

Special risk survey: Coronavirus dampens enthusiasm for China

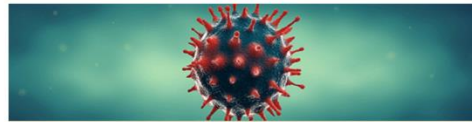
Jeremy Weltman Monday, February 17, 2020

Euromoney asked its panel of Asia analysts to assess the effects on investor risk of the novel coronavirus (Covid-2019) disease outbreak. This, the first of two reports on the survey results, focuses on how it will affect investing in China.



Battling coronavirus – a worker sprays disinfectant outside a building in Beijing's tech hub, Zhongguancun

Euromoney conducted a special crowd-sourcing survey among a subset of its normal contributors – all experts on political, economic and financial risk in countries across China and the rest of Asia.



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The results are intuitive, and illuminating, not least in the light of numerous comments provided by the survey experts, along with their revised risk assessments quantifying the effects.

China's total risk score, as expected, deteriorated – from 58.04 in the fourth quarter of 2019 to 57.25.

This means it has now slipped below Italy in the global rankings, to 48th out of 174 countries, while remaining comfortably above Trinidad & Tobago, one place below on a score of 55.83, though neither of those countries was surveyed on this occasion.

China's score may have been likely to fall slightly in any event for other reasons. There are issues with trade frictions, Hong Kong and corporate debt to name a few, although the Phase-One trade agreement with the US in January would have provided some uplift to economic prospects, and there were no big political risks to figure before news of the virus emerged.

Economic effects

The coronavirus is an uncertain event, as there is no knowing how long it will last, or its full impact on human health. It will partly depend on when an antidote can be found, and how effective the control and prevention measures are at stopping the disease from spreading.

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Considering this, many survey contributors naturally expressed caution with regards to evaluating its overall impact, notably as none would consider themselves experts in epidemiology. Additionally, there is a sense of not wanting to be drawn into overreactions to the daily reports of the number of infections and the death toll.

That said, there is a broad consensus that Covid-2019 will have a bigger impact on the economy than the spread of Severe Acute Respiratory Syndrome (SARS) in 2003.

This is partly due to the faster transmission rate that has required entire cities to be put under quarantine temporarily, causing disruption to normal commercial activity, as well as the fact the outbreak coincided with the Lunar New Year festive season. There has also been a substantial shift in China's trade dynamics over the 17 years since the SARS event.

"Hubei province is in physical lockdown, while the rest of the country is experiencing a self-imposed economic lockdown over the fear of contagion of the coronavirus and the still-rising infection and death rates," says Friedrich Wu, a professor at Nanyang Technological University who is one of Euromoney's 300-plus country risk survey panel members.

"Factories are idle because millions of migrant workers are stranded by travel restrictions. Bloomberg estimates that provinces accounting for nearly 70% of China's GDP are closed for business.

"Moreover, it is impossible to predict when factories and logistics companies can resume full operations, as it all depends on how the virus situation evolves."

This will make it difficult for state authorities to attain the annual growth target of around 6% for 2020, which in turn is reflected in downgrades to all five of the economic risk indicators the survey contributors are required to evaluate for China (and other countries in the survey), comprising economic growth, government finances, employment/unemployment, monetary policy/currency stability, and bank stability.

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- Friedrich Wu, Nanyang Technological University”

Another of Euromoney's survey experts is Matthieu Pautonnier, chief production officer and senior quantitative economist at TAC Economics.

His computer modelling of the economic effects suggest it will lower China's year-on-year GDP growth by 1.5 to 2 percentage points in the first quarter of 2020, on top of an already slowing economy.

The short-term intensity of the disease outbreak and asymmetric recovery will, he says, reduce China's year-average GDP growth below 6% this year. This comes after the economy slowed to 6.1% in 2019 from 6.8% in 2018.

Nanyang's Wu broadly concurs, stating that if the outbreak is successfully contained by the end of the first quarter, national GDP growth for that quarter would probably fall to 4.0%.

"With a recovery and then stabilization in the second half, full-year GDP growth would decelerate to 5.0-5.25%," says Wu. "But should the government fail to bring the outbreak under control, we might get to witness the first 'Made-in-China' global recession."

That could be serious. China accounts for 18.7% of world economic output (on a purchasing power parity basis), 28% of world manufacturing production, 13% of world exports and 11% of imports.

It is also the world's second-largest recipient country of foreign direct investment (FDI) inflow, and the third biggest FDI exporter. China is not only the largest trading partner with over 125 countries, it also holds a central position in the networks of global supply chains.

