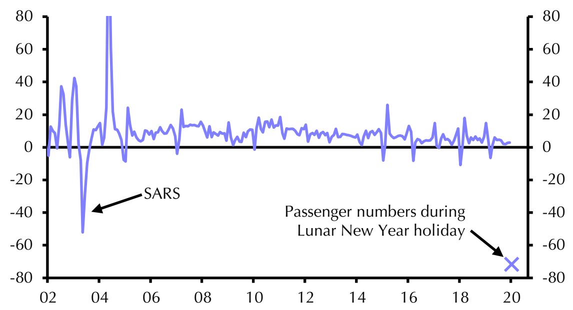
But SARS still offers a useful starting point for thinking about the economic impact because some elements of the response to the current outbreak have been similar.

Because of when the containment measures were introduced, on the eve of the Lunar New Year holiday, the initial impact showed up most clearly in traffic data.

Chart 6, for example, shows year-on-year growth in domestic travel, whether by road, rail, boat or air. There is always some volatility around the Lunar New Year holiday, which you can see in the small spikes and troughs around the turn of every year. (See Chart 6.)

We don't have fully comparable data yet for the start of this year. But we do know that there was a 72% fall in traffic volumes during the Lunar New Year holiday, which I've marked with a cross. We've only seen declines like that in modern times during SARS, which you can see towards the left of the chart.

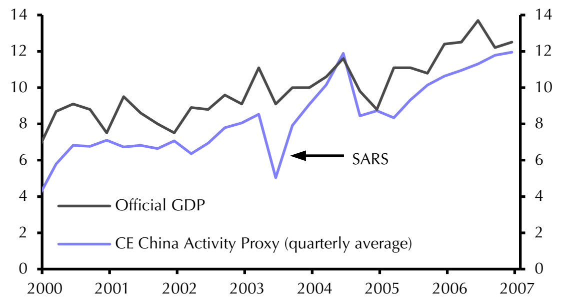
Chart 6: Domestic Passenger Traffic in China (% y/y)



Sources: CEIC, Capital Economics

There's no sign of weakness around the time of the SARS outbreak in the official GDP data. Our estimate though is that growth slowed by around three percentage points in the worst-affected quarter, the second quarter of 2003. (See Chart 7.)

Chart 7: China Activity Proxy & GDP around SARS (% y/y)



Sources: CEIC, Capital Economics

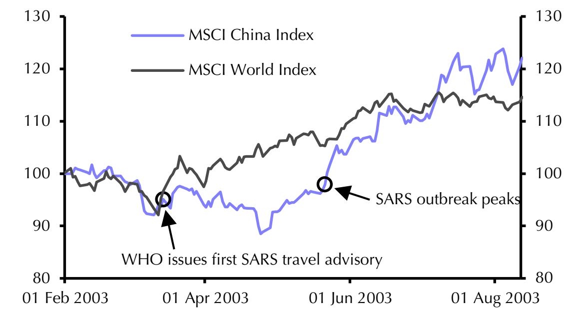
Our initial estimate is that the impact this time has been bigger. We are expecting growth to slow by four percentage points in Q1, from just under 6% y/y to around 2%. Perhaps more striking is that we expect the economy to contract at an annualised rate of nearly 10%, by some way the biggest decline in the past 20 years.

But Chart 7 also suggests some reasons for optimism. In 2003, growth rebounded very quickly. In fact, six months after the peak of SARS, growth was stronger than it had been before.

The reason for that is that people had spent weeks cooped up, avoiding public spaces, but they continued working and they continued being paid. When the danger passed, they went out and they spent the money they had ended up saving.

The same was true in financial markets.The MSCI China index fell about 10% when fears about SARS emerged but made back all of that decline when the outbreak peaked – which is the point marked by the second circle – and had caught back up with the MSCI World index within a few weeks. (See Chart 8.)

