Turning crisis into opportunity

Analysis on the Chinese economy and suggestion for companies amid the coronavirus
As the resumption of work has been under way in various places amid the novel coronavirus outbreak, the impact of the outbreak on the national economy and various industries is surfacing. In the short-term, the economy will be significantly affected, and in particular, offline retail, catering, transportation, cultural tourism, manufacturing and other industries are facing severe challenges.

At the meeting of the Standing Committee of the Political Bureau of the CPC Central Committee on 12 February, President Xi Jinping pointed out that it is necessary to coordinate the prevention and control of the outbreak and restore economic and social order, so that the outbreak will meet an "inflection point" soon without causing significant impact on the stability and vitality of China's economy. With the introduction of various government relief policies, relevant industries are expected to recover and rebound when the outbreak eases.

In addition to properly handling ongoing impact of the outbreak, companies should take the time to build a competitive edge in preparation for uncertainties arising from the market that will follow. This will also serve the interests of China's economy by helping it to recover when the turmoil is over.

At present, the infectivity, toxicity, and infection routes of the novel coronavirus are still not entirely clear, and the development of the outbreak remains uncertain. Zhong Nanshan, an epidemiologist and pulmonologist, expects the outbreak to stabilize by the end of April. The strong control measures currently adopted by local governments, as well as the allocation of a large number of medical personnel and supplies, have played a key role in curbing the spread of the outbreak. However, with the resumption of work happening in various places, human flow within and across provinces and cities will certainly continue to rise. In the face of the outbreak, the top priority for companies is to ensure proper prevention and disease control in daily operation to safeguard employees' health and safety.

[1] tv.cctv.com/2020/03/03/ARTIonCkfHscB9FlJsaveRh200303.shtml
The number of infections and deaths in this outbreak has exceeded those of SARS. Combined with China's current stage of economic development and industrial structure being significantly different from 2003, the implications and adverse effects of this outbreak on the economy may be greater.

In 2003, China was in a period of rapid economic growth after joining the WTO. The robust demand from external markets and export growth drove its economy to bottom out in the third quarter of the year, and the annual GDP still grew by 10%, representing an increase of 0.9 percentage points from 2002. China was faced with tougher internal and external economic environments in 2019 than in 2003, with the disappearing demographic dividend and increasing pressure on economic structural transformation and downward pressure on the economy.

Chart 1: Economic growth slowed to 6.1% in 2019

The resumption of normal production in various industries soon after the Chinese New Year helps to stabilize upstream and downstream industrial chains and supply chains and avoid longer-term negative impacts. According to the Survey on Companies’ Capability to Resume Production conducted by the Institute of Sociology of the Chinese Academy of Social Sciences, up to 67.7% of companies cannot afford a two-week delay in resumption; only 7.1% can afford a delay of more than a month; and only 1.7% can afford a delay of more than two months. Among them, private small and micro businesses are hit hardest by the outbreak.

Source: Wind

2 www.ftchinese.com/story/001086221?full=y

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The impact of the outbreak on the economy primarily depends on whether prevention and control measures could achieve significant results in the short term. If the outbreak wanes very soon, the negative impact on the economy may mainly appear in the first quarter. Winning the fight against the outbreak will demonstrate China's economic strength and capabilities in policy formulation and resources mobilizing, thereby strengthening investor confidence at home and abroad. Some of the losses in consumption in the first quarter will be restored in the second quarter; similarly, manufacturing orders and investment decisions after the holiday will not be affected in the long run.

Stabilizing the economy also requires the government to introduce effective policies as soon as possible to meet the urgent needs of companies. However, as Lian Weiliang, Deputy Director of the National Development and Reform Commission, pointed out at a press conference on 3 February, that China’s economic strength, physical infrastructure, and ability to handle emergencies are significantly better than during the SARS epidemic in 2003. It is expected that various ministries and commissions will further introduce measures and guidelines to support economic growth.