In addition, Chinese outbound travellers – averaging around 150 million annually – are the world's biggest tourism spenders.

"In short, China has been the growth engine for the world economy in a decade," says Wu. "Hence, for better or for worse, whatever happens to the Chinese economy will have impactful rippling effects on the rest of the world."

While the risks are clear, many analysts are understandably reluctant to be drawn into worst-case scenarios in the belief the outbreak will peak, or possibly has already peaked.

One is Sher Mehta, director of macroeconomic research and country analysis at Virtuoso Economics, who expects economic activity to pick up from the latter half of the second quarter, or in the second half of 2020, and doesn't expect annual GDP growth to fall by more than one percentage point.

He notes the various measures taken by authorities, including monetary policy support, tax breaks and low-interest loans to companies in certain sectors, as well as prospective monetary, tax and financial policies that will combat negative effects.

Political impact

Clearly the virus may also have some impact politically, given that it presents a test of the Chinese bureaucracy's ability to manage and cope with a security and prevention exercise.

It has also seen China opening up more than usual in terms of data transparency and allowing criticism of local officials, not least concerning the handling of the doctor who warned of the virus at an early stage and who subsequently died of the disease.

Analysts see no impact on the risk of government non-payments/non-repatriation of capital from China, while the score for the regulatory and policymaking environment has improved, reflecting the government's fiscal, monetary and other reactions, which demonstrate a high degree of flexibility of response.

The score for government stability declined, however, highlighting how the epidemic across China is testing president Xi Jinping's leadership qualities and is undermining faith in local authority efficiency, leading to the removal of several local party chiefs and healthcare officials in affected regions.

The political effects are quantified to be less than half the economic effects, but certainly not trivial, according to Euromoney's survey.

ECR contributor Joy Rankothge, principal of Country Acuity Advisors, views the immediate economic effects as more serious than the political ones.

"The state and party have enormous capacities to manage social stability," he says. "As such, to me, it seems unlikely for the Wuhan crisis to morph into regime change as some analysts and media claim."

The risk picture would obviously change the longer the outbreak continues though, and the more widespread it becomes, but even so Rankothge remains sanguine about the political effects.

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- Joy Rankothge, Country Acuity Advisors

However, there are clearly some differences of opinion on this, which also tend to reflect the timespan dynamics.

"Every time I view the coronavirus saga, it looks worse from public health and economic points of view," says Steve Hanke, a professor of applied economics at the Johns Hopkins University who is also a member of Euromoney's group of risk experts. "But, these problems will eventually abate and pass. The real impact will be political.

"As a result of their mishandling of the coronavirus, Xi Jinping and the Chinese Communist Party have taken a big hit that will have long-run implications.

"These could take one of two paths. They could either be in the form of a more ruthless authoritarian path à la Mao Zedong, or a more liberal path à la Deng Xiaoping.

"Alas, we don't know which path. What we do know is that things will change politically and perhaps dramatically."

Survey contributor Kenneth Hung, head of China database at CEIC, tends to agree the epidemic will have a profound impact on China's overall social development, with implications for political risk.

"People's dissatisfaction with the political system will certainly initiate various anti-government activities, awakening because life is not guaranteed, and dissatisfaction driven by material damage," he says. "It is very likely the overall social development has fallen back by more than 10 years, and that the international image requires the reconstruction by another generation."

Financial challenges

Virtuoso Economics' Mehta also refers to the medium-term implications for financial stability, which have been contemplated for some time in the light of the build-up of liabilities in China.

The official fiscal target has been raised in recent years and some economists believe it may go above 3% of GDP, with higher risks of policy stimulus worsening the debt overhang and bank stability – one of the risk indicators downgraded in the survey.

"This is due to the possibility of further rise in non-performing assets," says Mehta, "given that there has been a substantial loss of production, which in turn implies that many firms, particularly small and medium-sized enterprises, will probably increasingly default on loans.

"Moreover, Chinese firms are selling bonds to bolster their finances in a tough business environment. Essentially, the logical corollary of such a stimulus is excess leverage, which is likely to have downside implications for growth in the medium term.

TAC Economics' Pautonnier remains cautiously optimistic, but also notes that political developments combined with the sheer size of credit leverage in China and international economic tensions could be particularly negative.

"None of the two watchlist indications that our models have shown for China (currency and economic activity) have turned into a full-fledged crisis signal, but we would also need to have the first post-pandemic hard data to check, as there is no doubt that China is coming closer to such critical thresholds."

