

# Corona shock deeper and longer for weakened global economy

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## Estimates revised down

*The outbreak of the Covid-19 virus is inflicting a shock on an already weakened global economy. Until recently, falling demand in China and supply chain disruptions were the main factors dampening global economic growth, but now growth-inhibiting effects are also coming from other countries where the number of infections is growing daily. The worst-afflicted economies (Italy, South Korea, Japan and Singapore) jointly account for 8% of the global economy. The virus is expected to spread further, but the pace at which this will happen is uncertain.*

*This prospect, together with the government measures to prevent further contagion and the worldwide travel cancellations by households who want to play safe, will put a stronger and longer drag on global economic growth than we assumed so far.*

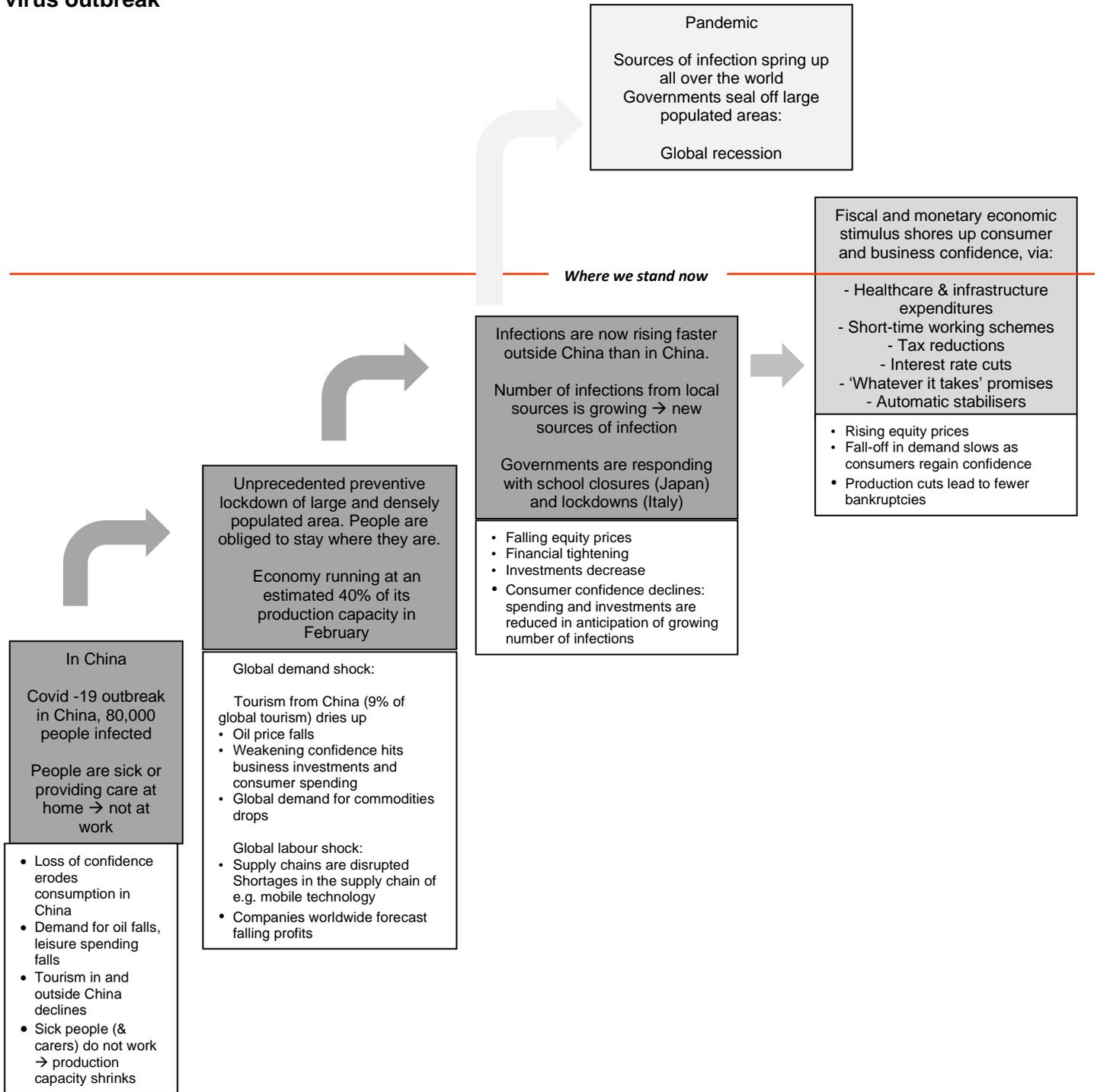
*An additional factor is that the equity price falls since 24 February have led to tighter financial conditions worldwide. Monetary policy authorities will no doubt respond and have already done so, but the effectiveness of their actions will also depend on fiscal policy back-up. We expect relatively extensive fiscal measures to prevent a recession, so that the overall stimulus package will comprise a mix of monetary and fiscal support. As the stimulus measures will need some time to take effect, we see the global economy moving into recession territory (as defined by the IMF) in the coming months. A clear recovery is foreseen towards the end of the year, assuming that the virus is under control by the end of the second quarter.*

