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Novel coronavirus outbreak in China: Impacts on China's economy and implications for China-US trade relations

The novel coronavirus outbreak in China has been in the headlines lately. In this special report, we look at the potential economic impact of the coronavirus. We offer two scenarios for China's economy. If the coronavirus could be under control by end-March amid strong government measures to contain the epidemic, we predict that GDP growth in 1Q20 will be reduced by 2.0 ppts to 4.0% yoy, but China's economy will quickly rebound in 2Q20. Even in the pessimistic scenario that the coronavirus will only be under control by end-June, we expect that China's economic growth will return to normal in the second half of the year. Despite near term concerns, we believe that China's economy is resilient enough to withstand the shock caused by the coronavirus, and the current epidemic will not leave a long-term scar on the Chinese economy, given China's strong economic fundamentals.

Background

The first outbreak of the 2019 novel coronavirus (2019-nCoV) was in Wuhan, Hubei province, in mid-December. The virus has since then spread across China as well as to 24 other countries. As of 10 February, the death toll in China reached 908, with confirmed cases passing 40,000.

Chinese government's measures to contain the epidemic

To help stop the spread of the coronavirus, the Chinese government imposed a lockdown in Wuhan and other cities in Hubei on 23-24 January. Dozens of other cities such as Wenzhou, Hangzhou and Nanjing have also been put in a partial lockdown lately.

The central government has extended the Chinese New Year holidays by three days to 2 February nationwide. Moreover, local governments in at least 24 provinces, regions and municipalities have requested businesses not to resume work before 10 February at the earliest. For example, Guangdong, Jiangsu and Zhejiang provinces announced that the resumption of work will be delayed to 10 February, while enterprises in Hubei province will be closed till 13 February.

Impacts on the Chinese economy

The impact of the coronavirus outbreak and the government's control measures is set to be significant:

(1) Fall in consumption

The coronavirus outbreak coincides with the period surrounding the Chinese New Year, which is a high season for consumer spending. Amidst the coronavirus outbreak, a large number of people choose to stay at home and avoid taking public transport. As a result, retailers of various kinds are the first to suffer. Restaurants and communal places like cinemas[1] and gyms are also witnessing a drastic drop in the number of customers. Moreover, both inward and outbound tourism are impacted as transportation networks have been disrupted or even shut down.[2]

(2) Suspension of production

The lockdown in Hubei and the extension of the Chinese New Year holidays nationwide have led to prolonged factory shutdowns and production outages. In particular, Hubei, an important manufacturing hub for automotive, electronics, steel and biopharmaceuticals, is under heavy economic blow.

(3) Disruptions of external trade

Due to nationwide shutdowns of manufacturing plants and cuts in air and sea freights to some countries, exports of goods from China have been disrupted. Worse still, Guangdong and Zhejiang provinces, two of China's top three export manufacturing hubs, have confirmed the highest number of infections after Hubei. If the resumption of normal industrial production in these two

[1] China's box office revenue on 25 January (the first day of the Chinese New Year) only reached 1.81 million yuan, a mere 0.13% of the 1.45 billion yuan achieved on the same day last year.
[2] During 24 to 30 January, the rail passenger traffic and road passenger traffic in China dropped by 61.5% and 64.6% respectively compared with the same period of the Chinese New Year in 2019.

provinces takes longer than expected, the epidemic could make a big dent in China's exports.

Our assessment

(1) GDP growth

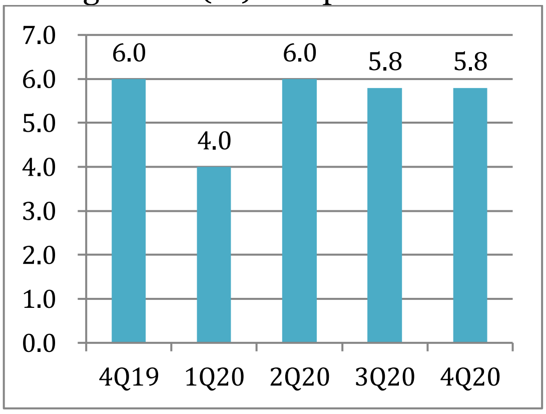
We envision two scenarios of China's economic growth amid the epidemic:

i. Optimistic scenario
Based on the assumption that the coronavirus will be under control by end-March, we believe that China's GDP growth in 1Q20 will be reduced by 2.0 ppts to 4.0% yoy. However, the economy could rebound quickly after the outbreak is contained and if stimulus measures are implemented by the Chinese government. GDP growth in 2Q20 to 4Q20 is forecast to be 6.0% yoy[3], 5.8% yoy and 5.8% yoy, respectively. The overall impact of the coronavirus outbreak on China's full year GDP growth could be relatively limited: China's full year GDP growth is forecast to be 5.4% yoy, which is 0.6 ppts lower than that in 2019.