Chart 8: Equity Indices (1st Feb. 2003 = 100)



Sources: Bloomberg, Capital Economics

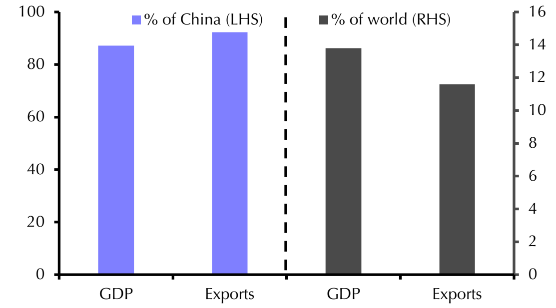
So SARS offers reassurance that it is very possible for a sharp downturn to be fully reversed within a short period. For the time being, that's the assumption we're making this time about the new coronavirus outbreak too.

But a rapid rebound is certainly not the only possibility. What made this possible in 2003 was that wages continued to be paid. No one lost income. The longer the disruption in China goes on this time, the less confident we can be that the same will be true.

For a start, there is a greater risk of spillovers if companies get into difficulties, given the scale of the shutdowns over the past week.

Last week, by our estimate provinces accounting for 90% of China's GDP and exports in normal times were shut down. Viewed in a global context, the shutdown provinces generate well over a tenth of both global GDP and global exports. (See Chart 9.)

Chart 9: GDP & Exports of Provinces on Shutdown Last Week



Sources: World Bank, CEIC, Capital Economics

Shutdowns are ending now but many workers are stranded in their home towns hundreds of miles from their workplaces. Many of those that are returning have been put into 14-day quarantine, which is making it very hard for firms to resume operations now, and many local government are apparently going against directives from Beijing and telling firms not to reopen for the time being.

These measures may prove effective in containing the outbreak but every day that they prevent firms from reopening raises the risk that firms can't pay wages, which would make it harder to reverse the downturn.

Two scenarios for 2020

There are therefore two plausible scenarios for the near-term economic outlook with very different implications for growth in China and elsewhere and for markets.

In both scenarios growth contracts sharply this quarter. Our forecast is for a 2.5% decline, or 10% at an annualised rate.

On the benign scenario, this lost output will be almost entirely made up over the next few quarters. Annual growth might end up only half a percentage point slower in 2020 than last year. But if firms don't reopen soon, household incomes suffer and the economy only gets back on its feet around the middle of the year, growth for the year as a whole could be two percentage points slower.

All of these are forecasts for actual growth rather than published GDP. Xi Jinping yesterday said that China would still meet its economic targets this year despite the outbreak. The most important of these is the Party's longstanding target to double 2010 GDP by 2020. To do that, the government will need to publish annual growth this year of at least 5.7%. It is likely to do that come what may.

In normal circumstances in China, we would expect a large and sudden economic slowdown to be met with a significant monetary and fiscal policy response. But if companies aren't open, and workers are hundreds of miles from workplaces, lower interest rates and fiscal spending won't do much good. Instead, a key focus of policy support over the past couple of weeks has been on limiting the risk that containment measures hurt incomes.

Companies have been banned from sacking workers or stopping their pay as a response to coronavirus restrictions. Creditors have been told to go easy on debtors. Concessionary loans are available to help firms pay creditors and workers.

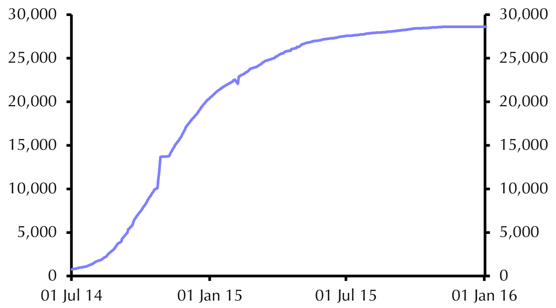
As recovery returns though, we will also see increasing policy support through the usual channels. We're expecting both fiscal loosening and 50bp of rate cuts this year. Local government are gearing up to front-load spending: as of Monday, they had already issued RMB850bn in bonds, well above the RMB780bn issued by the end of February last year. The finance ministry yesterday further increased the quota for local government bond issuance in the early part of this year.