*One crucial assumption in our outlook is that the sources of infection outside China can be sufficiently contained to prevent the further spread of the virus. If the situation outside China spirals out of control, we will adjust our expectations to a scenario in which a pandemic triggers a deep global recession.*

## The virus, the government and the economy: a diagram

As Covid-19 spreads across the world, it can hit the global economy through a steadily ramifying set of channels. Figure 1 on the next page provides a diagrammatic illustration of these 'economic channels of infection'. The diagram is not exhaustive, but merely serves as a framework to focus our thinking.

**Figure 1 – Diagrammatic representation<sup>1</sup> of the step-by-step economic consequences of the virus outbreak**



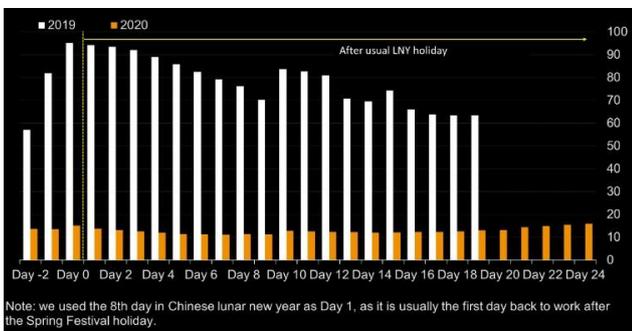
<sup>1</sup> This diagram does not indicate causal relationships.

### 1 Quarantine in China seems effective

The outbreak at the fish market in Wuhan just before the Chinese New Year prompted the authorities to impose a massive quarantine on Wuhan and later the entire province of Hubei. Millions of Chinese stayed indoors to prevent the virus from spreading. The tourist and leisure sectors (both in and outside China) were the first to be hit by a fall in demand. The oil price also slid sharply. After the extended Chinese New Year, traffic flow and other data showed that the supply side of the economy had largely ground to a halt. Estimates based on data from the Ministry of Transport and CO<sub>2</sub> emissions as well as specific data such as car sales suggest that the China economy crawled along at 40% to 50% of its capacity in February.

#### China: drop in transport volumes

Passenger transport since Chinese New Year (LNY)



Source: Bloomberg Economics

#### China: Caixin PMI manufacturing industry

Index (50=neutral)



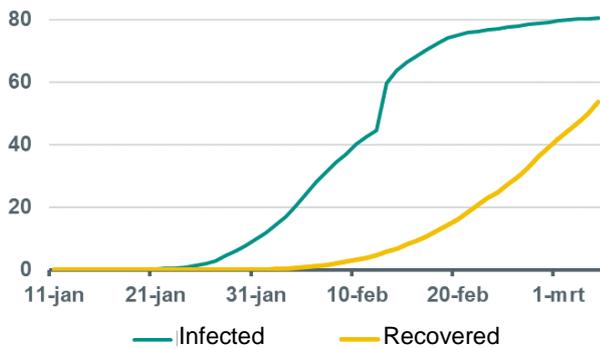
Source: Bloomberg

The Caixin purchasing managers index plunged to 40.3 in February from 51.1 in January. Though unprecedented, such a deep dive is hardly surprising considering that the Chinese economy was running at a mere 40% of its capacity during part of February.