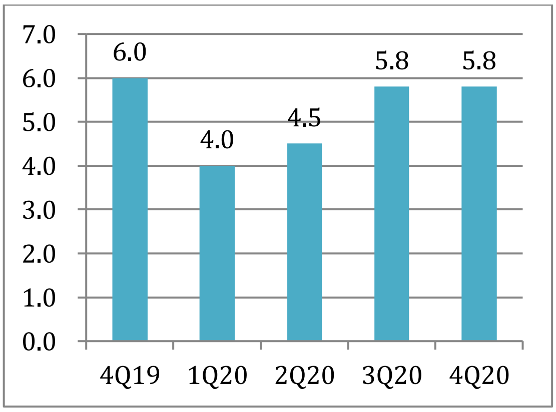
ii. Pessimistic scenario
Under this scenario, the coronavirus outbreak will not be under control until end-June, hence disrupting economic activities in the second quarter as well as the first quarter. China's GDP growth in 1Q20 and 2Q20 is forecast to fall to 4.0% yoy and 4.5% yoy, respectively. However, China's GDP growth could recover in the second half of the year, registering a 5.8% yoy growth in the final two quarters. China's full year GDP growth could drop to 5.1% yoy, which is 0.9 ppts lower than that in 2019.

[3] We expect to see a release of pent-up economic activities and thus a higher growth rate in the second quarter.

GDP growth (%) in optimistic scenario



GDP growth (%) in pessimistic scenario



Nevertheless, we believe that China's economy is resilient enough to withstand the shock caused by the coronavirus, and the current epidemic will not leave a long-term scar on the Chinese economy, given China's strong economic fundamentals.

(2)CPI growth

The epidemic and disruptions in logistics have led to panic purchases of food, daily necessities, and medical supplies such as face masks and disinfectant products in many cities. In the short term, higher prices of these items would exacerbate the already-elevated inflation in China. Thus, we expect the CPI growth of China to reach 5.0% yoy in 1Q20.

However, in the medium term, weaker consumer demand caused by the economic slowdown will likely push down the prices of other goods and services. Therefore, we predict that the CPI growth will ease in the following months till the end of the year.

(3) RMB Exchange rate

The coronavirus outbreak is expected to hit the Chinese economy badly, and China is likely to ease its monetary policy to reverse the economic slowdown, both of which would put downward pressure on the Chinese yuan. On 7 February, the USD-CNY exchange rate closed at 7.0024, representing a depreciation of the Chinese yuan against the US dollar by 2.0% since its recent peak (6.8598) on 17 January.

However, two factors will support the exchange rate of the Chinese yuan. First, the epidemic is conducive to an improvement in China's current account, as China's imports of goods and services, as well as outbound travel, are likely to drop sharply in 2020.

Second, China is committed to a stable exchange rate, as a sharp depreciation of the Chinese yuan will add more risks for a capital flight and financial instability.

All in all, we expect the Chinese yuan to stay weak in the near future amid the coronavirus outbreak and the resulting economic slowdown, but the USD-CNY exchange rate will not drop below 7.4 in 2020.

Implications for China-US trade relations

(1) No further tariff reduction amid the epidemic

White House trade advisor Peter Navarro has pushed back against the suggestion that the US would reduce tariffs on Chinese imports if the coronavirus outbreak hurts the Chinese economy badly. He said that keeping the tariffs in place would help ensure that there will be phase-two trade negotiations.

(2) Possibility of China not fulfilling its US$200-billion purchase pledge

In the phase one trade agreement between China and the US, China has agreed to increase imports of US goods and service by US$200 billion over the next two years. However, as the coronavirus outbreak has disrupted China's external trade and will likely lead to an economic slowdown, some suspect that China might not be able to live up to this promise, and it was reported that China would like to seek some flexibility on this.

Nevertheless, we do not expect this will create further trade tensions between the China and the US. The phase one trade deal, which will take effect in mid-February, has a clause that states that the two countries will consult 'in the event that a natural disaster or other unforeseeable event' delays either party from complying with the agreement. It is unclear whether China will request such a consultation and whether the two countries will reach a consensus if a consultation is held. However, even if China could not fulfill its US$200-billion purchase pledge, we expect a mild response by the US as long as China does increase its imports of US goods and services substantially over the next two years.[4]

[4] US Agriculture Secretary Sonny Perdue said on 5 February that the US has to be understanding of China's situation if China struggles to hit the purchase targets amid the coronavirus outbreak. However, it should be noted that he is not part of the US government team tasked with enforcing the terms of the phase one trade deal.

About the Organisations:

Fung Business Intelligence

Fung Business Intelligence collects, analyses and interprets global market data on sourcing, supply chains, distribution, retail and technology.

Headquartered in Hong Kong, it leverages unique relationships and information networks to monitor, research and report on these global issues with a particular focus on business trends and developments in China. Fung Business Intelligence makes its data, impartial analysis and specialist knowledge available to businesses, scholars and governments through regular research reports and business publications.

As the knowledge bank and think tank for the Fung Group, a Hong Kong-based multinational corporation, Fung Business Intelligence also provides expertise, advice and consulting services to the Group and its business partners on issues related to doing business in China, ranging from market entry and company structure, to tax, licensing and other regulatory matters.

Fung Business Intelligence was established in the year 2000.

Fung Group

Fung Holdings (1937) Limited, a privately-held business entity headquartered in Hong Kong, is the major shareholder of the Fung Group of companies, whose core businesses operate across the entire global supply chain for consumer goods including trading, logistics, distribution and retail. The Fung Group comprises 42,000 people working in more than 40 economies worldwide. We have a rich history and heritage in export trading and global supply chain management that dates back to 1906 and traces the story of how Hong Kong and the Pearl River Delta emerged as one of the world's foremost manufacturing and trading regions. We are focused on both creating the Supply Chain of the Future to help brands and retailers navigate the digital economy as well as creating new opportunities, product categories and market expansion for brands on a global scale.