How to track which path China is on

There are several timely indicators we can follow to get a sense of which direction things are moving. One set are those on the progress of the outbreak.

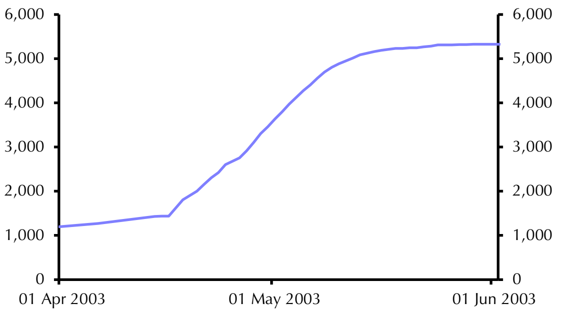
Cumulative infections during epidemics typically follow S-shaped "epidemic curves", such as this one for ebola in 2014 and 2015. (See Chart 10.) The numbers for SARS were skewed by the cover-up early on, but the later part of the outbreak followed a similar pattern: one point worth noting is that SARS outbreak in China outbreak essentially stalled over the course of just a couple of weeks. (See Chart 11.)

Chart 10: Global Ebola Infections in 2014/2015



Sources: CEIC, WHO

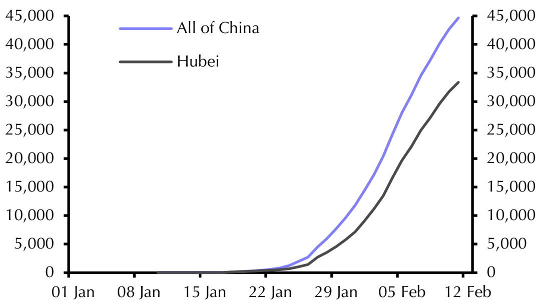
Chart 11: SARS Infections in China in 2004



Source: CEIC

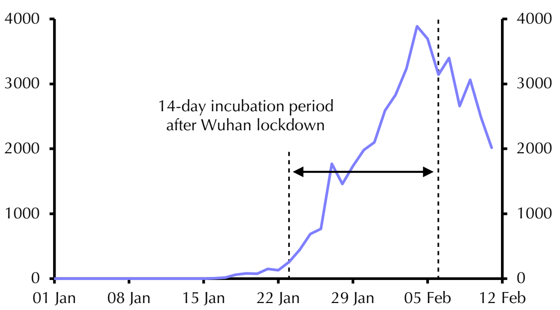
We are not at that point yet. (See Chart 12.) But the number of new infections has been trending down over the past week. (See Chart 13.) That turning point happened almost exactly two weeks after Wuhan was quarantined, so this might be a sign that the containment measures are working.

Chart 12: Total Cases of New Coronavirus in China



Sources: CEIC, Capital Economics

Chart 13: Newly-Confirmed Infections Each Day



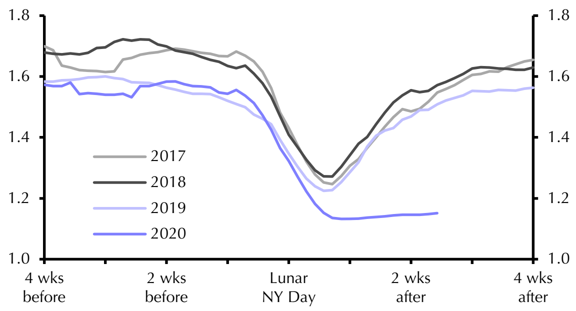
Sources: CEIC, Capital Economics

Some are as sceptical of these official infection numbers as we are of the GDP numbers. And the assumption of a 14-day incubation period has also been called into question by some researchers in the past few days (they suggest that, in some of the new coronavirus cases, the incubation period was considerably longer).