Given the current decline in the number of new infections in China and the growing number of people recovering and slowly returning to work, we expect the economy, aided by the stimulus measures of the Chinese government, to very gradually start moving back towards its former growth rate by the end of March.

#### China: Coronavirus

In thousands



Source: Bloomberg

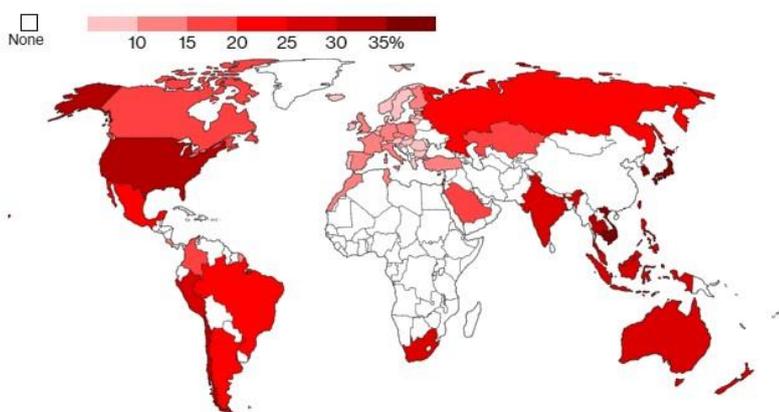
## 2a Global fall in demand from China

If Chinese consumer spending stagnates, other economies feel the consequences via (a) lower demand for their export products, (b) less tourism. China, for instance, accounts for between 45% and 55% of global demand for major commodities such as aluminium, copper, nickel and zinc. And Chinese travellers represent about 9% of global tourism, spending some USD 250 billion annually abroad. The speed with which China can ramp production up to full capacity depends on the extent to which queues arise within the supply chains as they kick back into motion. There is also a risk here of new infections occurring as workers return to the workplace.

Whilst the Chinese economy is slowly getting back on track, net growth will turn out lower at the end of the second quarter. This is because although Chinese consumers will start spending again, not all revenue is regained as some spending is discretionary. After all, people won't eat out twice as often this month because they were unable to do so last month. On top of this, it is fair to assume that consumer confidence in China has been severely dented and people will not snap into spending mode overnight. Moving into the second half of the year, we still expect growth to be flatter than under normal conditions as the continuing slowdown in other economies around the world will also weigh on Chinese growth.

## 2b Global supply chains disrupted

The Chinese economy represents about 16% of global GDP. Clearly, therefore, a China running at half of its capacity will cast a cloud over the rest of the world's economies. China is the world's manufacturing powerhouse. Countless companies depend directly or indirectly on Chinese suppliers. The map below shows intermediary imports from China as a share of total imports per country.



Source: OECD TiVA, Bloomberg Economics

In the immediate aftermath of the outbreak, S&P500 companies with a large exposure to China fell 5% in value compared to companies with a low exposure to China.

Furthermore, a sector's vulnerability to the virus outbreak depends not just on the volumes obtained through the supply chain, but also on the availability of alternative suppliers and/or the existence of buffers to weather a storm. The high-tech sector scores particularly poorly on all three counts: it procures high volumes of goods from China, has relatively few alternative suppliers and maintains structurally low inventory levels. Tech giant Apple, for instance, will struggle to keep customers happy, with the supply of iPhones likely to be cut by 5% to 10%. And in other sectors, too, lots of companies, including heavyweights such as Philips, Procter & Gamble, Adidas, Nestlé, Master Card and Burberry, have warned of both slack demand and supply chain disruptions.