In addition, under the strong leadership of the government and with the experience in dealing with SARS, companies are more proactive in tackling the outbreak. For example, many companies have stabilized jobs by “sharing employees”. And by leveraging industry policies, they made arrangements in technical channels in advance to promote integration of multiple businesses. In general, economic growth will inevitably be affected in the short term, but as the outbreak started in early 2020, there will still be considerable room for policies and maneuvers for the government and companies in the next three quarters. It is expected that economic growth will first drop and then recover in the year.
Industries under pressure with continued focus on optimizing the economic structure

Tertiary industry most affected and may slow economic recovery

With regard to the respective characteristics of industries, the tertiary industry is undoubtedly the most affected. As the outbreak reached its peak during the shopping season of the Lunar New Year, the retail, catering, cultural tourism, hotel, transportation and other industries that normally had strong demand during the holiday in previous years may face greater funding and cost pressures due to the dropping demand.

Meanwhile, the economic data before and after the SARS epidemic in 2003 showed that the recovery period of the tertiary industry was relatively long, and it was not until the end of 2003 that the growth rate of the tertiary industry significantly recovered. At present, the tertiary industry accounts for 54% of GDP, much higher than 42% in 2003. And consumption has become the strongest driving force for economic growth for six consecutive years, accounting for 57.8% of the economic growth in 2019. Therefore, the stability of the tertiary industry will directly affect the overall performance of the economy.

Chart 2: Growth rate of three industries pre and post-SARS in 2003

Source: Wind

http://caijing.chinadaily.com.cn/a/202001/22/WS5e28f27a812a3107bb6b579b404.html
Secondary industry susceptible to resumption in the upstream and downstream industry chain

The impact of the outbreak on the secondary industry in the early phase is mainly reflected in the delayed resumption of work and obstructed movement due to control measures. At present, most areas except Hubei province have resumed work. The State Council also issued the Notice on Safeguarding Smooth Highway Transportation to Ensure the Normal Traffic of Personnel and Vehicles on 8 February, requiring the orderly restoration of highway transportation services. However, labor costs may increase due to the relatively strict standards on the resumption of work in various places in response to the outbreak and the barriers for some of the labor force returning to the cities.

If the outbreak is not contained soon, the weakened consumer demand will be escalated, affecting the secondary industry. In particular, issues like labor costs and uneven resumption of work along the upstream and downstream industry chain may lead to problems such as supply chain disruptions and indirectly cause the industry chain to move abroad, which will have a long-term impact on the secondary industry.

Primary industry facing pressure in both distribution and sales

The primary industry is also suffering from dropping demand and obstructed movement. The overstocked agricultural products and blocked sales channels may break the supply-demand relationship in some areas, causing prices to rise. Moreover, given the possible rebound of sales-end demand when the outbreak ends, the prices of major agricultural products may then go up.

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4 www.xinhuanet.com/fortune/2020-02/10/c_1125553187.htm
Industries growth creates opportunities for economic restructuring

The accelerated development of some industries amid the outbreak can help to alleviate the downward pressure on China’s economy in the short term. It may also generate greater demand and market development, and support the optimization and adjustment of the overall economic structure in the long run. On 14 February, President Xi Jinping pointed out at the 12th Meeting of the Central Commission for Comprehensively Deepening Reform that it is necessary to improve the public health service system, optimize the investment structure of medical and health resources, put in place a sound medical insurance and relief system for major diseases, and improve the instant settlement system for nonlocal medical insurance, which will create impetus for the development of relevant industries.

Online retail. During the outbreak, people have relied more on online shopping for all kinds of supplies. Distribution channels have been much busier than ever due to personnel, transportation and other factors, but orders on major e-commerce platforms for fresh food have generally skyrocketed. The popularity of online retail will help make up for the negative impact of the outbreak on consumption, and the proportion of online retail in the total retail sales will continue to increase.

Online entertainment. Online video, games, and fitness and similar online activities have continued to gain popularity. When staying at home, people spend more time online. Meanwhile, some film and television production companies seek to cooperate with mainstream video platforms to mitigate the short-term impact and explore more ways and possibilities for industry chain integration in the future.
Industries growth creates opportunities for economic restructuring

Telecommuting and distance education. Major online telecommuting platforms seize the opportunities brought by delayed resumption of work and classes to boost market share. It is expected that telecommuting, online education and paid knowledge platforms will maintain a growth momentum when the outbreak ends, and drive greater development in areas such as communications and cloud services.

