Economic Research:

Resilient Domestic Demand Will Alleviate Coronavirus Consequences For Europe

February 12, 2020

Key Takeaways

- The likely loss in Chinese growth this year due to the new coronavirus is likely to shave 0.1% to 0.2% off eurozone and U.K. growth in 2020 via lower exports and business investment.
- The coronavirus poses a risk of disruption to the European value chain, amplified by the current low levels of European inventories. Looking at the direct value-chain links to China, the German economy appears to be the most at risk of disruption.
- The timing of the peak of infections is an important assumption in our assessment. For now, the shock to the European economy is likely to be felt mostly in the first quarter of the year, although tourism expenditures could take more time to recover than goods exports.

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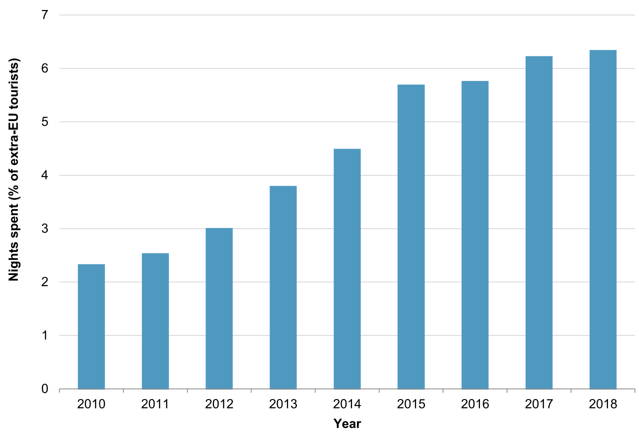
The European economy was not immune to the 2002-2003 outbreak of Severe Acute Respiratory Syndrome (SARS), a close cousin of the new coronavirus. Over the first three months of 2003, eurozone GDP contracted by 0.4%, while exports and business investment contracted for two consecutive quarters. The new coronavirus is likely to spread to the European economy through similar transmission channels--i.e. trade, supply chains, confidence, and financial conditions.

However, the analogy to SARS is limited in three key respects. First, the effect on confidence might be different. Although the coronavirus propagates at a much higher speed, it has only one-third the fatality rate of SARS and the Chinese health-care system has developed. On the other hand, social media has also developed since SARS, making digital disinformation campaigns more likely than ever. Second, the dependency of the European economy on China is more significant today, at approximately three times higher. European goods exports to China now make up 1.5% of GDP (€170 billion) versus 0.4% in 2003. Chinese tourists now account for 6.3% of holiday nights spent by non-Europeans compared with less than 2% back in 2003 (see chart 1). From a value-chain perspective, a significant share of Chinese components and semifinal goods are directly embedded in European production today (see chart 2).

Chart 1

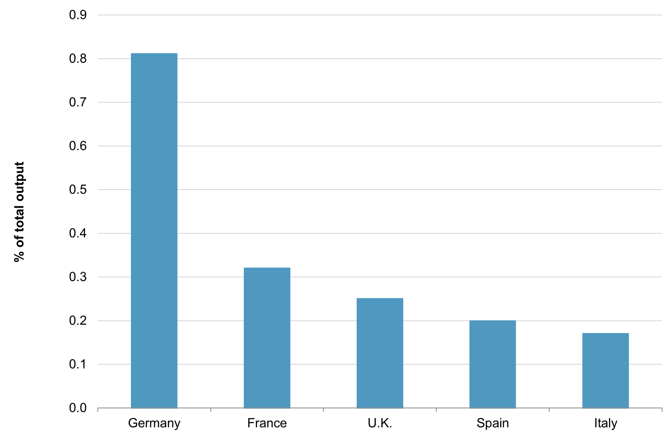
Chinese tourists account for more than 6% of extra-EU tourism
Share of Chinese in EU tourism*



*Hotels; holiday and other short-stay accommodation; camping grounds, recreational vehicle parks and trailer parks. Source: Eurostat, S&P Global Ratings.

