The economic impact on China will be huge in the first quarter of 2020

It will be some weeks before the effects of the virus and subsequent containment measures will be reflected in real economic data. But it does not take complex models to predict that the country will not be able to generate much output in the first quarter (Q1). Provinces generating two thirds of China’s economic output instructed businesses to extend the New Year holiday until at least 10 February, and there is still much uncertainty over the pace of reopening, before an eventual return to “business as usual.”

With the limited set of data at our disposal, we have shaved our first quarter gross domestic product (GDP) growth forecast for China by -35%, from just under 6% year-on-year to 3.9%, with an actual contraction quarter-on-quarter given the enormous loss of working hours (chart 1).

1. China’s growth will take a significant hit in Q1 2020

Sources: Datastream, Lombard Odier calculations
The base case remains a temporary disruption. Why?

a. The rapidity of Chinese authorities’ response and containment efforts have allowed for the vast majority of cases to remain in China, with only three deaths outside of China, and near 52,000 cases out of the almost 65,000 total for China in the province of Hubei alone. This is a major difference from the 2003 SARS episode, which led to 774 deaths worldwide, 425 of which were outside China.

b. Despite the large jump in new cases and deaths on 12 February, reflecting the one-off inclusion of “backlog” patients diagnosed with new clinical means, the underlying trend remains encouraging. The number of cases confirmed by laboratory tests continues to fall and recoveries are still rising faster than deaths. This should allay concerns that China is trying to undermine the extent of the outbreak, and it increases the likelihood that the disease’s actual fatality rate is lower.

c. In this context, and with China agreeing to share information with the global medical community, it doesn’t seem unreasonable to assume that either a cure will be found, or the epidemic will die out by itself, as long as there is no lapse in the rigour of border controls and isolation periods.

In this base case scenario, China still has some room to manoeuvre and offset some of the lost output over the remainder of 2020.

a. Economically, epidemics are similar to natural disasters. Excess savings accumulated over the affected period will eventually be spent, and providing that there was no permanent damage to production capacity, the backlog in investment will be recovered.

b. With underlying inflationary pressure still low in China, the People’s Bank of China (PBoC) has room to cut interest rates, while fiscal measures will be enacted to support businesses, investment and growth. So far, the PBoC has cut the reverse repo rate by 10bps and stepped up liquidity injections. Officials have also announced tax breaks and subsidies for firms and households. There is little doubt that more stimulus is in the pipeline in the coming weeks.

c. In this context, we are reluctant to trim our full year Chinese economic growth forecasts too drastically at this stage. We now expect 5.4% annual growth for 2020, down from 6.3% previously. However, the situation is extremely fluid. If successful containment of the virus fails to materialise during Q2 at the latest, the damage to consumption and supply could turn out to be more permanent and much tougher to make up during the second half of the year. In this case, we would downgrade our outlook.

What about the rest of the emerging world?

The most visible and direct effect is felt through tourism

It goes without saying that there is a large pool of Chinese tourists who will have spent very little money during Q1 2020. Many Asian countries will be severely impacted by a loss of income, which will be difficult to recoup at a later stage. These include Hong Kong, Cambodia, Thailand, Singapore and Vietnam. However, the remaining emerging markets have very little exposure to Chinese tourism (less than 1% of their GDP) and should therefore remain unscathed.

Indirect economic effects have the potential to be much larger for emerging countries

a. The first – and probably most important – indirect effect is supply chain disruptions.

With China coming to a standstill, all countries that buy intermediary goods from the country, or that are...
So far, emerging market currencies have held up remarkably well throughout the COVID-19 episode, with the JP Morgan Emerging Currency Index down less than 3% peak to trough in January.

However, should downward pressures on currencies intensify sharply, and in a lasting manner, central banks may be forced to abandon their accommodative stance, ultimately questioning the economic dynamic in emerging markets.

**Economic growth should remain supported, but a strong rebound is unlikely**

With the global manufacturing Purchasing Managers Index (PMI) in expansionary territory since July 2019, the bottoming out process in growth seemed in place before the virus outbreak. China’s first quarter slowdown will inevitably weigh on global growth, but again, as long as the disruption is temporary, we would still expect the US-China trade truce and accommodative monetary conditions to support growth in emerging markets in 2020. That said, we believe the rebound will nonetheless be gradual and shallow, given the slow recovery expected in the developed world and stronger links between emerging and developed economies.

**Stéphanie de Torquat, Macro Strategist**

(b) Falling commodity prices would also affect emerging economies.

Obviously, some countries would suffer more than others. Peru and Chile are dependent on copper, Brazil on iron ore, and Colombia, Mexico and Russia on oil. On the other hand, India and Turkey would benefit from lower oil prices.

But all in all, sharp and extended falls in commodity prices have historically tended to be a net negative for emerging markets as a whole, as the 2014/2015 episode proved once more.

The S&P GSCI commodity index lost close to 35% peak to trough in January. This is a significant figure, but still manageable, especially after a 20% rally in 2019. Further protracted falls could however become more problematic.

c. The third indirect transmission channel to the rest of the emerging world would be currency weakness.

Significant monetary easing and particularly accommodative financial conditions within emerging economies were a key reason why they did well in 2019 from an economic standpoint. Not only have rates dropped significantly over the course of just a few months, but they are also close to ten-year lows (chart 3). At the end of 2019, the lagged effect from low rates on economic dynamics made us reasonably positive on emerging markets ex-China growth for 2020.

3. **Central banks in emerging economies are particularly accommodative**

![Central banks in emerging economies are particularly accommodative](chart)

Sources: Bloomberg, Lombard Odier calculations
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