China Spotlight
An Economy Under Quarantine

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- The damage to China's economy by COVID-19 will far exceed the impact of SARS and the GFC.
- Though factories have reopened, it will take much longer for service sectors to recover.
- China needs to prepare for a second shock wave of much weaker export demand.
- A multi-pronged policy response is likely but will be less aggressive compared to the 2009 GFC response.
- We expect whole-year GDP at 2.8% but with significant downside risks.

The Carnage of COVID-19

It is an extraordinary time. The damage to the Chinese economy from COVID-19 will be far greater than the SARS epidemic in 2003 and the global financial crisis (GFC) in 2008 (Exhibit 1). In Jan-Feb 2020—the height of China's virus response measures—industrial production, fixed asset investment and retail sales plunged by 13.5%, 24.5% and 20.5% y/y, respectively, down from 5.7%, 5.4% and 8.0% in 2019.

Within industrial production, labor-intensive sectors and those with long supply chains—such as textiles (-27.2%), machinery (-28.2%) and auto (-31.8%)—suffered greater losses. Within retail, restaurants (-43%), housing-related goods (-30%), auto (-37%), and discretionary items like jewelry (-41%) took greater hits.

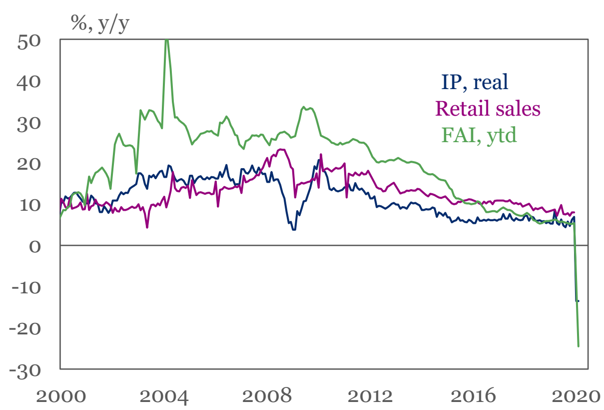
Investments in manufacturing, infrastructure and real estate plummeted by 31.5%, 26.9% and 16.3% in Jan-Feb, down from their 2019 levels of 3.1%, 3.3% and 9.9%. Real estate may continue to weaken in future quarters, amid depressed home sales (-39%) and housing starts (-44%) (Exhibit 2).

Out of ICU

It is reported that 95% of factories reopened by mid-March (Exhibit 3). However, anecdotal evidence suggests that the utilization rates are still low due to the lack of orders and workers. We expect manufacturing activity to return to normal in April, though it will take much longer for service sectors like restaurants and tourism to recover.

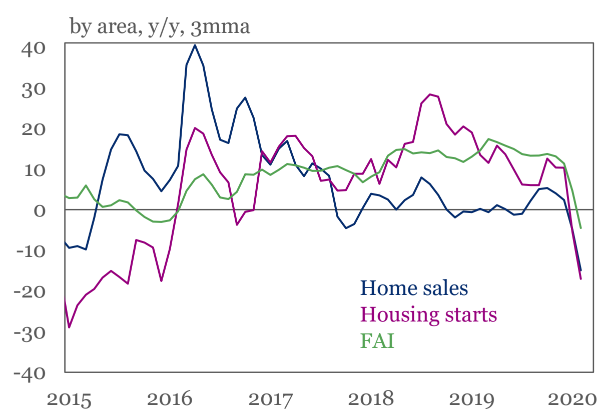
As the COVID-19 pandemic hits the world economy, China should prepare for a second shock wave of weaker export demand. China's export growth already fell to 0.5% in 2019 due to U.S. tariffs. The seasonally adjusted PMI sub-index, or *Export Orders,* plunged to 28.7 in Feb 2020, down from 45.2 in Feb 2019. Repealing the tariffs imposed by Washington and Beijing, even partially, could help boost the global economy and market confidence.

Exhibit 1. Sharp drop in Jan-Feb.



Source: Haver, IIF

Exhibit 2. Housing market halted.



Source: Haver, IIF

Complicated policy cocktail

Authorities have taken many policy steps in the past two months to soften the blow of COVID-19. The PBoC cut required reserve ratios by 100 bp, cut repo and MLF (medium-term liquidity facility) rates by 10 bp each, pumped liquidity through repo and MLF, and provided ¥800 billion in emergency loans through relending to banks. Some taxes and fees have been suspended or postponed. Banks were allowed greater regulatory forbearance. Utility charges and rent have been reduced for some businesses.

