POLICY OUTLOOK

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Economic Impacts of the Novel Coronavirus Outbreak

Mustafa Metin Başbay

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It has been less than a month since the world learned about the Novel Coronavirus outbreak in China. So far, the disease has taken almost 500 lives, infected more than 20,000 and spread to many other countries. In addition to the human and social costs, the Chinese economy, the world's second largest, has been hit by the outbreak as well. Consumption has declined, and production is at a standstill. This Policy Outlook discusses the implications of the Novel Coronavirus outbreak for both the Chinese and the global economy. It also reflects on the potential impact on the ongoing trade negotiations between the US and China.

Introduction

It has been less than a month since the world learned about the novel coronavirus in China. So far, the disease has taken a reported 490 lives, infected more than 20,000 and spread to many other countries. As the initial plan to contain the disease in China had failed, the World Health Organization (WHO) declared a global health emergency. Analysts of different fields have been discussing the numerous implications of the outbreak and its possible impacts in the event that the disease continues to spread at its current rate. This paper investigates the potential economic effects of the Novel Coronavirus outbreak both for the Chinese and the global economy. It also reflects on geopolitical implications especially in the context of the ongoing trade negotiations between the US and China.

The most immediate economic effect of the crisis on the Chinese economy is the sharp decline in consumption. Millions of people are now living in quarantine (mostly self-imposed) which naturally affects their consumption patterns. In late January, China celebrated its lunar new year. This being the most important holiday of the year in China, tourism and leisure sectors have been directly affected by the outbreak. Furthermore, the government extended the official holiday period which has also negatively affected production. As a result, most of the Chinese economy is idle and businesses fear that holiday may be extended even further. Chinese manufacturing industries are very important for global production as well because they are at the very centre of global supply chains. China is a major purchaser of primary products from developing economies and a seller of critical inputs to global companies. If the current standstill prolongs, there is potential of a significant impact on global production and international trade.

The Coronavirus outbreak has also influenced foreign investments in China. A number of global retail firms have already closed thousands of branches across the country. Moreover, some major airlines have reduced their flights or cancelled them altogether. International companies producing in China have restricted their operations and announced they are closely following the situation and are trying to assess the depth of the crisis. Given that China is home to many multinational corporations' production sites, this trend has serious implications for Chinese employment and growth. The financial markets are even more fragile. The holiday delayed the panic in the stock markets for a while, but financial markets are now going through a period of turbulence. Upon reopening on the 2nd of February, Chinese stocks had their worst day in years. Many fear that this may lead to a downward spiral.

The outbreak may also lead to significant geopolitical consequences. Wilbur Ross, Commerce Secretary of the US, claimed that the outbreak may help bring manufacturing back to the US. This is a long shot, however, what is certain is that the outbreak will certainly influence trade negotiations between the US and China. On the one hand, Beijing finds itself in a more difficult position economically which may translate into less leverage in trade negotiations. On the other hand, it makes it more unlikely that China will be able to meet the conditions of the trade deal outlined by the US. Washington wants China to purchase more American products, however, decreasing demand in China as a result of the outbreak will make it more difficult for China to increase its imports from the US. This has implications for the American elections as well.

How will the outbreak affect the Chinese economy?

Even before the outbreak began, China was experiencing an economic slowdown. China is often thought of as an unstoppable and resilient economic power. This reputation is backed by the fact that the Chinese economy has experienced incredible economic growth for almost two decades. However, in the last few years, China has been going through a rough patch. For example, industrial expansion hit an 18-year low in 2019 while the growth rate slowed to 6% in the fourth quarter of last years, marking a 29-year low. Last year, the government announced a combination of fiscal and monetary measures to boost economic growth to a target of 6%, however, this now seems unlikely. In addition to uncertainties caused by trade conflict with the US, the Chinese economy now must navigate the consequences of an ongoing outbreak as well.

The outbreak is disrupting the Chinese economy in several ways. First of all, measures to fight the virus have necessarily translated into a drastic drop in consumer spending. In an effort to contain the epidemic, the Chinese government has effectively quarantined more than 50 million people and enforced extensive travel restrictions across the country. Moreover, people have been voluntarily quarantining themselves. Consequently, consumer spending on shopping, dining, entertainment and travel has been significantly reduced. The fact that the outbreak began during the festive season of the Chinese Lunar New Year has intensified the impact.

During this time, many Chinese usually travel home to spend time with family. Now that millions of people cannot easily travel, consumer spending on airfare and domestic tourism has markedly dropped. To put this into perspective, Chinese consumers spent more than $145 billion during the holiday in 2019. While it is too early to measure the exact effect of the outbreak on consumer spending, in all likelihood, spending will be low in comparison to previous years. According to China's Vice Minister for Transport, the total number of trips on the first day of the Chinese Lunar New Year fell by 30 per cent while travel by plane or train fell by more than 41 per cent compared to last year.

