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EXOGENOUS SHOCKS AND AFRICAN REGIONAL ORGANISATIONS: FROM REACTION TO PREVENTION

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Historically, the world’s economy has been marked by numerous shocks. Indeed, since 1929, the global economy has had to deal with numerous shocks at various times and of varying magnitude.

Over the last three years (2007-2009), African nations, most of which are low-income countries, have had to deal with a series of successive shocks, originating primarily from outside their borders. Their economies are fragile and extremely vulnerable to such exogenous shocks, which have a significant impact on their economic performance.

An exogenous shock can be defined as an externally originating event which has considerable adverse effects on the economy, and which is beyond government control. It may be due to a fall in commodity prices, including oil, natural disasters, or even trade disruptions following a conflict or crisis in neighbouring countries.

Exogenous shocks are to a large extent unexpected and the impact they generate is usually outside of market expectations. There are several types of shocks: exogenous or endogenous in relation to a country or a group of countries. Some affect demand, others supply, while others still, impact both supply and demand. Their effects on economic activity can be temporary or more lasting depending on the vulnerability of the given countries, and they can affect virtually all sectors of the economy.

The issue of exogenous shocks and their impact on African countries highlights the economic vulnerability of those States. We can still remember (i) the food crisis generated by the spike in commodity food prices, which plunged some of the world's poorest regions into crisis, leading to political instability and rioting in several African countries; (ii) the energy crisis which caused a sharp increase in the price of crude oil and resulted in an average price of over US$147 a barrel in July 2008; (iii) the economic and financial crisis that led to a collapse in the price of commodities, of which African countries are major producers, as well as budget and balance of payment deficits; (iv) the climate crisis due to climate change that is impacting several economic sectors (primary, economic infrastructures, tourism, health, IDE).

Three elements contribute to countries being vulnerable and susceptible to the effects of shocks: i) scale of the shock; ii) degree of exposure to shocks; and iii) resilience or ability to react to shocks.

Several questions come to mind with regard to the susceptibility of African countries, and ACP countries in general, to exogenous shocks: What can African regional organisations do to build their capacities to prevent and react to exogenous shocks and how do they go about doing this? How do states react when hit by shocks? In what way can the ACP-EU Partnership contribute to mitigating the impact of shocks?

Before attempting to provide answers to these questions, which all have to do with measures to be taken against exogenous shocks at both the national and international levels, I should perhaps give you an idea of the scale of exogenous shocks in African countries and the degree to which these countries are exposed.

1. Exogenous shocks in African countries: scale and exposure

The exogenous shocks that African countries most often face derive from natural disasters such as floods, drought and earthquakes, as well as from conflicts and significant fluctuations in export and import prices. Whatever the origin, such shocks are a major source of vulnerability in African countries. Whereas natural disasters and conflicts destroy physical and human capital stock and cause a decline in revenues and production, fluctuations in export and import prices reduce public and private sector revenues.

Other types of exogenous shocks, in particular conflicts in a neighbouring country, can come at a high cost to the countries in a region. The impact of the Côte d'Ivoire crisis on Burkina Faso and Mali in 2000 can be cited as an example.

According to econometric analyses, there is a strong link between exogenous shocks and macroeconomic variables. Indeed, in addition to the destruction of capital and loss of earnings, exogenous shocks can have indirect consequences on an economy including a decrease in production and investment, macroeconomic imbalances, and deterioration of public debt indicators.

African countries appear to be extremely vulnerable to the effects of exogenous shocks which often have a higher incidence than in other categories of countries. Indeed, shocks tend to affect poor countries more severely and with deeper consequences than other developing countries. Indeed, the recent earthquakes in Haiti and Chile provide a good illustration of the disproportionate nature of the impact of such shocks on different categories of countries. While Haiti recorded upwards of 200,000 dead, Chile reported a death toll of about 300 for a natural disaster of the same magnitude.

Now, the economic vulnerability of African countries, in particular, and developing countries in general, is not a new subject. In many economic reports, the problem of instability, especially in the area of commodity exports and international prices, and the lack of production diversification have always occupied an important place in the analysis of problems caused by shocks. More recently, the vulnerability of developing countries has again become one of the priorities on the international agenda. Not only has the global economy remained unstable, but new aspects and new consequences of that instability have also emerged.

Developing countries, however, are still unable or less able to protect themselves by constituting reserve funds or by consolidating their public revenues. Market insurances are often costly and therefore inaccessible and cannot be considered as alternatives.

2. Capacity of African States and Regional Economic Communities to cope with exogenous shocks

African States

The best way for a country to reduce the vulnerability of its economy to the negative effects of exogenous shocks is to reform its economic policy, adapt its budgetary and monetary policy, and adopt measures that would enable it to mitigate the effects of shocks when they occur.

Some of these measures include:

- encouraging production diversification (market liberalisation and private sector development, for example);

- building social safety nets;

- constituting financial reserves or purchasing formal insurance;

- adopting and applying an appropriate construction code that can limit the immediate effects of shocks.

However, all these measures are costly, especially for low-income countries, and some of them, such as production diversification and financial market development are long-term undertakings.

Similarly, low-income countries have not been able to benefit from insurances and other risk management mechanisms notably because the weakness of the financial markets makes their access to the international insurance markets difficult. A substantial portion of the total losses suffered by low-income countries following natural disasters is generally not insured and therefore cannot be offset.

In the absence of preventive and compensatory measures, the available resources, which are moreover inadequate, are no longer likely to be used to finance long-term investments (education, health, infrastructure, etc.), but instead to cushion the effects of shocks. When deciding to adopt preventive measures, countries must therefore compare their cost with that of the after-effects of shocks, particularly in relation to the frequency and extent of the shocks.

