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The global impact of Wuhan crisis

Its health risks will become clear next week but its impact on the economy is already evident -it will be considerable

Akash Prakash February 18, 2020 Last Updated at 00:00 IST

The economic impact of the novel coronavirus outside China has been limited to date, but the outbreak will undoubtedly damage the Chinese economy and pose a serious risk to global growth.

While the number of daily new cases in China has dropped to 2,000, down from 5,000 two days ago, there have been more than 1,600 deaths and 68,500 people have been infected. The spread outside China has been modest, though there have been the usual scare stories in the media of the virus ultimately affecting almost two-thirds of the global population. The next 7-10 days will be critical as more than a 100 million Chinese workers will report back to work. As factories start up, will we see a new round of infections?

When thinking about the impact on the Chinese economy, one should look at three dimensions. First, the health risk. There is undeniable fear and concern globally about the spread of the virus, but the impact outside China should be limited. The virus is largely concentrated in China, with about 500 cases in 30 other countries. Even in China, ex-Hubei, the number of cases has dropped to 166 on February 15, compared with a peak of 890 on February 3. The death toll outside China has been five compared with 1,600 in the country. The coronavirus outbreak now seems to be resembling a fast-spreading but low-mortality flu, rather than the less infectious but far more deadly (in terms of mortality rate) SARS and MERS viruses. Just for context, the mortality rates for the novel coronavirus seems to be a little over 2 per cent, compared with 10 per cent for the SARS virus and 30 per cent for the MERS strain. Next week will be critical in determining the spread of the virus globally as the Chinese economy starts to get to work, and workers cross the 14-20 day incubation period.

In terms of its economic impact, the current quarter will undoubtedly be a total write-off for the Chinese economy. We will see sales of durables and cars slow by 20-40 per cent, and property transactions come to a grinding halt. The only saving grace is that the months of January/ February have historically been the slowest in any year due to the lunar holidays. Most plants were due to start last Monday. Travel restrictions and health precautions, though, have created uncertainty as to when plants will get back to full capacity. There is a lot of anecdotal evidence of factoriesremaining shut or at partial utilisation as workers are unable to return or are being placed in quarantine. Foxconn, the largest employer in China has been unable to reopen one facility, and has been forced to restart production at its Shenzhen and Zhengzhou plants with less than half its workforce. The consequences of the extreme measures put in place by the Chinese authorities to stop the spread of the virus are having a far greater impact on the economy than the outbreak itself. Hubei province, the centre of the outbreak, accounts for 9 per cent of Chinese auto production, and a larger share of component production. Global auto supply chains seem the most vulnerable to the shutdown of Hubei.

The outbreak will have a chilling impact on the property markets in China. Buying and selling of property requires face-to-face interactions, which are being actively discouraged as part of restrictions on all retail activities. More than 60 Chinese cities have put restrictions on property marketing; as a consequence, property sales are almost non-existent at the moment.

Illustration by Ajay Mohanty

The hit to sales is already greater and the financing environment for real estate much tighter today than in 2003. The main fear is that with such a large drop in sales, the financial condition of most property developers will weaken and could cause a big slowdown in new construction. This point can be made more broadly across Chinese industry. Chinese corporations have a record leverage, and a shock to production and sales of the type being witnessed is undoubtedly going to stress balance sheets.

In trying to balance preventing the spread of the virus, with ensuring the economy does not slow beyond a point, the Chinese government is promising to make sure that firms do not lay-off workers. Thus, most firms will not be able to cut fixed costs, as sales shrivel, cutting cash flows dramatically. Although the central government is trying to get banks to lend to private sector companies, banks seem reluctant to extend support. As credit concerns mount, we should be prepared to see more corporate defaults coming out of China.

In terms of global impact, tourism is one obvious area of weakness. China accounts for 20 per cent of global tourism spend, and 30-50 per cent of it is in Asia. Most countries in the region have suspended all flights to China. The slowdown in tourism will hurt all Asian economies.

Oil prices are already down 20 per cent from their short-term peak of $72 to $55(Brent). Most commodities have also followed suit, falling between 10 and 15 per cent. This is a big boon for India, but in general a drag on the emerging market asset class. Oil prices are closely correlated with inflation expectations, possibly opening the window to further central bank easing globally. In this narrative, once the Fed comes into play, bad news economically is actually good news for the markets.

Despite many western media outlets highlighting the outbreak as being China's Chernobyl moment, it is unlikely that much will change. Already the central leadership has built a narrative of how it has acted decisively, as soon as it became aware of the seriousness of the outbreak. Most of the blame has been put on the local leadership in Wuhan and Hubei. The extreme steps of putting the entire province of Hubei in a lockdown, and more than 60 million people in effective quarantine have been highlighted as key measures taken by a strong leadership to prevent further spread of the disease. Yet, with questions emerging about who knew the extent and seriousness of the outbreak and when, there will be a feeling that China is not a reliable member of the global economic system — certainly not befitting the second largest economy in the world. This unreliability will be traced to its opaque political system and a lack of transparency in internal dialogue. Given this lack of trust and the difficulties they have experienced over the past 18 months, with the US-China trade war, many multinational companies will continue to diversify their sourcing away from China. Vietnam remains the biggest beneficiary of this move.

Global markets have been complacent, determined to believe that the SARS outbreak of 2003 is a good template. That was a good buying point for Asian assets. I hope history repeats itself, and all is forgotten in six months. That is still the most likely scenario. However, given the complacency and one-sided positioning, it may make sense to be more careful and thoughtful than the consensus. Cheap hedges may be worth considering.

The writer is with Amansa Capital