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The Asian Tsunami: Economic impacts and implications for aid and aid architecture

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With the benefit of just a little distance from the immediate impact of the tsunami on 26 December, some important points are becoming clear about the economic impacts and the wider implications for aid and aid architecture.

First, the response by the international community has been extraordinary, but the countries affected will bear the main financial costs of the tragedy, as well as the social and psychological costs. This is most evidently true for India, which refused international assistance, but even for the worst-affected country, Indonesia. It is fortunate that none of the countries affected, with the exception of Somalia, is among the world's poorest, and that all in the Indian Ocean were experiencing strong growth. Most of the countries affected are middle income or close to it: Thailand, for example, has a per capita income of over $2000 a year, compared to perhaps $100 for Somalia. By the same token, most of the food, water and other relief supplies can and have been purchased locally in these relatively well-developed and well-provisioned economies.

Second, the individual and community consequences are terrible to consider, but in most cases the national level consequences are unlikely to be severe or long-lasting. In the case of India, for example, the impact is estimated at 0.07% of GDP. The figure will be higher in Sri Lanka and, specially, the Maldives, but even in these cases, the costs will be offset by the boost to economic growth associated with relief and reconstruction activity. This is confirmed by the absence of any visible impact on the currencies or stock markets of India, Indonesia and Thailand. It is rare that natural disasters have a large impact on GNP or reduce growth significantly. There are two important exceptions: widespread drought, now most evident in Africa, and small, island economies such as in the Caribbean, simply overwhelmed by the disaster.

Third, there may nevertheless be economic disruption at national level, caused by the impact of relief expenditure on national finances. If public expenditure runs out of control, inflation and higher interest rates may follow. That is why the two most important people in managing natural disasters, after the relief coordinator, are probably the Minister of Finance and the Governor of the Central Bank. Few developing countries have the luxury of large contingency funds in the national budget, and even if they did, the scale of the tsunami disaster would overwhelm these reserves. That means either cutting other expenditure at short notice or, more likely, running a budget deficit, with predictable consequences. Examples from history are flood and famine affected Bangladesh in 1974 and many African countries impacted by El Niño and La Niña related extremely low or high rainfall in 1983/4, 1991/2 and 2000-2002.

Fourth, this is the context in which debt relief can be a boon, contributing donor money directly to government budgets. The alternative is for governments to borrow from international financial institutions or private capital markets, increasing their indebtedness. There are lessons about how to manage debt relief, however. In the case of the Highly Indebted Poor Countries Initiative in 1999, debt relief was only provided in exchange for a national poverty reduction strategy, monitorable, carefully costed, locally produced, and with strong participation by the poor themselves. The equivalent in the Indian Ocean would be debt relief conditional on the preparation of a rehabilitation plan. It is likely that Sri Lanka and Thailand would find this straightforward. Indonesia is a more difficult case, because of concerns about corruption, governance and conflict. The lesson from debt relief experience elsewhere is that if these problems cannot be solved, project aid may be more appropriate.

Fifth, the international response has been extraordinary, as noted, to the extent that standards have been set: not only for future crises, but also for current crises elsewhere. The comparisons are stark. Speaking at ODI on 15 December, the UK's Secretary of State for International Development, Hilary Benn, identified variability in response as a problem and described two appeals in 2003: the first, for Chechnya, was successful and raised $US 40 per person affected; the second, for flood relief in Mozambique, was less successful and raised only $0.40 per person. In the Indian Ocean, current pledges suggest that relief adds up to perhaps $US 1000 for each of the five million people affected. How can the response to crises be levelled up to this kind of amount? Perhaps the new donors who have stepped up to help in the Indian Ocean, especially those in the Middle East, can take on wider responsibilities?

Sixth, it is important to remember that the pledges for the Indian Ocean are in almost every case from existing aid budgets. They do not, therefore, represent new money. Within limits, all aid programmes maintain contingencies for emergencies, and money is available to commit now because most donors are at or close to the start of their financial year. For example, the UK's DFID spends about 10% of its annual aid budget on emergencies, some £400m in a budget of £4bn. Nevertheless, it must follow that money spent in the Indian Ocean means that less money will be spent elsewhere. Crudely, the costs of relief are being met by taxing the poorest people in the world. At some point, donors will have to face up to this and increase aid budgets faster than they would otherwise have done.

Sixth, some important lessons have been learned about the inescapable role of the UN, but also about the need for reform. Concern about the UN's capacity to deliver were widespread before the tsunami . The US responded by setting up its own core group, but retreated rapidly to shelter under the UN umbrella. However, if the UN is to be able to fulfil its mandate, the Office for the Coordination of Humanitarian Affairs needs to be strengthened. Hilary Benn has suggested giving OCHA authority over all UN agencies in the field and backing this up with a new $US 1bn fund to give OCHA the financial muscle it needs to do this job.

Finally, the cost-effectiveness of hazard warning and prevention is only too clear. The World Bank has estimated that every dollar spent on risk reduction saves $7 in relief and repairs. Prevention now needs greater emphasis.

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