But if officials believe that containment measures have worked, they will feel more confident encouraging firms and workers to return to work.

One way to track whether that return to work is happening is to monitor traffic congestion in China's cities, which we are doing now on a daily basis. There is always a pronounced dip in traiffic congestion around the Lunar New Year Holiday. But most provinces were supposed to go back to work on Monday. Our data runs to Tuesday, and suggests that activity still had not picked up at all from the holiday low. (See Chart 14.)

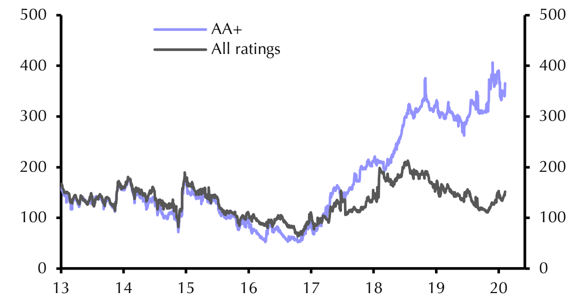
Chart 14: Average Road Congestion across 100 Cities in China (7d ave.)



Note: Congestion defined as ratio of peak to non-peak travel times.
Sources: Wind, AMAP, Capital Economics

Another daily series to watch is property sales. As I mentioned earlier, property developers were facing headwinds even before the coronavirus outbreak. Credit spreads for some of the weaker firms have surged over the past couple of years. (See Chart 15.) Property developers are the most highly leveraged part of the private corporate sector and they are dependent on cashflows from new sales. A prolonged freeze in residential purchases would put them under strain.

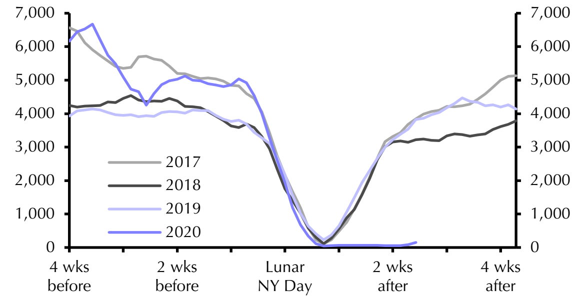
Chart 15: Credit Spreads (Property Developer Bonds, bps)



Sources: Wind, Capital Economics

As with traffic congestion, we can track property purchases on a daily basis. And with traffic, the latest figures suggest the disruption has not even started to return towards normal. Sales have been 97% or more below the normal level over the past couple of weeks. (See Chart 16.) These charts and others tracking daily energy usage and passenger transport are available for all to view on our on our website. We are updating them every day.

Chart 16: Daily Property Sales in 30 Major Cities (7d ave)



Sources: CEIC, Capital Economics

The political implications of the outbreak

A final question we've been asked is about the political implications of this outbreak. Many people in my view are too quick to predict that the Communist Party is facing a major challenge. There is no sign that Xi Jinping's position is under threat within the Party and the barriers to any external challenge are even higher than usual when people are reluctant to gather in groups of any size.

What the outbreak has done is damage faith among Chinese people in the competence of their leaders, and in particular in the idea that has animated all of President Xi's period in office, that concentrating power in the Party is the best way forward for China.

An optimistic view might be that the leadership will respond by changing course. They may do in some narrow areas – for example, giving more space for healthcare workers to report concerns to the centre, circumventing local authorities whose initial response to both SARS and the new coronavirus was to cover it up.

But I think it far more likely that, whenever the outbreak is brought under control, the Party and Xi will present that success as demonstrating that their aggressive containment measures were the right choice, and one that only a strong Party could have made. The Party was right all along. That has economic implications of course. Increased centralisation of power and decision-making in the state under President Xi is one of the key reasons why we think China's growth will slow substantially over the medium term.

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