ALLIANZ RESEARCH

Coronavirus outbreak in China: Risks of supply chain disruption increase with time

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EXECUTIVE SUMMARY

- The official PMIs for January released today do not yet reflect the magnitude of the economic concerns around the ongoing coronavirus 2019-nCoV outbreak in China. However, we think that its impact on the Chinese economy and the rest of the world is not negligible.
- The hit to China's GDP y/y growth could amount to c. 1pp, mostly over Q1 2020. A recovery should thereafter be possible, based on pent-up production and policy support.
- A protracted pause in Chinese activity could be disruptive for certain supply chains such as chemicals, transport equiment, textile and electronics.
- The top five economies potentially hit by this disruption are Taiwan, South Korea, the Netherlands, Hungary and Indonesia.

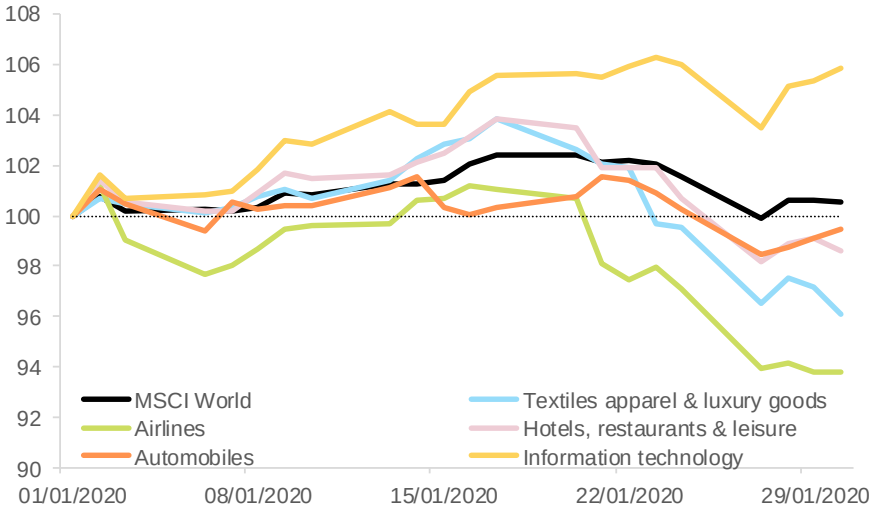
The official PMIs for January released today do not yet reflect the magnitude of the economic concerns around the ongoing epidemic outbreak in China. The manufacturing PMI edged down to 50 (from 50.2 in December), while the non-manufacturing PMI rose to 54.1 (from 53.5). Such resilience is due to the cut-off of the surveys being 20 January, i.e. just when the epidemic started getting public attention. We expect the February surveys to better capture the economic impact of the epidemic. The onshore market in China will open on Monday 03 February, providing a gauge for local sentiment. We think that the impact on the Chinese economy and the rest of the world is not negligible.

The coronavirus 2019-nCoV outbreak is a public health emergency of international concern, according to WHO. The outbreak was first reported in China in December 2019 and has been receiving intense public attention since mid-January 2020. The latest reports indicate around 9,800 confirmed cases and 210 deaths. At this stage, important containment measures taken by Chinese authorities have managed to limit the epidemic mostly at the domestic level (c.98.5% of confirmed cases are in mainland China). On 30 January, after split debates, the World Health Organisation (WHO) decided that the epidemic constituted a public health emergency of international concern.

Markets have reacted strongly to the epidemic. Unlike for political risks, central banks' accommodative stance did not suffice to calm market reactions. Equity markets have indeed corrected from stretched levels, with the MSCI World, APAC and China indices down by 1.8%, 4.7% and 8.5%, respectively, since 20 January. The industries most likely to be immediately impacted by the epidemic are bearing the brunt, with the sectoral components of the MSCI World index for airlines, textiles apparel & luxury

goods and hotels, restaurants & leisure declining by 6.9%, 6.4% and 4.7%, respectively, since 20 January. Conversely, safe assets have performed well over this period: The JPY appreciated by 1.1% vs. the USD and the U.S. 10y Treasury yield was down by 25bp. The CNH depreciated by 1.7% vs. the USD, suggesting markets are starting to price in lower growth in China. This caution may only disappear when an inflection point is observed in the spread of the epidemic.

Figure 1 – MSCI World indices for selected sectors (01/01/2020 = 100)



