Assessing the Economic Effects of the Coronavirus

by Phillip Orchard - February 11, 2020

There's irony in the fact that, as Chinese Vice Premier Liu He was in Washington on Jan. 15 signing the "phase one" deal formalizing the impasse in the U.S.-China trade war, a stealthier threat to global trade was spiraling out of control at home. Over the past few weeks, **the mysterious new coronavirus epidemic has begun to do what tariffs never quite could**. The scramble to contain the outbreak has shut down Chinese factories en masse, put China on the brink of twin financial and political crises, and sent foreign executives scurrying to revisit plans to pull out of the country. And now, with the U.S. and other major economies imposing strict border controls and bans on travel in and out of China, the flow of Chinese goods to its most important consumer markets is at risk of nose-diving.

The severity of potential economic disruption – both for China and the world – is impossible to forecast. (Not that that's stopped **anyone from trying**.) The impact will depend mostly on just how much worse the outbreak gets, which itself can hinge on the evolutionary vagaries of microorganisms. There's also unpredictable factors as varied as the ability of oil exporters to agree on production cuts, ethnic tensions involving Chinese tourists in Southeast Asia and the medium-term investment plans of tens of thousands of businesses. Perhaps the most pernicious is fear – the sort that was emptying out airplanes even before the travel bans kicked in.

We can say this: Absent a mutation in the virus that accelerates both its spread and lethality or the eruption of another black swan event, most of the economic damage will likely be short-lived. And most of the hardest-hit sectors will be primed for turbocharged recoveries. But there are certain risks where a rupture would cause colossal long-term damage. And, at minimum, the crisis will expedite a profound paradigm shift about the wiring of the global economy.

Short-term Pain

The most direct comparison to the current pandemic is the SARS outbreak in 2003, which dinged Chinese gross domestic product by as much as $40 billion, reducing annual growth by between 1 and 2 percent. Globally, the bill for the pandemic ran up to as much as $100 billion. Within a year, China had returned to pre-outbreak growth levels.

But this benchmark tells us only so much. With the new virus, which originated in Wuhan, the scale of the lockdown has been much wider. It would be painful enough if it extended only to the outbreak's epicenter in Hubei province – an area with the population of Argentina and the GDP of Sweden – which functions as a rail and shipping hub that's vital to the government's efforts to stitch together the wealthier coastal provinces and the interior (**a core Chinese imperative**). But the lockdown was extended nationwide, and disruptive quarantine measures have been reported across the country, including all-important advanced manufacturing hubs like Shenzhen, Guangzhou and Shanghai that were most affected by the trade war. Moreover, a lot has changed in China since 2003. The population is older, more urbanized, more dependent on internal consumption, and more reliant on vast internal flows of migrant labor – all factors that can amplify both the spread of the virus and the extent of its disruption.

As a result, the coronavirus has hit the global economy with three main waves: The most immediate was Chinese consumption (nearly 40 percent of Chinese GDP in 2018), as hundreds of millions of people canceled Lunar New Year travel plans; restaurants, shopping malls and movie theaters were suddenly emptied; and so on. This is also a problem for foreign firms like Starbucks and Walmart that have pegged their growth strategies to the growing appetites of Chinese spenders, as well as countries such Cambodia and Thailand that have come to economically rely on Chinese tourists.

The second was labor disruption. Today, **China is home to an estimated 288 million migrant workers**, or roughly one-third of the country's total labor force, most of whom return to their hometowns during the New Year. Though most Chinese factories outside Hubei were allowed to go back to work this week, operations won't reach full speed until travel restrictions and fear subside.

The third wave hit as countries throughout the world (plus, crucially, Hong Kong) started to impose restrictions on travel to and from China. This highlights perhaps the biggest difference between today and 2003: China is much more tightly integrated with the world – and, despite halting U.S. efforts to pare back this interdependence, at the center of a dizzying network of supply chains optimized overwhelmingly for efficiency, not resilience. Shutting down cross-border travel impedes business and decimates tourism, of course, but it also hampers shipping, as "belly cargo" on commercial flights accounts for more than half of air freight.

The worst-case scenario for global trade is that the contagion risks will compel the U.S. and Europe to ban not just commercial air travel but oceanic shipping as well. This is highly unlikely; the virus can't survive on surfaces for long, particularly not a months-long journey, and the relatively small number of crew arriving at ports won't overwhelm their health screening capacity. Still, Chinese ports can't operate without stevedores, nor ships without sailors. As a result, even without a sweeping ban on shipping, Chinese port activity has slowed by an estimated 20 percent since mid-January. This is a problem for exporters foreign and domestic in China, as well as for commodity exporters like oil producers, and manufacturing operations elsewhere that depend on intermediate goods made in China. (This was a side effect of most of the U.S. tariffs as well.) Auto assembly operations in Japan and South Korea have already been suspended because of a shortage of parts, for example. Some 450 U.S. companies source components from Hubei province alone.

Long-term Risks

The short-term impact may be immense, but as with the SARS epidemic, there's minimal structural damage being done to the Chinese economy, and most affected sectors will bounce back within a matter of months. This isn't always the case with black swan events. The 2011 floods in Thailand, where investors had already been spooked by cycles of mass political violence, wiped out hundreds of thousands of cars from automaker inventories and shut down critical infrastructure for nearly a year. Japan still has yet to fully recover from the Fukushima disaster. But unlike natural disasters, conflicts and other more destructive black swans, the fallout from epidemics is comparatively easy to manage. Factories and public transportation lines in China are closed, not buried under rubble or coated in radioactive fallout. Hundreds of millions of people may be stuck at home, but the virus isn't exactly wiping out the Chinese labor force for good. There's little stopping key pillars of the Chinese economy like fixed-asset investment and the services sector from rebounding quickly, especially as the government opens the stimulus spigots. And China-centric supply chains can't be rerouted quickly or cheaply enough for the country to be replaced in the meantime. Moreover, Chinese manufacturing grinds to a halt every year during the Lunar New Year, typically taking weeks to return to full production. Most importers of Chinese goods had likely already stocked up in anticipation. From this perspective, the epidemic came at a pretty good time.