## Japan and emerging markets

Japan is contending with a relatively large number of infections as well as a substantial loss of demand due to Chinese tourists staying at home. Until March alone, around 400,000 Chinese holidaymakers are expected to cancel their planned trip to Japan. Chinese tourists in Japan contribute some 0.3% to Japanese GDP. The school closures announced by Prime Minister Abe will also dampen economic growth as many workers must stay at home on child-minding duty. Considering the contraction of no less than 6.3% in the fourth quarter of 2019, we still expect Japanese growth to be positive in the first quarter, but the revival will be much less strong due to the virus outbreak and the containment measures.

As for the regional emerging markets (South Korea, Singapore, Malaysia, Hong Kong and India), we have revised our growth expectations down from 5.1% to 4.8% (year on year) - though additional fiscal and monetary measures could help to cushion this decline.

## Eurozone already out of breath before the outbreak

The eurozone economy grew at a snail's pace (0.1% quarter on quarter) in the last quarter of 2019. Moreover, the retail revenue and industrial output data were very weak in December, just before the outbreak. Against this backdrop, the eurozone, which is more dependent than the US on China and global trade, will have been hit hard. Germany, where the trade conflict, on top of the diesel scandal, had already caused a industry recession in 2018-2019, is expected to contract by 0.2% quarter on quarter in the first quarter of 2020.

Germany's ZEW Indicator of Economic Sentiment plummeted from 26.7 in January to 8.7 in February.

For the eurozone as a whole, we foresee a mild recession in the first half of 2020 and, assuming that the virus has been brought under control, a strong revival towards the end of the year and early 2021.

### Germany: ZEW Index



Source: Bloomberg

## United States

In the US, by contrast, the pre-outbreak economic figures were actually better than expected. Our growth estimates were predominantly below the consensus. This was mainly due to factors other than the coronavirus (see our publication [Global Daily – Four themes for 2020](#)). Before the scenario of further infections and economic stagnation outside China became our baseline scenario, we had counted on 0% growth in Q1. Now that the virus has also reached the US itself and many other countries, we see growth for 2020 dipping -0.3% to 1%. The growth deceleration is mainly caused by a decline in consumption due to the coronavirus fear factor in the first and second quarters, and possibly some slight shrinkage in the second quarter. The Federal Reserve's decision on 3 March to cut interest rates by 50 basis points is already factored into this estimate.



## Equity prices plunge, financial tightening to follow

As soon as it became clear that the virus outbreak would not be largely confined to China, and that governments outside China were willing to lock down entire regions (Italy) and schools (Japan & Italy), investors realised that this would be no temporary dip. On 24 February the equity markets nose-dived in response. And the steady stream of profit warnings did nothing to alleviate the growing sense of anxiety.

The loss of confidence on equity markets around the world increases the risks of financial stress and corporate bankruptcies. Moreover, a sharp adjustment in equity markets causes a loss of household wealth and a decline in consumer confidence, bringing consumer spending under pressure. This gives rise to a negative 'feedback loop' for the global economy.

### Equity markets: US and China



Source: Bloomberg Economics

### VIX (volatility index of the S&P500)



Source: Bloomberg

## Monetary and fiscal policy reactions

The virus-induced economic shock reinforces our conviction that the global monetary easing cycle is not yet at an end. The repercussions from the shock will probably be more prolonged than we thought up to this point. Looking to the short term, it will put a significant drag on an already weak global economy. Underlying inflationary pressure is modest, so central banks are unlikely to hit their inflation target. We therefore expect all policy authorities to loosen the monetary reins: the US Federal Reserve, the European Central Bank (ECB) and the Chinese central bank (People's Bank of China) have all stated their intention to take measures as and when necessary. In fact, the Federal Reserve has already announced a further rate cut of 50 basis points. For the latest on our monetary policy expectations, see our publication [Global Daily – Global monetary easing coming soon](#) (Nick Kounis, Arjen van Dijkhuizen, Bill Diviney and Aline Schuiling)

Governments, too, must flex their fiscal muscles and pursue expansive policies (notably in Italy) to mitigate the economic implications of the virus outbreak. The OECD this week published its analysis of the economic implications of the outbreak and called upon governments to take rapid and vigorous action along three lines:

- Households and workers:

More resources are required to provide healthcare to the growing number of sick. Vulnerable families should receive extra income support via cash transfers and, finally, governments should, according to the OECD, consider short-time working schemes to avoid lay-offs.