Source: Bloomberg, Euler Hermes, Allianz Research

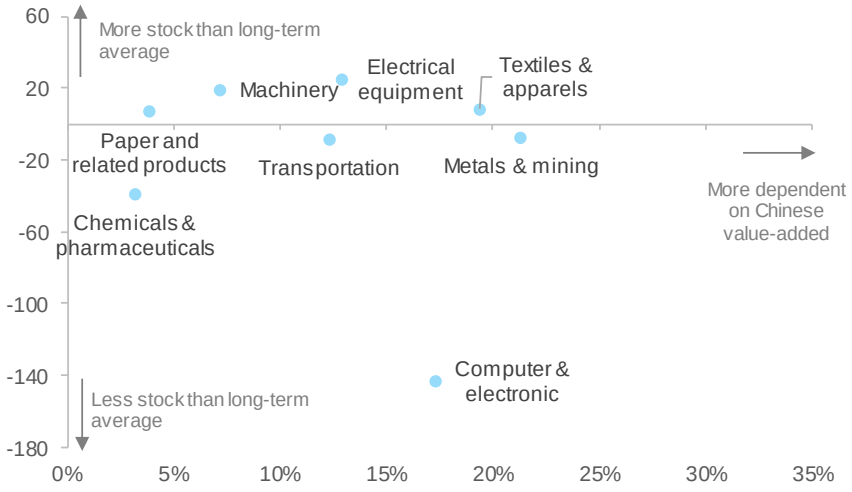
The hit to China's GDP y/y growth could amount to c. 1pp, mostly over Q1 2020. A recovery should thereafter be possible, based on pent-up production and policy support. The ultimate economic impact will depend on the severity and duration of the epidemic, which is tough to predict at this stage. On top of the direct impact of the epidemic itself, the unprecedented containment measures taken by Chinese authorities mean that the impact on economic activity may be larger than what we initially thought. Both the demand and supply sides are under pressure: the epidemic and the 'fear factor' associated with it will weigh on consumer spending, and the extended Chinese New Year holidays will delay production. In 2003, the SARS epidemic resulted in a 2pp decline in China's GDP growth in Q2 that year (to +9.1% y/y from +11.1% in Q1). All else equal, the impact of the ongoing epidemic could be even larger, given that the Chinese economy is now more dependent on private consumption (50% of GDP growth in 2019 vs. 28% in 2003). That being said, the authorities' reaction has been swift. Drawing from the SARS epidemic, we continue to think that the hit to growth can be recovered in one to two quarters.

Policy support to increase. A few measures have already been implemented: The PBOC is increasing liquidity injections, large state-owned banks are offering more favourable credit conditions to firms affected by the epidemic, etc. Going forward, further monetary easing is likely. Our forecasts for 150bp worth of cuts in the reserve requirement ratios and 30bp in the loan prime rate over 2020, which previously seemed ambitious, may now look highly probable. On the fiscal side, authorities can increase public spending beyond the 2.7% of GDP we currently expect for 2020. These policies could help soften the economic impact of the epidemic (particularly preventing businesses from going under), but are unlikely to fully make up for it.

A protracted pause in Chinese activity could be disruptive for certain supply chains such as chemicals, and transport equiment, as well as textile and electronics. In the Hubei province, the most important industries are chemical and non-metallic mineral products (22% of the gross industrial output in the province) and transport equipment (18%). It is worthy to note that the Hubei province represents 9% of total motor vehicles production in China. Given the very high degree of interconnectedness between the car industry and the rest of the economy, the impact of the epidemic is likely to be significant on most industrial activities.

The high degree of integration of the Chinese economy in the global supply chains means that this epidemic is likely to have a broader impact outside the country. Textile and computers & electronic sectors are particularly exposed to disruptions happening in China, given that Chinese value-added in these sectors represent 19% and 17%, respectively, of global production. Given the relatively low level of inventories in the electronics sector, shortages are plausible. Looking at economies, the top five which depend the most on China are Taiwan (5% of local output uses Chinese inputs), South Korea (4%), the Netherlands (3%), Hungary (3%) and Indonesia (3%).

Figure 2 – Share of Chinese value-added in global final demand, by sector (%) vs. inventories compared to long-term average, by sector (in number of days)



Source: OECD, Bloomberg, Euler Hermes, Allianz Research

Figure 3 – Economic context and impact of SARS and 2019-nCoV epidemics

	SARS	2019-nCoV
Chinese authorities' response to the epidemic	The crisis was hard to contain • Delayed information sharing: the first case occurred in November 2002, but was identified much later and the WHO was notified only in February 2003 • Social panic	As of 30 January 2020, the response seems efficient • The epidemic was quickly identified and not covered up • Sharing of medical information with foreign and international institutions (WHO) • Unprecedented measures in order to contain spreading of the epidemic

Economic impact on China	Some impact noticeable at the regional/global level • The global macroeconomic impact of SARS was estimated at USD30-100bn (c.USD3-10mln per case) • In China, the impact was estimated at USD12.3-28.4bn (c.1% of GDP) in China	Under current circumstances, we expect c.1% of GDP over roughly one quarter: • The severity will depend on how long and far the epidemic spreads • The 'fear factor' and extended Chinese New Year holidays should weigh on private consumption and output
Cyclical position of China	GDP growth was accelerating (10% in 2003) following China's entry into the WTO in 2001.	The Chinese economy is slowing: GDP growth declined to +6.1% in 2019, after +6.6% in 2018. We expect +5.9% in 2020.
China's dependence on private consumption	In 2003, private consumption contributed to 28% of GDP growth	We estimate that in 2019, private consumption contributed to around 50% of GDP growth.
China's dependence on exports	In 2003, gross exports contributed to 68% of GDP growth	We estimate that in 2019, gross exports contributed to around 5% of GDP growth.
U.S. and international reaction	• In April 2003, the U.S. government called back non-essential personnel in their consulates in Hong Kong and Guangzhou. • The U.S. government advised citizens not to travel to the region. • U.S. imports of meat from China declined by 24.2% in 2003. • The WHO also advised visitors to avoid Hong Kong and the Guangdong province.	• Health screening of passengers coming from China at airports has been strengthened. • U.S. citizens are advised against travelling to China. • Mongolia, North Korea and Russia have closed their borders with mainland China. • Kazakhstan, Malaysia, Singapore, Sri Lanka, the Philippines and Vietnam suspended visa issuance to Chinese citizens and Hubei-related visitors • The WHO decided on 30 January 2020 to call for a "Public Health Emergency of International Concern".

Source: "The Impacts on Health, Society, and Economy of SARS and H7N9 Outbreaks in China: A Case Comparison Study" (Qiu, Chu, Mao, Wu, 2018), Official announcements, WHO, Euler Hermes, Allianz Research

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