Can China’s economy withstand the Coronavirus?

By Michael Spence

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The COVID-19 epidemic’s tail risks are significant and frightening, but as of now, they do not seem particularly likely to materialize. Instead, the outbreak’s economic consequences will probably be substantial but transitory.

The new coronavirus, COVID-19, that emerged in Wuhan, China in December has already killed thousands, altered the daily lives of hundreds of millions, and put the entire world on edge. Because epidemiologists have not yet fully discerned the virus’ transmission mechanisms, no one can say for sure when the outbreak might be contained, let alone what its economic fallout will be.

This does not mean, however, that no educated guesses can be made. Historical experience with similar large shocks suggests that the short-run economic damage may be considerable. As investors de-risk their portfolios, market volatility should be expected, especially in sectors deemed to have the largest exposures, such as travel and tourism, luxury goods, and autos.

A number of credible estimates (some public and some private) suggest that China’s annual GDP growth could fall by 2-4 percentage points per quarter until the virus peaks. In particular, consumption and output will take a hit, not least because of mobility restrictions, both voluntary and enforced. The bump that the Lunar New Year holiday usually provides is already lost.

The question is when that peak will come. Optimistic forecasts indicate a partial recovery in the second quarter of this year. I believe that it is more realistic to expect a third-quarter recovery, with a material impact on annual global growth. But one cannot rule out the possibility of a prolonged pandemic causing far more extensive damage to economies, owing to business failures, declining employment, faltering private investment and weak or late policy responses.

Barring such a “black swan” event, however, history suggests that the COVID-19 outbreak’s long-term effects may rather small, even negligible. This is all the more likely, because China’s economy is far from fragile. Indeed, it is less dependent on trade than it was in 2003, during an outbreak of another coronavirus, severe acute respiratory syndrome (SARS), and it is equipped to bounce back from reasonably large shocks rather quickly.

One under-appreciated source of strength is the rapid expansion of China’s digital economy. As much as 35.3% (though probably closer to 25%) of all Chinese retail sales now occur online; mobile Internet penetration is very high and rising; and China’s mobile-payments systems are the world’s most advanced. Because most people and businesses are connected and active online, it is easy to generate large amounts of data that, thanks to artificial intelligence, instantly expand the scope and effectiveness of digital ecosystems.

This will go a long way toward boosting China’s economic resilience, especially in the face of a crisis that limits physical mobility. Advanced digital infrastructure means that workers in many jobs and industries can continue to work from home, even if they are quarantined or locked down. Similarly, sophisticated online educational platforms may be able to offset some of the effects of school closures.

Moreover, for businesses experiencing cash-flow and working-capital challenges, credit can be extended, and terms adjusted, remotely.

This would minimize the long-term damage to the service sector, especially small and medium-size enterprises. Online insurance products can also be extended in several areas, including health. Ordering medical supplies online might circumvent crisis-induced shortages, as algorithms quickly detect and respond to blockages and bottlenecks. Online platforms can also provide a powerful defense against opportunistic price gouging, which limits the availability of essential goods and services, especially for the most vulnerable. Amazon, for example, has already warned sellers to refrain from charging exorbitant prices for face masks or risk getting kicked off the site.

As an even greater share of the economy is brought online, tracking its performance becomes easier, faster, and more precise. Such data can be used to tailor policy responses and improve the accuracy of forecasts, thereby boosting business confidence, encouraging investment, and accelerating the recovery.

As for the rest of the world, tourism is facing a particularly large negative shock, even in countries that are not badly affected. Companies that have a significant presence China – such as in the automobile and luxury sectors – are also likely to suffer, but they will probably recover alongside the Chinese economy.

Even if COVID-19 is contained fairly soon, however, the crisis could hasten efforts to move key elements of global supply chains away from China. This process has been underway for several years, driven by the shift in China's comparative advantage from cheap labor-intensive production to higher-value-added tradable activities. Trade tensions between the United States and China have reinforced this trend. The coronavirus could provide an additional impetus.

But more important than China's position in global value chains is the recognition that global supply networks overall are wound too tightly and lack resilience, though it is far from clear whether the COVID-19 outbreak will spur change. After all, this was also the lesson of the 2011 Tōhoku earthquake and tsunami in Japan, which triggered a meltdown at the Fukushima Daiichi nuclear-power plant and disrupted global supply chains.

Some expect the COVID-19 outbreak to take a toll on the Chinese government's credibility as well. This seems unlikely. Despite early delays, the Chinese authorities ultimately took decisive action. It may not have been perfect, but in a crisis like this, there are no great choices, and there is no guarantee that chosen measures will work.

Nonetheless, there are lessons for China's leaders. An obvious one is that objective, bottom-up information is critical to early detection and response. It seems likely that, once the crisis is contained, China will take steps to ensure that the system neither blocks nor filters the flow of such information in the future.

The COVID-19 epidemic's tail risks are significant and frightening, but as of now, they do not seem particularly likely to materialize, especially if one assumes continued diligent, aggressive, and adaptive domestic and international responses. Instead, the outbreak's economic consequences will probably be substantial but transitory. What will not pass, unfortunately, are the human costs.

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