COVID-19: LESSONS FROM CHINA

By Arthur Kroeber

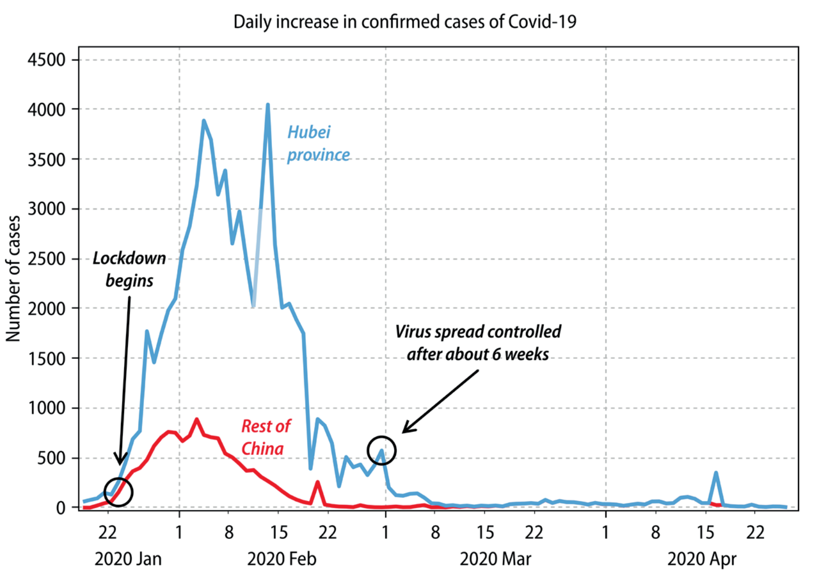
Since January, the Covid-19 epidemic has swept around the world and led governments in Asia, Europe and North America to shut down their economies in varying degrees to control the disease. The outbreak began in China, which showed one of the most successful containment efforts - at very high economic cost. Western countries are following China with a lag of two to three months. What can they learn from China's experience?

The first thing to note is that responses to the epidemic, and success in combating it, do not appear to vary much based on political system. After China put the whole country on virtual lockdown in late January, many analysts (including me) assumed that even if the disease spread to other countries, liberal democracies would not resort to such extreme measures and thus the economic cost of pandemic response would be lower outside China.

This proved wrong. While most countries have not resorted to the same level of individual controls as prevailed in China, they did rapidly decide to shut down most non-essential businesses. As a result, we can reasonably expect that economic activity in the West will broadly follow China's trajectory.

After imposing its lockdown on January 23, China experienced about 5-6 weeks of severe economic hardship, with most high-frequency indicators (such as property purchases, car sales and freight traffic) showing declines of 30-80% from normal levels. At the beginning of March, the focus of government policy began to shift from disease control to economic restart, and most indicators showed sharp recoveries in the following weeks. By early April the economy was operating at roughly 80% of its normal capacity.

Figure 1: China's lockdown controlled the outbreak in about six weeks



Source: Gavekal Data/Macrobond

In the subsequent weeks, though, the recovery began to lose steam. One reason was that the government was very slow to provide monetary and fiscal support. This was because policy makers simply underestimated the depth of the economic damage, and because they were wary of enabling another huge debt build-up, as occurred in the aftermath of the investment stimulus they unleashed in response to the 2008 global financial crisis. Another reason was that, as the country emerged from lockdown, small flare-ups of new cases occurred. Although most of these new cases were imported, local governments in many areas continued to urge caution, and this cut the speed of the return to normal.

But the biggest reason was simply that consumer confidence and the small-business sector suffered severely during the lockdown, and have proved slow to bounce back. Despite rosy government statistics declaring that most businesses were back in operation by early April, independent surveys such as one conducted by the prestigious Tsinghua University found that more than half of small businesses had not re-opened by mid-April. And many of the businesses that have re-opened, are probably earning a fraction of their normal revenues. For instance, restaurants in many cities operate under strict social-distancing rules, which reduce the number of people that can be served at once.

Similarly, consumer confidence has been battered. China's unemployment statistics are notoriously unreliable, but a combination of anecdotal evidence, surveys and extrapolations from other indicators suggest that the impact of the Covid-19 shutdown is likely to be at least as great as that of the 2008 crisis—when about 25 million people, mostly in export industries, lost their jobs—and probably greater.

