EDITORIAL

ANNOUNCEMENT OF VACCINE CUTS TAIL RISK

The announcement that a Covid-19 vaccine that is under development is highly effective caused major reactions in financial markets, reflecting a feeling that the growth outlook has changed. The prospect of a vaccine offers hope that in the medium run activity will normalise, but the positive impact on growth will take time to materialise. Clearly, the view that better times are ahead of us very much depends on the horizon one takes. However, decisions of households and businesses not only depend on expected growth of income and profits but also on the distribution around the growth forecast. The prospect of a vaccine reduces the probability of very negative outcomes and this reduction in uncertainty should eventually contribute to a pick-up in growth.

The announcement that a Covid-19 vaccine that is under development is highly effective caused a big jump in equity indices and bond yields as well as spectacular increases in the share price of certain companies whose business had been severely impacted by the pandemic. These reactions are, at least in part, explained by a view that the news of a vaccine has profound implications for the economic outlook. Comments of specialists that other vaccines are also nearing completion have reinforced the impact of the message. In the absence of a vaccine, it seems likely that the stop-start recovery – with a succession of lockdown–induced contractions and short-lived recoveries – would continue. This would increasingly weigh on the longer-term outlook due to rising corporate bankruptcies and unemployment, and persistent uncertainty. Compared to this very negative scenario, the prospect of a vaccine offers hope that activity will normalise in the medium run.

But what about the near-term consequences? Looking at 2021, the effect of a Covid-19 vaccine on the economy crucially depends on its medical effectiveness and the public acceptance. This also involves ethical choices, such as who will first benefit from the vaccine, will vaccination be free, and will the poorer countries have access. When distribution starts also plays a key role[1]. Quite likely, distribution is still months away and will be gradual both within a given country and in terms of geographical reach. For these reasons, the positive impact on growth may take time to materialise and in the near term, newspaper headlines will remain dominated by lockdowns in many European countries and the rapid increase of new infections in the US.

Clearly, the view that better times are ahead of us very much depends on the horizon one takes. However, decisions of households and businesses not only depend on expected growth of income and profits but also on the distribution around the growth forecast. The range of possible outcomes may be wide, which will weigh on the confidence in a given forecast. It can also be skewed, with a dominance of downside risk. The extreme end of the distribution – the tail risk - may be particularly fat, implying that very negative outcomes have a high probability. That is where the announcement of a vaccine is particularly important. Although the positive impact on GDP growth will probably be slow to materialise, the change in the statistical distribution should occur more quickly because it is based on a re-assessment of all potential outcomes. The prospect of a vaccine reduces the probability of very negative outcomes and squeezes the left tail of the distribution. Administering a vaccine will increase the resilience of the economy whereas a succession of stop-start cycles and their detrimental longer-term consequences, should be avoided, etc. It implies that uncertainty about the path of activity next year and thereafter is now lower than before[2]. This is particularly important for corporate investments, which represent an irreversible long-term commitment of financial resources of a company[3]. As a consequence, profitable companies with a good balance sheet will be more easily inclined to step up their investments when uncertainty has declined sufficiently. This in turn should have spillover effects to other sectors, including the labour market. Such a development is very much important for those households that have accumulated forced savings during the lockdowns. Increased confidence in the outlook would push them to step up their spending. The reduction in uncertainty should eventually contribute to a pick-up in growth.

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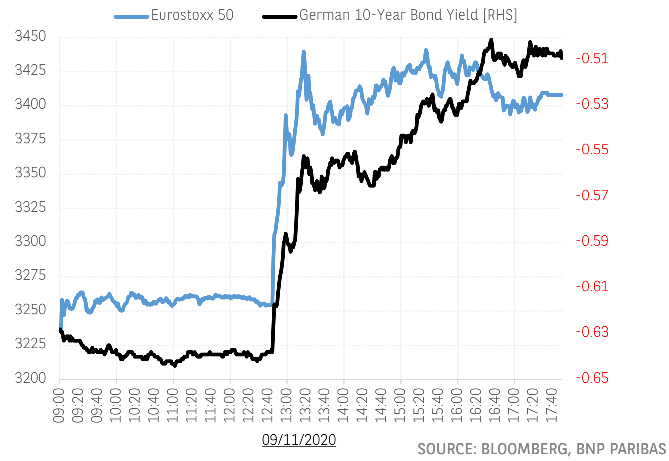
1. Hence, rather than speaking about the economic impact of a vaccine, we should focus on the time-weighted economic impact.

EUROSTOXX 50 & GERMAN 10-YEAR BOND YIELD



SOURCE: BLOOMBERG, BNP PARIBAS

2. Research shows that a rise in uncertainty significantly increases the downside risk to growth and is also associated with a left-skewed distribution of future growth. A reduction in uncertainty has the opposite effect. However, the economic response is highly asymmetric: it is higher to an increase in uncertainty than to a decline. Source: Uncertainty and Growth Disasters, Boyan Jovanovic and Sai Ma, NBER Working Paper No. 28024, October 2020

3. Irreversible because most projects, once started, cannot be stopped or scaled back. This is a key difference between gross fixed capital formation and financial investments. For the latter, transaction costs are low and an investment can be easily reduced or even sold.

> Although the positive impact on GDP growth of a vaccine will probably be slow to materialise, the change in the statistical distribution should occur more quickly.