Chart 2

Chinese components are directly embedded in European production
% Chinese value added in total output



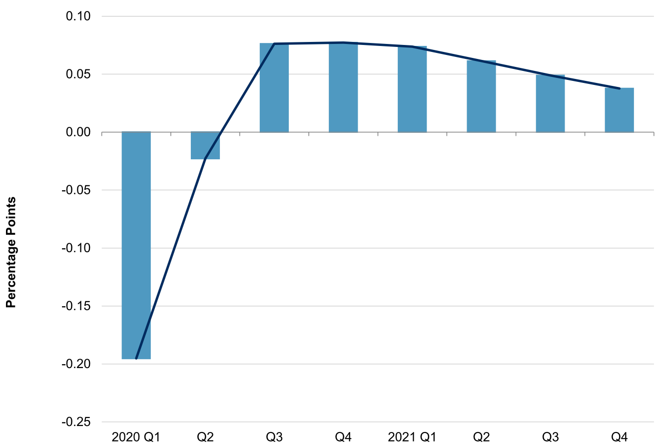
Source: WIOD, S&P Global Ratings.

A third difference from the SARS outbreak is that European domestic demand--especially consumer spending, is much more resilient today than when SARS hit. In 2003, the European economy was still recovering from the dot-com bubble burst that followed the 1994-2000 period of massive growth in the use and adoption of the Internet. Germany was exiting a recession and the unemployment rate was still on the rise across the continent. Today, European unemployment is close to an all-time low. Moreover, by lowering global growth expectations, the coronavirus has weighed on the oil price, which will lend support to households' purchasing power in Europe.

The reduction in Chinese GDP growth that we expect for this year due to the coronavirus, to just 5%, down from 5.7% expected before the outbreak, (see "Coronavirus To Inflict A Large, Temporary Blow To China's Economy") is likely to shave between 0.1 and 0.2 percentage points off eurozone growth. This comes mainly via lower exports of goods and services as well as business investment. First-quarter eurozone growth could come in at around zero instead of +0.2% expected so far. The timing of the peak of infections is an important assumption in our assessment. Should the coronavirus indeed peak in March, as is currently assumed, the shock to the European economy is likely to be felt mostly in the first quarter of the year (see charts 3 and 4), although tourism expenditures could take more time to recover than goods exports. A large share of economic activity hindered by the outbreak of the virus, especially goods production, would just be postponed rather than canceled altogether. If a catch-up effect materializes, the economic outlook for 2021 could even be slightly higher than our current baseline forecast of 1.2%.

Chart 3

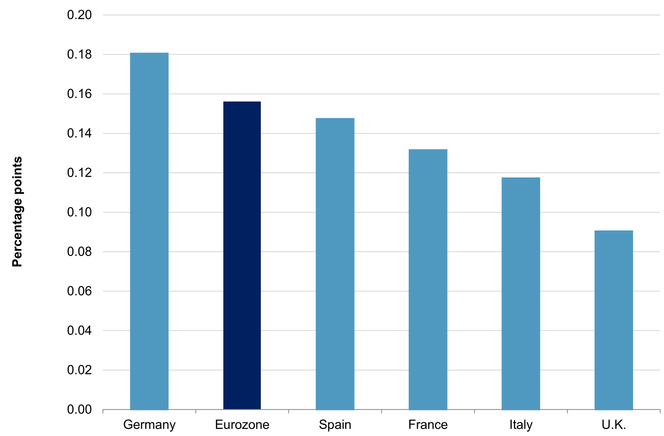
The hit to eurozone growth in Q1 should be followed by a recovery from Q3
Deviation from baseline in quarterly GDP growth due to coronavirus



Source: S&P Global Ratings.

Chart 4

In Europe, The German economy appears most at risk to disruption
GDP growth lost due to the new coronavirus in selected economies