Second, the outbreak has also affected production because the lunar New Year holiday has been extended to the 2nd of February by the government in order to prevent the virus from spreading in crowded work environments. The holiday began on the 24th of January and was originally scheduled to end on January 30th. Additionally, fourteen provinces and cities, including the country's biggest city Shanghai, have announced a further extension to the 9th of February. According to Bloomberg, 78% of China's exports, 90% of copper smelting, at least 60% of steel production, 65% of crude oil refining and 40% of coal output come from this region. Essentially, this means that two-thirds of the Chinese economy will shuttered for another week. China is heavily dependent on manufacturing production, thus an extended holiday period will take its toll on the Chinese economy. However, necessary health precautions have to be undertaken and are most likely the top priority for the Chinese authorities.

Third, the outbreak represents a concern for foreign investors operating in China. Starbucks, for instance, reportedly closed two thousand branches in order to "to protect its staff and support government efforts to contain the coronavirus." Similarly, Ikea announced the closure of all its stores in mainland China until further notice. Other retailers which closed their branches include McDonald's, Pizza Hut, H&M, and Dairy Queen. Tech companies, such as Apple and Facebook, for their part, have limited staff travel. Moreover, despite the reassurances of the WHO that flights do not need to be restricted, major airline, including American Airlines, Delta, United, and British Airways, have also cancelled their flights to the country until the situation improves.

Arguably, the Chinese economy will feel the most pain in the financial market. For financial markets, panic is contagious and spreads like a virus. That's why financial markets, compared to real businesses, respond to pessimism much more quickly and often in more dramatic ways than industry. On their first day of trading after an extended Lunar New Year holiday, the Shanghai Composite index and the Shenzhen Component Index plummeted 7.7% and 8.5%, respectively. In fact, before the holiday, the Shanghai Stock Exchange had already lost more than 3.5% value due to the outbreak. The Taiwan Stock Exchange and Hong Kong's Hang Seng index also lost 5% and 6% value respectively in the first days after the New Year holiday came to an end. The situation is not very different in other major stock markets, especially in Asia. A fear held by many is that panic in Chinese stock markets may snowball and turn into a major financial crisis. In response, the Chinese central bank announced it will pump 1.2 trillion yuan ($173 billion) into the economy.

Global Economic Consequences

China is the second-biggest economy in the world and a manufacturing powerhouse. It provides critical intermediate goods for international companies and cheap consumer products for economies around the world. Furthermore, China is a major purchaser of primary products mostly from developing countries and advanced consumer products from developed economies. Thus, the consequences of a Chinese slowdown will be felt globally. In a worst-case scenario, global supply chains will be disrupted, major companies will struggle to find necessary components and prices will increase for both consumers and producers.

As said above, it is too early to estimate the cost of the ongoing crisis, especially until the situation is completely under control. However, analysts are trying to make comparisons with the SARS epidemic of 2003. Severe Acute Respiratory Syndrome (SARS) is another coronavirus that also originated in China. According to the World Bank, SARS cost the world economy $54 billion in 2003. The ongoing turbulence is in many ways similar to the SARS epidemic, however, there are some notable differences. Firstly, SARS was effective in the capital city of Beijing which accounts for a much bigger share of the Chinese economy compared to Hubei province where the Novel Coronavirus has spread. In that regard, it may be expected to have a smaller effect. However, there is another important difference: between 2003 and 2020, China has become an economic powerhouse and a key player in the global economy. In 2003, China accounted for only 5% of the global manufacturing output. Today, it accounts for 20%. What happens in China, and to the Chinese economy, matters to the global economy a lot more than it did in 2003.

One critical market that has already been hit is oil. China is the biggest purchaser of oil globally, however, due to the manufacturing standstill and consumption slump, China's daily fuel consumption has dropped by 20%. To put this in context, this amount is equivalent to the oil demands of Italy and the UK combined. As a result, the price of crude oil decreased below $50 for the first time in a year. Representatives of OPEC (The Organization of the Petroleum Exporting Countries) and its allies are gathering this week to discuss how to react to decreasing demand for oil. 14 members of OPEC control roughly half of global oil production, which gives the organisation a half-monopoly power in the oil market. Saudi Arabia has been pushing for a reduction in production for some time, although Russia and some other members have been reluctant to take such an action. Now that demand is plummeting due to the Coronavirus outbreak, Saudi Arabia may have a stronger hand to play.

The outbreak has also affected the global tourism and travel industry. In 2018, Chinese tourists accounted for 20% of international tourism spending, amounting to $277 billion. In 2019, the number of Chinese tourists increased by 4-5%. During the Lunar New Year holiday, Chinese tourists usually travel to Asian destinations such as Taiwan, Thailand, Japan and Hong-Kong, but in general, top destinations for Chinese tourists include France, London and New York. Most recently, Chinese tourism has already negatively impacted due to protests in Hong-Kong, and now that countries including Russia, Australia and the US have closed their borders to Chinese arrivals, there will be a significant reduction in the total number of tourists to or from China. It is too early to make a full impact assessment, however it is clear that the global tourism industry will be hit hard.