However, China is unlikely to repeat the enormous post-GFC fiscal and credit stimulus. China's public debt increased from 27% of GDP in 2008 to 55.6% in 2019. Its corporate sector is already the world's most leveraged, with its debt at 99.3% of GDP. Though PPI (-0.4%) is in deflation territory, elevated CPI (5.2%) driven by food prices (21.9%) prevents the PBoC from cutting interest rates quickly. The risk of capital flight and the weak global economy rule out RMB devaluation as a stimulus tool. Moreover, strong demand stimulus will lead to supply-side constraints, such as labor shortages.

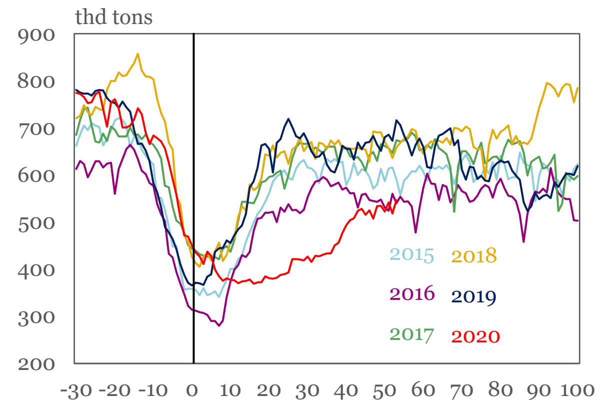
We expect the near-term policy response to remain focused on stress relief. Major fiscal expansion through both tax cuts and spending boosts will be formulated in late spring and delivered mostly in H2 of the year. We expect the *general deficit* and *augmented deficit* to be materially higher than the 3.5% and 8.1% in 2019. The PBoC will likely deliver further interest rate cuts after CPI abates in early summer.

Prognosis for recovery

Assuming activities are 95% back to normal in March, which accounts for 40% of working days in 1Q, we estimate that the GDP of the secondary and tertiary sectors will plunge by 8.3% and 6.0% y/y in 1Q, respectively (Exhibit 4). We expect the GDP for the four quarters to be -10.4%, 11.2%, 4.9%, and 2.8% in non-annualized sequential terms, and -6.5%, 2.5%, 6.0%, and 7.5% y/y (Exhibit 5). Of course, the situation is still highly uncertain, depending on whether China can avoid a virus resurgence, other countries can contain the pandemic effectively, as well as the size and effectiveness of stimulus policies. There is still a marked downside risk to our forecast.

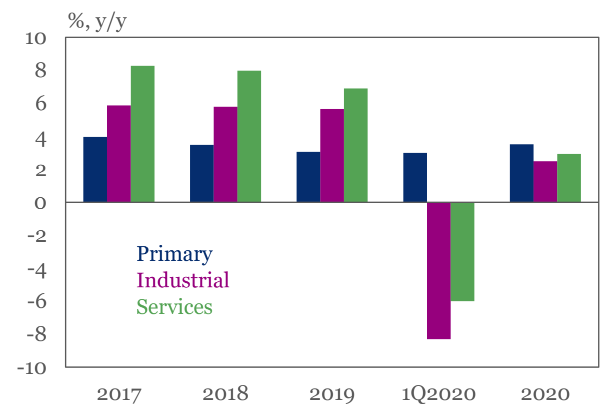
We expect the spillover effect of China's recovery to be much smaller than in 2009. Though China's share of global GDP is greater now at 15%, the post-virus stimulus will likely center on 5G, data centers, smart city technologies, and healthcare, which are much less material-intensive than the roads and bridges built in the aftermath of the GFC.

Exhibit 3. Coal consumption around Lunar New Year.



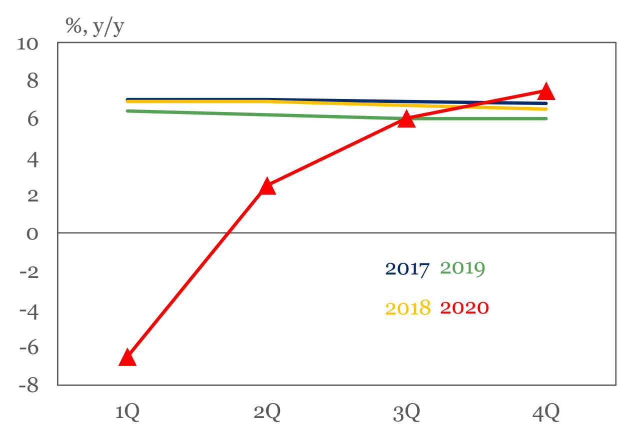
Source: Bloomberg, IIF

Exhibit 4. GDP growth by sector.



Source: Haver, IIF

Exhibit 5. Quarterly GDP growth.



Source: Haver, IIF

