CAPITAL ECONOMICS

GLOBAL ECONOMICS UPDATE

First thoughts on B.1.1.529

- **It goes without saying that it's still too early to say exactly how big a threat the new B.1.1.529 strain poses to the global economy. We'll have more to say as the picture becomes clearer, but in the first instance there are three points worth making.**
- **First, the lesson from Delta is that it's very hard to stop the spread of virulent new variants**. Several countries (including the UK) have already imposed restrictions on travel to and from Southern Africa, where the B.1.1.529 strain first emerged. Others are likely to follow suit.
- But this probably won't prevent it spreading to other countries, particularly if it's as contagious as currently feared. Two cases have already been found in Hong Kong and another in Israel. For countries where vaccine coverage is still low, the key issue is whether the new strain is more transmissible and more likely to result in severe illness or death. In most places, though, the key issue is the extent to which this new strain can escape vaccines. These are questions for scientists rather than economists and we may not know the answer for several weeks.
- **Second, the lesson from the past couple of years is that it's the restrictions that are imposed in response to the virus – rather than the virus itself – that causes the bulk of the economic damage.** So, the key question is how governments will respond in the event that the B.1.1.529 strain spreads. That in turn will hinge on the extent to which it escapes the vaccines and, importantly, causes strains in national healthcare systems.
- However, this point notwithstanding, different approaches to managing the virus are starting to emerge. In the UK and the US, governments have shifted a bit more towards an approach of "learning to live with the virus". This means the bar for imposing severe restrictions on activity is probably higher than in Europe, where governments are already adopting new measures in response to a spike in the Delta variant.
- **Meanwhile, the arrival of B.1.1.529 in China would probably cause Beijing to double-down on its "zero COVID" strategy.** That would mean localised lockdowns as outbreaks emerge, tighter restrictions on regional travel and a greater likelihood of port shutdowns. China has proved adept at managing outbreaks, but the long-run economic costs will mount if highly-transmissible strains are endemic globally.
- **The final point to make is that the global economic backdrop is very different now than in previous waves of the virus.** Supply chains are already stretched. A virus-related surge in goods spending, or port closures, would exacerbate existing supply strains and add upward pressure to goods inflation. Likewise, a new, more dangerous, virus wave could cause some workers to temporarily exit the workforce, and deter others from returning, making current labour shortages worse. (Clients can track shortages on our dashboard, here.)
- **All of this will complicate the policy response.** At the margin, the threat of a new, more serious, variant of the virus may be a reason for central banks to postpone plans to raise interest rates until the picture becomes clearer. The key dates are 15th December, when the Fed meets, and the 16th December, when several central banks, including the BoE and ECB, meet. But unless a new wave causes widespread and significant damage to economic activity, it may not prevent some central banks from lifting interest rates next year.
- As for markets, risky assets and bond yields have fallen sharply. Sectors and countries most exposed to the pandemic (tourism, energy etc.) have been hit hardest. We expect those patterns to persist in the near term as investors digest the implications of the new variant. In particular, short-term interest rate expectations in the US and several other major DMs had risen considerably over the past two months. **In our view, they looked somewhat overdone even before today's news, and there is ample scope for a further drop in yields, especially at the short end of the curve.**
- Oil prices are also down sharply today, reflecting the fear that the new variant will lead to widespread travel restrictions and lower oil demand. **OPEC+ are set to meet next week and these demand concerns could prompt them to delay or halt their planned gradual increase in supply.**

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