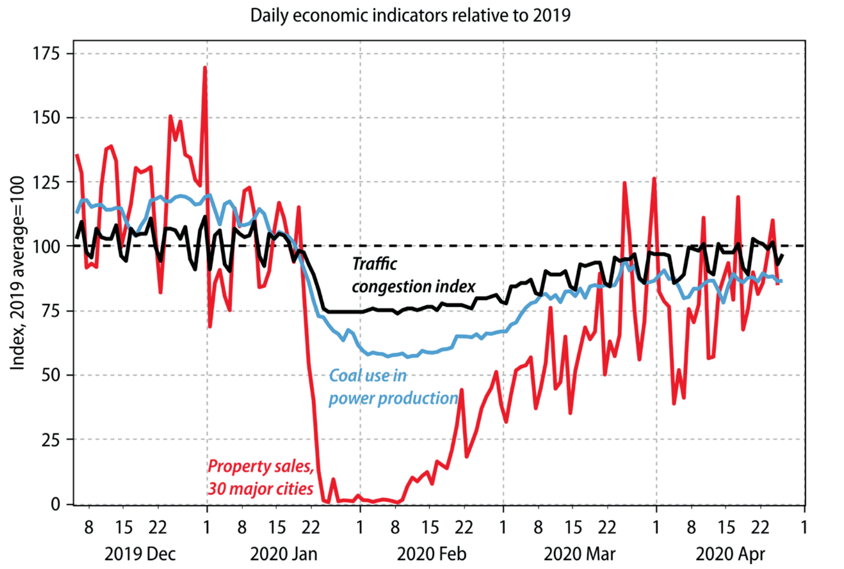
Even those who still have jobs, are more worried about losing them, and have a far dimmer view of their future income growth, than they did before the epidemic. Surveys in April by my colleagues at Gavekal RedTech, who analyze China's internet and consumer sectors, found that half of urban consumers were worried about losing their jobs. A year ago, more than half were expecting salary increases. Today, a majority believe their pay will decline this year.

Although revenues of firms selling necessities (such as groceries) over the internet are holding up nicely, and online education is booming, many other sectors are seeing dramatically reduced demand. Travel and tourism expenditure could fall as much as 60% for the year as a whole, and nearly half of all planned purchases of consumer durables have been canceled or postponed.

Because of the difficulty in restoring confidence among small businesses and consumers, we should expect that the progress of China's economic recovery over the rest of this year will be slow. The government reported that GDP growth fell 6.8% year on year in the first quarter, a figure that tallies with most private-sector estimates. Even with improvement in subsequent quarters, growth for the year as a whole is unlikely to be much more than one or two percent—by far the weakest performance since China began its market-oriented economic reforms in 1979.

Western countries should anticipate a similar trajectory: one really bad one-quarter period, followed by a slow recovery, rather than a sharp V-shaped rebound. It is quite possible that even by the end of the year, most Western economies will be operating at below their pre-epidemic capacity.

Figure 2: Recovery was fast in March but slowed in April



Source: Wind, Gavekal Data/Macrobond

China brought the number of daily new Covid-19 cases down to the single digits after six weeks of very tight social controls. (There are valid doubts about the quality of Chinese data, and there are probably more cases than reported. But the general point that the disease spread has been controlled enough to permit economic reopening, cannot seriously be disputed.) Because social controls are generally less stringent in open Western societies, the disease will probably not be suppressed to the same degree, but daily new cases will probably fall to tolerable levels after about 6-8 weeks of controls.

This implies that for most European countries, which imposed social controls in mid-March, gradual reopenings through May and June are plausible. These re-openings will be staged very carefully, and many activities—such as non-essential long-distance travel, sports events, and people-intensive activities such as conferences—will probably remain severely restricted through the summer, and start resuming in the autumn. The United States is likely to follow the same pattern, state by state, with an average lag of a couple of weeks behind Europe.

In most countries, the biggest headaches will be restoring small-business vitality and consumer confidence. Large companies with big cash reserves and established banking relationships should be able to weather the crisis, or receive government bailouts if they cannot. Small businesses that operate on tight margins and depend on weekly cashflows will find it harder to bounce back.

Household spending is likely to remain anemic. Even if those who have lost jobs get re-employed quickly, they will probably spend a few months paying down debts or adding to their savings, rather than returning to their old consumption habits. China's experience shows that Covid-19 can be contained to a tolerable level with social lockdowns of no more than a month or two. But it also shows that the path to full recovery will be slow and arduous. «

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