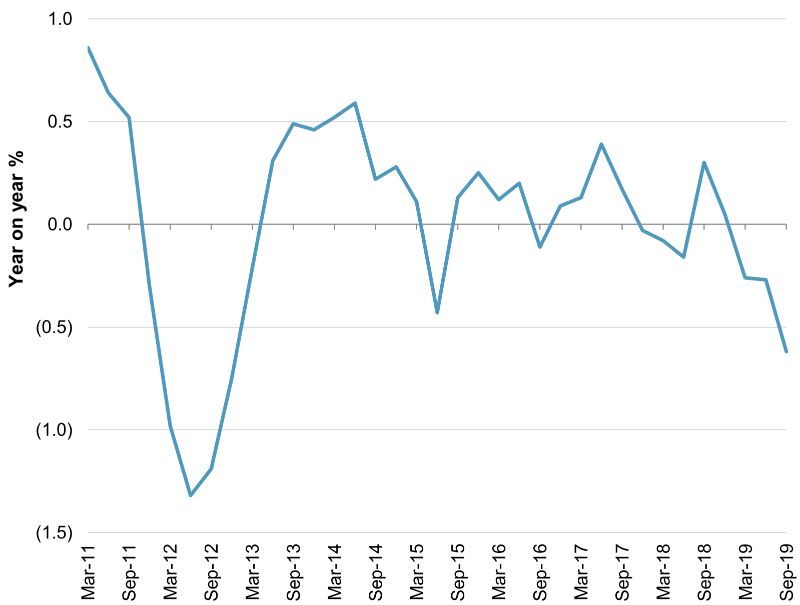
Source: S&P Global Ratings.

The risk of disruption to the European value chain also depends on the timing of the peak of the coronavirus. If the peak comes no later than March, the disruption risk should be relatively contained. At the same time, the risk of disruption is amplified by the currently low levels of European inventories (see chart 5), especially in the car sector, after four consecutive quarters of contraction.

Looking at the direct value-chain links to China, the German economy appears to be the most at risk of disruption (see chart 4). The manufacturing sector and especially the production of computers and electronics, electrical equipment, machinery equipment, and cars are the most exposed (see table 1). The European construction sector also contains a non-negligible portion of Chinese components.

Chart 5

European firms' destocking in 2019 will amplify the impact of the coronavirus
Contribution of inventories to annual GDP growth



Source: Eurostat, S&P Global Ratings.

Table 1

Sectors With The Highest Share Of Intermediary Input From China (As % Of Total Output)

Germany	Computer & electronic	Textiles	Electrical equipment	Furniture; others	Machinery & equipment	Motor vehicles and trailers
	2.65	2.42	2.15	1.70	1.53	0.88
Italy	Computer & electronic	Electrical equipment	Machinery & equipment	Motor vehicles and trailers	Pharmaceuticals	Textiles
	2.54	1.91	1.26	1.06	0.98	0.95
France	Textiles	Computer & electronic	Electrical equipment	Motor vehicles and trailers	Other transport equipment	Furniture; others
	3.04	2.42	2.41	1.66	1.63	1.55
Spain	Textiles	Computer & electronic	Electrical equipment	Motor vehicles and trailers	Pharmaceuticals	Machinery and equipment
	3.47	2.13	1.75	1.39	1.33	1.26
U.K.	Computer & electronic	Electrical equipment	Machinery & equipment	Motor vehicles and trailers	Furniture; others	Telecommunications
	4.33	2.89	1.72	1.72	1.57	1.51

Table 1

Sectors With The Highest Share Of Intermediary Input From China (As % Of Total Output) (cont.)

Source: WIOD, S&P Global Ratings. The table shows the first order link to the Chinese value chain, which gives a sufficient information on the relative risk of disruption faced by European production.

A strong policy response to the coronavirus across Europe seems unnecessary at things stand. However, this could change if we see a bigger shock to public health, economic sentiment, and financial conditions. As regards the latter two kinds of shock, monetary policy would be the first to react. The European Central Bank would likely lower rates further and do anything necessary to maintain ample liquidity in the system. Any fiscal response would depend on the shape of the virus.

We are not yet there today. For now, sentiment indicators are bottoming out and financial conditions--credit spreads and equity markets--do not suggest that the coronavirus will cause a big shock to the European economy. The relatively small hit to growth that we currently expect should be quickly overcome, not least owing to the resilience of domestic demand.

Related Research

- Global Credit Conditions: Coronavirus Casts Shadow Over Credit Outlook, Feb. 11, 2020
- Unless Coronavirus Spreads More Widely, Its Impact On The U.S. Economy Should Be Modest, Feb. 11, 2020
- Coronavirus Impact: Key Takeaways From Our Articles, Feb. 12, 2020
- Coronavirus To Inflict A Large, Temporary Blow To China’s Economy, Feb 7, 2020