MACRO RESEARCH

A Close VIEW

Will the Delta Variant Derail the Economic Recovery?

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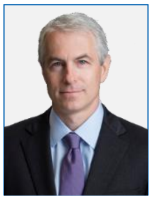

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Probably not. Growth will likely moderate in major economies, but progress in vaccination campaigns and more effective treatments reduce the odds of a return to lockdowns and a more pronounced slowing in economic activity.

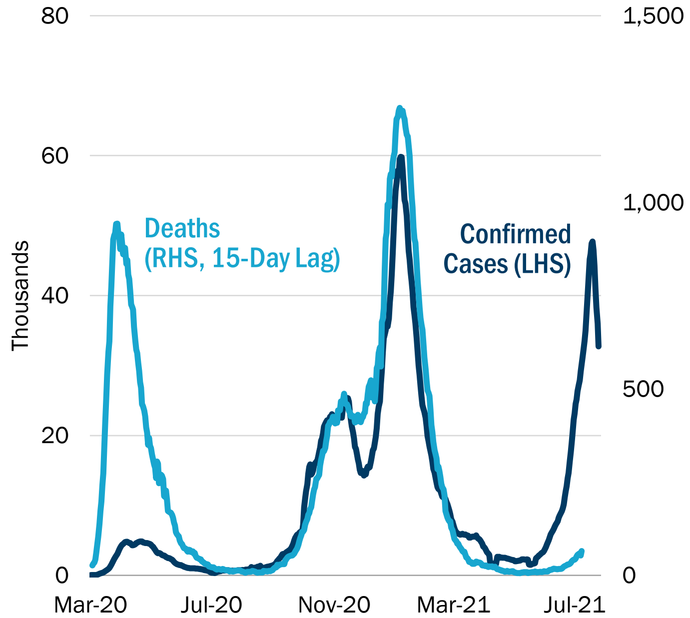
Market concerns are increasingly focused on the potential economic impact of the Delta variant of COVID-19, and for good reason. The rollout of several highly effective vaccines earlier this year fed hopes of a rapid reopening of the global economy, but this optimism has collided recently with the reality of a new, highly transmissible variant of the virus. Over the past month, global confirmed cases are again rising, even in countries with relatively high vaccination rates.

New variants of COVID-19 are likely to exact a significant toll in terms of mortality and overall hardship until vaccination becomes widespread globally. But the economic impact should be relatively small. Growth could slow in many countries as consumers pull back on activities outside the home and labor supply termporarily declines. But new variants and a rebound in COVID 19 cases around the world are unlikely to halt the global economic expansion underway, for several reasons.

Most importantly, even if vaccines exhibit reduced efficacy against new variants, early evidence suggests they are highly effective at preventing severe illness and death. In the UK, where vaccination rates are relatively high, the number of new cases began to rise in early June, but the number of deaths has not increased meaningfully (Figure 1). If hospitalization and mortality rates remain low, countries with high vaccination rates are unlikely to impose restrictions on business and household activity that would lead to a significant slowdown in growth. Individuals, too, may also incorporate news on better outcomes for the infected into their decisions to engage in activities outside the safety of home. And news that vaccines reduce the severity of COVID cases resulting from new variants may prompt more individuals to sign up to be vaccinated.

An important exception to this central case, however, is emerging Asia, where vaccinations rates remain low and

FIGURE 1: DAILY CONFIRMED COVID CASES AND DEATHS IN THE UNITED KINGDOM



Source: Bloomberg.

authorities have been more willing to re-impose restrictions. Countries in the region are therefore likely to experience a more meaningful loss of economic momentum, at least through the third quarter, and until vaccination rates pick up substantially.

In addition to the positive news on vaccines, accommodative monetary and fiscal policy continues to support the global economic recovery, with policymakers still in “whatever it takes” mode. In China, for example, the central bank recently cut banks’ reserve requirements, in a pre-emptive effort to promote lending and safeguard growth. This is a telling indication of the central bank's attentiveness to downside risks, given that until recently, Chinese officials were intent on normalizing policy. Even those central banks in advanced economies that have moved towards withdrawing accommodation, such as the Norges Bank, the Reserve Bank of New Zealand and the Bank of Canada, are taking measured steps that indicate they are willing to reverse course if risks to growth materialize. Finally, Jerome Powell and other core Federal Open Market Committee members have stressed their patient approach to assessing whether the recent increase in inflation will prove transitory. Inflation risks may be somewhat greater than the Committee anticipated at the beginning of the year, but the Committee still plans to wait until the economy is back at maximum employment before contemplating a first rate hike.

Reduced fiscal stimulus may be a drag on growth in many countries this year, but in some cases, such as the euro area and the US, the drag may be less than anticipated. In the euro area, disbursements from the EU recovery fund are just getting under way. In the US, where the impact from household stimulus checks and enhanced unemployment insurance benefits is fading, other provisions of the spring-time American Rescue Plan are kicking in. Close to 40 million households, with approximately 88 percent of all children in the country, received the first installment of the new child tax credit in July, and most states, local governments, and school districts have yet to spend the bulk of federal funds received.[1]

None of this is meant to suggest an insignificant human toll associated with new, highly transmissible variants of Covid. Nor is meant to deny that surging new cases will be a drag on growth in many countries, largely due to reduced household consumption and constraints on labor supply. But progress in vaccination campaigns and more effective treatments reduce the odds of a return to lockdowns that would derail the economic recovery.

More broadly, the prevalence of new variants highlights an uncomfortable reality. Sustaining a global economic recovery will require significant progress in vaccination rates around the world. Until that occurs, expect an uneven and halting recovery, marked by sluggish spending on services, continued capacity constraints, inflation pressures, and widening income inequality. And the longer it takes to achieve high rates of vaccination in both advanced and emerging economies, the greater the odds of longer-term economic damage.

[1] "IRS, Treasury announce families of 88 percent of children in the U.S. to automatically receive monthly payment of refundable Child Tax Credit," IRS, May 17 2021.