- **African Regional Economic Communities**

In the face of exogenous shocks and the extreme vulnerability of the African economies, African regional economic communities are beginning to integrate these problems into their policy programmes.

Among the mechanisms that can be mentioned in this regard is the African Union and ECOWAS Council for Peace and Security, which assists in the prevention and resolution of conflicts in Africa.

Mention can also be made of the African Regional Strategy for Disaster Risk Reduction. The strategy aims to foster sustainable development and to help eradicate poverty by including disaster risk reduction as a factor in development. Based on the institutions and programmes in African States and Regional Economic Communities, the strategy will focus on both natural and man-made disasters.

In addition, the African Development Bank (AfDB) is increasingly investing in vulnerability reduction strategies.

In the face of the gravity of the economic and financial crisis, the AfDB adopted a policy paper entitled “Bank’s Response to the Economic Impact of the Financial Crisis”. The Response comprises four initiatives to be considered together:

- An Emergency Liquidity Facility with a budget of 1.5 billion;
- A Trade Finance Initiative with a total budget of 1billion dollars ;
- A Framework for Accelerated Resource Transfer of African Development Fund (ADF) Resources to eligible countries;
- Enhanced Policy Advisory Support.

In the same vein, in order to deal with and reduce the impact of climate change, the Bank has developed two strategies:

- The Climate Risk Management and Adaptation Strategy which aims to (i) help African countries to build their capacities to respond effectively with the risks, threats and opportunities associated with climate change and (ii) ensure that the operational investments of the Banking Group achieve the expected development outcome.

- The Clean Energy Investment Framework aimed at promoting access to clean energy.

A framework for the implementation of the two strategies is being prepared.

Although these initiatives for dealing with exogenous shocks are to be encouraged, they are still quite recent (2008-2009) and it is still too early to fully assess their implementation or effectiveness. In fact, as a policy and strategy to reduce vulnerability to exogenous shocks, these initiatives, still at the embryonic stage, are inadequate and not holistic in nature.

3. What action can the International Community take to address exogenous shocks?

The International Community can supplement the efforts made by the national authorities and African regional economic communities to cope with exogenous shocks. Concessional external aid can help mitigate the effects of exogenous shocks, provided it is promptly provided.

In the short term, this type of aid may stem any further fall in revenue, consumption and investment and so ensure that the direct effect of a shock does not curtail growth and worsen the poverty situation. However, in addition to providing aid, the International Community should also concentrate its efforts on building the capacities of African States and African regional economic communities.

Donors and international financial institutions already provide foreign aid to countries suffering all forms of external shocks: grants or loans, financial aid or other tangible resources through various channels and mechanisms.

In this regard we can cite the IMF Facility for protection against exogenous shocks which provides economic policy support and financial aid for low-income countries suffering the effects of external shocks.

The Director-General of the World Bank has called for the creation of a Vulnerability Fund to which each developed country would contribute 0.7% of its Economic Stimulus Plan. This Fund would help to finance social protection programmes, investments for infrastructure and support for SMEs and micro-finance institutions.

Before concluding, I would like to touch on the European Union’s support within the framework of ACP-EU cooperation, in the event of exogenous shocks. I will cite just one example which I consider important. The Cotonou Agreement provides for a financing mechanism in the event of short-term fluctuations in export earnings. The mechanism intervenes to provide additional financial support when an ACP country records a 10% loss in earnings from the export of goods or agricultural or mining products and a 2% worsening of its budget deficit.

In the face of the economic and financial crisis whose impact exceeds export earnings, the compensatory mechanism, such as it exists, has proved inadequate. To more effectively counter the effects of the crisis in the ACP countries, the European Commission has put in place a new compensatory financial instrument called “Vulnerability FLEX”. This is a new short-term financing mechanism for providing, on the basis of specific criteria, additional aid in the form of grants, to attenuate the impact of the crisis, especially its potential social repercussions in the most affected ACP countries with limited domestic response capacity. The Vulnerability FLEX, wider in scope than the existing FLEX Mechanism, appears to be more adapted to the challenges posed by the current crisis. A study is being conducted and its conclusions should facilitate the creation of an institutional mechanism and a model compensatory financial mechanism for dealing with situations of exogenous shocks.

Other intervention mechanisms exist for dealing with other types of exogenous shocks, namely natural disasters and conflict situations. I would like to point out that in future, additional resources will be allocated to ACP regional organizations in the framework of the revision of the Cotonou Agreement to strengthen the regions' capacity to deal with certain types of exogenous shocks.

Exogenous shocks are most often unexpected or unpredictable events. By their nature and from experience, it is clear that countries will always be confronted by these events. On the other hand, countries' vulnerability to shocks can be reduced. In the final analysis, the most important asset for dealing with the effects of exogenous shocks is resilience, i.e. the political and institutional capacity to resist and deal with increasingly frequent shocks. Resilience, however, depends on policies.

It is at this level that states must adapt and enhance their capacity to respond to exogenous shocks through the implementation of appropriate policies and mechanisms.

The response capacity of African regional economic communities is still limited, if not inexistent. Promotional and capacity-building programmes are useful and necessary to reduce the high vulnerability of African States to exogenous shocks, which constitute major challenges to their development. At the level of the international organizations, the development of coordinated mechanisms for the rapid disbursement of aid and financial compensation would make it possible to respond to the most urgent needs and safeguard the macro-economic balance required for economic reconstruction following exogenous shocks.

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