Health care and life health. In addition to the surge in demand for medical supplies to combat the outbreak, the government and companies will also increase investment in drug research and development (R&D), which may accelerate the introduction of foreign original drugs and medical devices and continue to benefit health care and medical industries in the short and medium term. In the long run, it is expected that China will continue to increase investment in public health and medical systems and accelerate the application of new technologies in disease prevention and control, testing and treatment.
Various measures to cope with the outbreak

First, companies should make proper arrangements for the resumption of work and production. In addition to the Notice on Safeguarding Smooth Highway Transportation to Ensure the Normal Traffic of Personnel and Vehicles issued on 8 February, the State Council also issued the Notice on Effectively Strengthening Scientific Prevention and Control of the Outbreak and Orderly Resumption of Work and Production, requiring local governments to prevent and control the outbreak in preparation for labors resuming work and production, and promptly tackle difficulties and problems encountered so as to provide strong support for economic and social stability. The Ministry of Human Resources and Social Security also issued an opinion to actively mobilize employees to return to work.

Industries and companies should accelerate the transition to digital office and employ digital means such as telecommuting if possible to facilitate flexible work arrangements for employees. At present, various developed telecommuting tools can meet the needs of attendance recording, meetings and follow-ups, document management, asynchronous communication and more. With effective integration, digital office will improve corporate operation efficiency in the long run, and also help to foster a flexible, efficient and innovative corporate culture.

Second, companies should comprehensively review and prevent various risks, and focus on improving risk mitigation. Companies should establish a dynamic risk management and internal control system, evaluate the possibility and impact of various risks, and build a complete emergency and risk handling process and capability. In light of the current outbreak, companies may need to focus on the following risks.

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5 www.xinhuanet.com/2020-02/09/c_1125550568.htm
6 www.xinhuanet.com/local/2020-02/07/c_1125544518.htm
► **Policy compliance risks.** Companies should comply with various policy requirements on aspects such as safe production, inspection and quarantine, price control, waste disposal, taxation, employment, compensation and benefits during the outbreak prevention and control. Any noncompliance may lead to penalties such as suspension of business and fines and very unfavorable public opinion. Therefore, companies should collect and sort out relevant laws, regulations and policy papers in a timely manner and seek precise interpretation by the regulatory and legal authorities, while integrating relevant requirements into internal systems and processes, communicating effectively internally, and supervising proper implementation, so as to avoid compliance risks.

► **Foreign trade risks.** On 31 January, the WHO officially declared the outbreak of the novel coronavirus a Public Health Emergency of International Concern (PHEIC). Many countries have taken measures soon afterward to restrict international travel, trade and other activities involving China, which have had a significant impact on many aspects such as foreign trade, business cooperation and exchanges of companies, including direct cancellation of orders, rejection of inbound goods, custom control by importing countries and suspension of business visas. Companies should comprehensively evaluate all factors influencing foreign trade and secure proper safeguards and confirmation records of product safety and employee health so as to enhance confidence of business partners. Meanwhile, they should reduce risks and losses in foreign trade by seeking insurance claims, negotiation, review and revision of contract terms and other means.
► **Supply chain risks.** Many upstream suppliers fail to fully resume work at this stage due to the outbreak. In addition, transportation and logistics have not been fully restored, resulting in a supply shortage of raw materials. Companies do not often have sufficient on-hand inventory to sustain operations. They could, however, start planning multiple supply channels, including location in their selection criteria for suppliers, and optimizing the supplier structure to ensure the supply of raw materials; introduce third-party logistics as appropriate to improve overall transportation capabilities; establish information sharing mechanisms with upstream suppliers and downstream customers to match resources according to market demand and supply capacity and enhance flexibility and resilience of the supply chain, so as to achieve "maximum benefits and minimum risks".

► **Delivery performance risks.** These risks include failure to perform and delay in performance of transactions. In order to reduce the risks of disputes and lawsuits caused by the failure to perform, companies should conduct a comprehensive review of ongoing contracts, evaluate the possibility and impact of the failure to perform contracts, and communicate with the counterparties in a timely fashion. Companies should transform their production and operation practices to accelerate resumption of operation and prevent further losses, while retaining relevant documents and proof that necessary measures have been taken and valid evidence that notification obligations have been fulfilled, and negotiating with customers in accordance with lawful and valid rules such as force majeure or change of circumstances to minimize losses of both parties.
Third, companies should focus on liquidity and conduct financial stress tests. During the outbreak, company productions and operations may get into trouble or even stagnation. It is necessary for them to take stress tests on their financial risks; adjust business plans according to the outbreak; recalculate relevant revenues, costs, cash inflows and outflows; estimate conservatively the number of months their cash flows can sustain before they cross the red line; refine various expenses; and adjust flexibly according to the outbreak and circumstances to review realistic financial risks.

