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What is an external shock?

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WHAT DOES IT MEAN?

An external shock is an unpredictable event that originates outside an economy but is expected to impact it in a significant and visible way. Examples include a sharp increase in oil prices and the coronavirus outbreak.

The more open an economy is, like Singapore's, the more susceptible it is to external shocks.

WHY IS IT IMPORTANT?

People usually overreact or under-react to shocks.

Examples include bank runs where people rush to withdraw their deposits, or supermarket runs where people clean out the shelves and hoard goods.

Under-reaction is also unwise because it might lead to latent over-reaction as people become more aware and knowledgeable about the impact of the shock. In the early days of the coronavirus outbreak, the Chinese government basically under-reacted. The inaction saw an estimated five million people leave Wuhan city before the lockdown, which further escalated the magnitude of the crisis.

How can psychological biases such as over- or under-reaction be avoided?

The answer is to have rational planning and open discussion with transparent information disclosure and inputs from experts for a more informed and balanced decision.

Accurate and timely information dissemination will help to curb the fear so that people will react appropriately.

When an external shock hits, it may be timely for fund managers and investors to relook their tactical asset allocation and shift into more promising industries.

However, the intermediate and long-term impact will depend on the duration of the shock, its severity and the economic structure of the affected country.

IF YOU WANT TO USE IT, JUST SAY:

"An external shock is, by nature, a surprise. To avoid over- or under-reaction, reliable information and/or expert insights can help households embark on a rational course of action."

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