



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

February 2020

PRIME MINISTER

Economic impacts of Covid-19 (Coronavirus)

As you know a huge amount of work is going on across Government on our response to the Covid-19 outbreak. I commend this work and The Treasury will continue to talk with departments to ensure they have appropriate budget cover on coronavirus pressures. Public health is our first concern in such a situation. But there are also economic implications of the outbreak. This letter serves to outline what HM Treasury sees as the key risks to the UK economy stemming from Covid-19 and what our next steps in better understanding these are.

Risks to the global economy

As the origin of the outbreak, China is likely to be the hardest hit economically in the short term. Actions to control the outbreak to date are almost certainly detracting from economic output. It is difficult to assess the magnitude of this precisely, and it will be several months before we can start to form a reliable picture. External estimates of the impact (on the assumption the outbreak is largely contained in Q1) is for growth to be in the range of 0.1 to 1.5ppt lower. Containment this quarter is by no means assured, however, not least because of concerns about the reliability of the data on the caseload. A 1.5 to 2 ppt impact appears more plausible. Longer term, the negative economic impacts of the virus could exacerbate structural vulnerabilities in the Chinese financial sector, which has seen an increase in low-quality private debt levels. As the world's second largest economy, largest global trader and largest contributor to global growth, China's economic performance matters to the global economy. Even without a substantial global outbreak, a slowdown in China will impact global and, as an open economy, UK growth.

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However, if the virus is not contained in China then there would be wider impacts. In this case efforts to contain the international spread of the disease (both those led by authorities and changing consumer patterns due to risk aversion) would hurt global economic flows. Many of the main transmission vectors also have economic benefits, for example tourism and international flights. Global confidence is also likely to fall as the rate of increase in the outbreak escalates, amplifying the direct impacts.

Financial markets

The Covid-19 has the potential to affect both the UK and global financial system. The effects on financial stability are limited for now but will ultimately depend on the prevalence of the disease. The Financial Policy Committee recently judged that the UK banking system would be resilient against deep simultaneous recessions in the UK and global economies, including China and Hong Kong. This tested scenarios with more severe economic shocks in China and Hong Kong than current worst-case estimates of Covid-19 impacts on China and Hong Kong.

Financial market reactions have fluctuated, tracking news flows on the spread of the virus and mitigating actions taken by the authorities. Market activity has concentrated on China and Asian markets, whereas developed financial markets have seen relatively muted impact. Global stocks fell initially, with the Shanghai Composite Index losing 10.7% and the S&P 500 down by 2.4% between 20 January and 3 February, as investors moved into safe assets such as government bonds. Commodities, sensitive to Chinese demand, also fell, with the Brent crude oil price down by 16% to \$54.5 per barrel. Since February, equity markets have partially recovered amid expectations for stimulus from the Chinese authorities and optimism (potentially misplaced) that the spread of the virus may be slowing. The Shanghai Composite has recovered 5.2% and European and US stocks have rallied to reach record highs.

While UK financial markets have followed global sentiment, Covid-19 has not been the main driver of market moves domestically. I will be monitoring financial markets closely for any change to this. We should avoid increasing



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levels of concern in the markets without good evidence of the impacts of the virus.

Potential risks to the UK economy

Assuming the outbreak is largely contained in China, the economic impact from the outbreak will largely be from a slowdown in China and could be in the range of 0.1–0.2 ppts. However, the impact of an outbreak of Covid-19 on the UK economy is highly uncertain: the infection and mortality rates, persistence of an outbreak and measures to prevent the spread would all have direct effects on economic activity through hours worked. For instance, closing schools to limit transmission between children would affect parents' ability to attend work. Indirectly, there could be effects through supply-chains, within the UK and with other countries, and via confidence.

Initial Treasury analysis, based on the assumed reasonable worst-case scenario (RWCS) of a UK pandemic flu outbreak where 50% of the UK workforce are infected, there is a 2.5% mortality rate and a duration of 4 months, suggests GDP could be between 1% and 2.5% lower by 2021 compared to current expectations. Growth would be lower as the caseload rises and then as life returns to normal some of the lost economic activity would be expected to be made up. These estimates are highly uncertain: if the infection rate is higher or lower, duration longer or shorter, or the measures to prevent transmission more or less restrictive than the RWCS planning, the hit to hours worked and GDP would change directly. It also does not factor in that other countries may well be facing similar economic impacts from the outbreak. With little data or precedent, the wider effects from confidence or supply chains provide further uncertainty around any direct estimate.

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[Implications and] Next steps

[Dealing with unexpected events like this illustrates why maintaining fiscal space within a credible framework is important. My new fiscal framework allows for this by providing flexibility to fund time-limited short-term pressures such as this.]

Building on WHO/DH's analysis of the spread of the virus, HMT will continue to work with Cabinet Office, FCO, BEIS, DFID, DIT and other departments to monitor and analyse the economic impacts and risks of the outbreak. As the medical picture evolves and markets respond, I will continue to update you on the likely economic impacts.

[LEAVE THE BELOW 4 LINES EMPTY]
[DO NOT INCLUDE CLOSING ARTICLE]

SAJID JAVID

CC: Sir Mark Sedwill (Cabinet Secretary)