Under the current circumstances, companies should work on both internal and external fronts in managing liquidity. Internally, companies may adjust their business appropriately in the short term, invest more prudently in R&D, training and other areas, evaluate the rationality of inventories, adjust production and procurement plans in a timely manner and reduce production and procurement costs. They should improve the accuracy of cash flow forecast, and use different scenarios and forecast models for capital planning, income and expenditure scheduling. They should keep track and make full use of preferential/subsidy policies introduced by government departments and financial institutions such as loan extensions, and deferral of social insurance and house fund to control corporate cash outflows.

Externally, companies should manage receivables and payables, enhance dispute management, speed up fund recovery, tightly control new accounts receivables, reduce the proportion of credit sales, update customer credit ratings in a timely manner, and reasonably evaluate the speed of payment of credit sales orders and the possibility of bad debts. At the same time, they should encourage customers to shorten the account period through discounts, actively negotiate with suppliers and service providers to extend accounts payable periods, strictly approve payments in accordance with contract payment time and conditions and avoid prepayment, and use acceptance bills, forward bills and other payment methods in combination to reduce cash payments.

In addition, companies should broaden their sources of income through multiple channels. They may consider securing liquidity through financing according to their own circumstances and may also seek financial support of shareholders when necessary.
Fourth, companies should take advantage of government economic policies. The central and local governments issued a number of supportive economic policies involving taxation, treasury, finance, foreign exchange, customs clearance and other aspects since the outbreak.

In terms of tax policies, the Ministry of Finance and the State Administration of Taxation jointly issued the Announcement on Relevant Tax Policies in Support of the Prevention and Control of Novel Coronavirus Pneumonia Outbreak, making it clear that the losses incurred by companies in difficulty-ridden industries in 2020 may be carried forward for up to eight years instead of five, thereby reducing tax burdens. In addition, companies related to outbreak prevention and control are given preferential treatments on corporate income tax, turnover tax and surcharges. For example, companies producing key supplies for outbreak prevention and control are entitled to preferential policies on the pre-tax deduction on corporate income tax and the full refund of incremental value-added tax retained. To support outbreak prevention and control, taxpayers providing transportation services for key supplies, public transportation services, daily living services, and courier services delivering essential daily supplies to residents are exempt from value-added tax and surcharges on income.

7 www.chinatax.gov.cn/chinatax/n810341/n810755/c5143593/content.html
In terms of monetary policies, the People's Bank of China, the Ministry of Finance, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, the State Administration of Foreign Exchange and other departments jointly issued 30 financial measures\(^8\), stating that: the corporate borrowing limit of foreign debt may be cancelled if necessary; companies may apply for registration of foreign debts online; credit support will be provided in key areas such as manufacturing, small and micro businesses, and private businesses; and relevant rents and interest for financial leasing businesses will be deferred or reduced. After the introduction of the 30 measures, the People's Bank of China immediately announced reverse repo operations in the amount of RMB 1.2 trillion to ensure ample liquidity supply\(^9\).

In terms of fiscal policies, the Ministry of Finance has issued a new local government debt limit of RMB 848 billion in 2020 in advance, plus a special debt of RMB 1 trillion previously issued to support the tax and charges reduction of small and medium-sized businesses and transfer payments to outbreak-affected areas, bringing the new local government debt limit in 2020 to a total of RMB 1,848 billion. The fiscal deficit may exceed the conventional limit of 3% of GDP this year.

\(^8\) Notice on Further Strengthening Financial Support to Prevent and Control the Outbreak of Novel Coronavirus (Yinfa No. [2020] 29)


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Faced with the challenge of the outbreak, companies should innovate their businesses, plan ahead, improve risk management and emergency response mechanisms, focus on opportunities and long-term development when the outbreak ends, and develop corresponding strategies in time for changes. After this outbreak, the outlook of China's economy and companies is expected to be positive. More in-depth insights on how industries may tackle the outbreak will be coming, stay tuned.