- Companies:

Short-time working will help companies deal with a larger number of unproductive workers who are at home sick or to provide care. Specific sectors could be given temporary tax reductions and exemptions. The government could provide companies with extra liquidity or credit.

- Macroeconomic support:

The OECD calls upon central banks to increase liquidity for banks and lower interest rates as well as to consider asset-purchasing programmes. The OECD also recommends allowing automatic stabilisers to work fully (running up government deficits via lower tax revenues and higher pay-outs) in order to free up funding for public investments.

### **A final word**

A virus outbreak is an exogenous shock for the global economy. Though the current outbreak looks likely to have more severe implications for the economy than hitherto assumed, it is and remains a temporary shock that will ultimately be resolved through a) the development of a vaccine or medicine, or b) the acceptance that this is just another kind of flu that we must learn to live with. The greatest economic impacts arise from a loss of confidence and the subsequent behavioural reactions leading to, notably, a fall-off in demand. The more familiar we become with this virus, the milder the behavioural reactions of households, companies and investors will be. A sudden solution such as a rapidly available medicine or vaccine or an unexpected drop in the number of new infections could also trigger a strong rebound from the world economy, particularly as the current growth deceleration is mainly, but certainly not only, demand-driven.

That said, the actual scenario may become even worse than the one sketched above, leading to a deep worldwide recession. If local outbreaks outside China escalate into major areas of infection comparable to the ones in China, and if the resumption of production in China itself unleashes a new wave of infections, the world economy will be in grave danger. If that happens, so the OECD also warns, monetary policy alone (i.e. without maximum fiscal support) will be insufficient. But we have by no means reached that stage yet.

## Main forecasts

	Yearly			Quarterly			
	2019	2020		19Q4	20Q1	20Q2	20Q3
<b>US: gdp</b>	2.3	1.0	% q-o-q ar	2.1	0.0	0.1	1.4
<i>Old</i>		1.3		0.8	1.0	1.1	1.4
<b>Eurozone: gdp</b>	1.2	0.4	% q-o-q	0.1	-0.1	-0.1	0.3
<i>Old</i>		0.8		0.1	0.2	0.2	0.4
<b>China: gdp</b>	6.1	5.3	% q-o-q	1.5	0.5	2.5	2.3
			% y-o-y	6.0	4.0	5.0	5.9
<i>Old</i>	6.1	5.8		6.0	5.9	5.8	5.8
<b>World trade</b>	-0.5	0.5	% y-o-y	-1.2	-1.9	0.3	0.9
<i>Old</i>	-0.3	1.0		-0.6	-0.4	0.8	1.0
<b>US: core-CPI</b>	2.2	2.1	% y-o-y	2.3	2.3	2.3	2.1
<b>Eurozone: core-CPI</b>	1.0	1.0	% y-o-y	1.2	1.1	1.0	0.9
<b>China: CPI</b>	2.9	3.5					
	3m	12m		Q1	Q2	Q3	Q4
<b>Fed funds target</b>	1.62	1.12		1.12	1.12	1.12	1.12
<b>ECB deposit rate</b>	-0.6	-0.6		-0.6	-0.6	-0.6	-0.6
<b>US 10y</b>	1.60	1.90		1.60	1.65	1.75	1.90
<b>Germany 10y</b>	-0.65	-0.40		-0.65	-0.60	-0.50	-0.40
<b>EUR/USD</b>	1.10	1.16		1.10	1.12	1.14	1.16
<b>Oil price (Brent)</b>	60	58		60	58	55	58

Source: ABN AMRO Group Economics

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