Still, there are three key long-term risks to watch. The first is the trade war. China was already likely to struggle to meet the import pledges it made in the "phase one" deal. To be sure, the epidemic (and **ongoing problems with African swine fever** and a new strain of the avian flu) will likely compel it to buy more U.S. farm products. But imports of other U.S. goods, particularly crude and liquefied natural gas, won't be as necessary, and government funds earmarked to help Chinese importers meet the targets may have to be diverted to short-term rescue measures at home. China may have a good excuse if it falls short when the U.S. conducts its reviews of Chinese progress on implementing phase one in the fall. But whether the White House responds to such a scenario charitably or restarts the trade war may depend entirely on election-year political factors. At minimum, the outbreak will force Beijing to **lean more heavily on things like subsidies and state-owned enterprises**

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A return to currency manipulation is also possible, though fairly unlikely. This means the already low chances of progress on negotiating a phase two deal – the one that would ostensibly **address the fundamental drivers of U.S.-China trade tensions** – are dropping further.

The second risk to watch is the one keeping Chinese leaders awake at night the most: that even short-term pain in one vulnerable sector or another will trigger a cascading crisis. Put simply, the Chinese economy is overwhelmed with interlocking risks, **from unchecked shadow lending to a fragile banking system to widespread asset bubbles**. As a result, deleveraging and "financial de-risking" have been the foremost priority for Beijing over the past few years. It's had enough success with efforts like metabolizing nonperforming loans, curbing reckless lending and rescuing ailing banks to prevent an uncontainable crisis from rupturing. But the limits of its ability to micromanage the economy have also been exposed, with Beijing often finding itself **playing a sort of high-stakes game of whack-a-mole**, where its efforts to address one problem worsen a problem somewhere else. In its campaign to stem a wave of bond defaults among small and medium-size enterprises, for example, it's struggled to force banks to lend to troubled firms.

Today, **SMEs account for roughly 60 percent of the Chinese economy**, plus around 80 percent of Chinese jobs. Compared to state-owned firms and private sector giants, SMEs are ill-suited to survive the cash-flow hits that result from the outbreak; in a recent survey, around a third said **they couldn't last more than a month on their current savings**. In response, Beijing is redoubling efforts to push banks to lend to the sector and reducing interest rates, but these measures will further weaken balance sheets across the banking system, which is already teetering amid a string of near-failures in 2019. Beijing is also cutting taxes, which will worsen the default risks posed by debt-ridden local governments (which Beijing is now allowing to pile up new debt to spur infrastructure spending). It's cutting pension contribution requirements, **which will amplify China's demographic crisis**. It even appears to be **easing off its shadow lending crackdown**. So even if China avoids a financial meltdown now, its moves will increase the risk of a crisis over the long term. Keep in mind that China was racing to eradicate these risks – and, as a result, **loath to flood the economy with fiscal stimulus** – before the next global recession. That's still looming.

A Death Knell for Interdependence

Finally, the epidemic will make other countries more wary of China's outsize role in global manufacturing. Since the 1990s, the cutthroat economics of globalization have pushed supply chains to become ever more complex and geographically diverse. For example, the Jeep Cherokee, the most “American-made” automobile in 2019, is built with components sourced from dozens of countries. But these economics have also pushed for the manufacturing of particular components, particularly research-intensive high-end technologies, to be consolidated in one or two countries. The result has been the proliferation of chokepoints.

It’s not just China. Taiwan dominates semiconductor fabrication. Japan, as we saw last summer **in its dispute with South Korea**, dominates production of various chipmaking materials. The U.S. is currently mulling how to leverage its dominance over chip design, software and the dollar-denominated global financial system to blunt China’s technological rise. But China has certainly made itself the king of chokepoints. And chokepoints can be really bad for business.

The U.S.-China trade war and **“tech war”** have underscored just how much supply chain bottlenecks can be weaponized or targeted for strategic or political purposes – and how easy it is for firms to be caught in the crossfire. **Likewise China’s crackdowns in Xinjiang and Hong Kong**. The coronavirus outbreak, along with the problems endemic to the Communist Party’s model of governance its exposed, has merely crystallized the risk of being dependent on China that much more. China isn’t the only manufacturing center vulnerable to epidemics, natural disasters, political spasms or geopolitical disruption. But until its relationship with the West finds stable long-term footing, and until its government can be confident in its long-term hold on power, China will be home to the most tightly concentrated and explosive matrix of supply chain risks.

This doesn’t portend a future of total Chinese isolation from global supply chains. Its manufacturing footprint and labor pool **are extremely difficult to replace at scale**, while the lure of access to Chinese consumers alone is enough to give most multinational corporations pause. Surveys indicate that most firms planning to leave China are doing so only partially, with the goal of effectively setting up parallel supply chains as a means to inoculate themselves from tariffs, Beijing’s capacity for coercion and whatever black swans may come. Firms may be merely seeking to protect themselves from events beyond their control. But the broader effect will be an accelerated if fitful disentangling of the chains binding Chinese and Western countries. This is a dramatic reversal of a more than 30-year trend with any number of potential geopolitical implications – the ability of nation-states to weaponize interdependence chief among them.

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