The Coronavirus outbreak may also lead to important beyond China. For the time being, the virus does not seem to have spread in other countries at a scale which would affect the economy of those countries. However, if it does, this will have dangerous impacts on the global economy. According to the WHO, the major risk is the spreading of the disease to "*countries with weaker health services*" than China. India, for instance, is at significant risk. Compared to China, India has very limited capabilities in dealing with a potential epidemic but has a similarly large population. Even though the country has only two reported cases as of February 3rd, if more people are infected, it will surely have dire international consequences as these two countries account for around 28% of the world GDP in purchasing power parity (PPP) terms. Japan, with 20 cases so far, has the highest number of infections outside of China. Japan is also a major economy and accounts for 4% of global GDP.

Geo-Political Implications

China and the US are currently locked in a fight for economic and political dominance. Especially since Donald Trump became President of the United States, the world's largest economies have been at odds over a number of issues, most notably trade. Trump's campaign promises included forcing American companies to produce in the US in an attempt to bring back jobs from China. As noted above, his Commence Secretary Wilbur Ross believes that the outbreak may help realise this promise. However, Ross's argument has been criticised by prominent economists as it does not take into account the intertwined nature of American and Chinese industries. If Chinese companies suffer, this can lead to serious damage to American companies as well because of their dependence on the import of intermediate goods from China. Computers and electronics, furniture, appliances and medical devices in particular are vulnerable to this potential. Indeed, Ross's approach seems to be short-sighted.

According to some analysts, the outbreak will likely impact ongoing trade negotiations between the US and China. After a long period of tit-for-tat tariff wars, Washington and Beijing have finally started negotiation and even recently signed a 'phase one' trade deal. According to the deal, China is obliged to increase its imports from the US by $200 billion. According to many, this was already a very ambitious, even unrealistic, promise on China's part and unlikely to be realised even before the outbreak began. With plummeting Chinese demand, many say this deal has become all but impossible. Negotiations will continue but if the outbreak seriously affects the Chinese economy, this may weaken Beijing's hand because they are now more vulnerable to tariffs and the potential economic damage they can cause.

Considering that 2020 is an election year in the US, failure of the trade deal may affect American politics as well. President Trump promised that a new trade deal with China will create opportunities for American businesses. Specifically, as part of the phase one deal, China pledged to increase its agricultural imports by $32 billion from pre-trade war levels. American farmers, which constitute an important constituency for President Trump, were hopeful that they would benefit from the deal. Therefore, if China cannot meet the condition, this could translate into farmers' disappointment with the President. In other words, if the economic situation in China deteriorates, ironically enough, President Trump may face potentially significant political consequences at home. As of yet, there have been no reports of any increase in agricultural purchases by China. After the outbreak, many doubt if there will ever be.

Outlook

So far, the epidemic has impacted a number of key Chinese economic sectors including tourism and leisure, and has some foreign companies to suspend their operations. It has also affected manufacturing industries to some extent due to the extended holiday. Considering that China had recently been struggling with low growth rates, this impact of the outbreak may have painful consequences for the economy, at least in the short run. At this point, it is plausible to argue that the government will be unlikely to achieve its previous target of a 6% real growth rate for 2020. Furthermore, financial markets in the country are set to go through a period of turbulence. Even if the situation does not worsen, financial markets risk falling into a downward spiral due to panic sales.

If the government prolongs the standstill in Chinese industries further, the effects will deepen. This is not unlikely given that factories are crowded workplaces where the disease can spread very easily, which would ultimately increase the economic and human costs of the exponentially. Financial markets may also implode if investors buy into the idea that the government and the WHO are struggling to get the situation under control. If this pessimistic scenario materialises, this will also lead to considerable disruption in the global economy due to the fact that Chinese industries have direct links to most economies around the world. The WHO claims that, given its strong central planning capabilities and advanced health system, China is capable of quickly and efficiently getting the situation under control. The real threat may be the spread of the disease to other countries with more limited capacity.

Lastly, unless the outbreak can be contained in the very short term, it may potentially affect the power play between Beijing and Washington. After months of trade disputes, the two countries are finally negotiating a new trade deal. However, China may lose leverage in negotiations because of potential damage to its economic resilience. Moreover, China's capabilities to meet the conditions of the trade deal may also be reduced. This has potentially complicated consequences; on the one hand, it potentially improves Washington's leverage in negotiations, on the other hand, it makes it difficult for President Trump to keep his promises to the American public because China may now be incapable of purchasing more American products as stipulated.