COVID-19 AND RUSSIA-UKRAINE WAR: TRADE IMPACTS ON DEVELOPING AND EMERGING MARKETS

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Abstract

Just as the world appeared to be turning the corner on the COVID-19 pandemic, the Russia-Ukraine conflict erupted, and the global economy may be about to enter new, uncharted territory. Increased geopolitical tensions threaten to dramatically alter the global economy's recovery prospects. The waning yet still reverberating pandemic has posed an unprecedented challenge to public health on a global scale, unleashing simultaneous global demand and supply shocks, spanning all nodes and centers of economic activity worldwide. With the global economy more interconnected than ever, the rate of cross-economic contagion is likely to take an unparalleled economic toll on all countries that relies on remittances and export receipts. The responses to the COVID-19 and Ukraine-Russia war created 'new normal' require a mix of policy levers and incentives to mitigate the economic impacts on the most disadvantaged households and workers. Further, it is required to avoid measures that constrain economic activity, deepen the economic slowdown, and lengthen post-COVID recovery.

JEL: *F17, F43, I15, C68*

Keywords: *COVID-19, Infectious Disease, Economic Growth of Open Economies, International Trade*

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INTRODUCTION

The novel coronavirus (COVID-19) pandemic posed an unprecedented challenge to public health on a global scale, with cases now confirmed in more than 210 countries. As governments scramble to safeguard people's health, the contagion has fast extended to the economic sphere, creating an international economic crisis. Just as COVID-19 is unparalleled in our lifetime in terms of its contagion rate and the toll on human lives, it is likewise unique in the expected economic contagion that is fundamentally different from previous shocks, such as the global financial crisis of 2008–09 and the Great Depression.

The Russia-Ukraine war has added a new devastating effect on commodity prices. Global inflation is already the highest since the 1998 financial crisis. A sustained rally in commodity prices will only add to inflationary pressure in the near term. In addition, a potential acceleration in supply chain disruption and economic polarization via greater regard for the security of supply concerning specific products is further adding to inflationary pressure on essential commodities such as energy and grains, as Russia and Ukraine account for a significant market share. The net impact of increased geopolitical and supply-driven commodity price rises adds to stagflation risk - higher inflation and slower growth, though the impact will vary by market.

This paper principally examines the transmission channels of COVID-19 economic contagion that adversely affect developing and emerging countries with particular reference to Sri Lanka and draws on the lessons learned from past crises. It also partially discusses the likely short-term impact of the Russia-Ukraine war on emerging markets, as it is too much of an elephant to ignore. However, the latter requires a comprehensive treatment beyond the time and scope. The dual shock requires a mix of policy levers that may shorten the depth and duration of the unfolding economic downturn and the impact on developing and emerging economies like Sri Lanka. Mitigating the adverse impacts and adjusting to the "new normal" requires addressing potential structural factors on how trade, financial, and services sector markets and efficiencies are addressed.

THE UNUSUAL AND HIGHLY DISRUPTIVE GLOBAL ECONOMIC IMPACT OF COVID-19

What makes the COVID-19 health and economic crisis different from other pandemics and economic crises? First, it is a massive and highly contagious global health shock. COVID-19 combines two marked differentiators—the rates of contagion and resulting mortality. COVID-19 proved to be far more contagious than the seasonal flu. The average global fatality rate as of May 9, 2020, was close to 7% and reaching above 14% in Italy, Spain, and Belgium (Johns Hopkins University and Medicine, 2020) put —far higher than the 0.1% average annual fatality rate for the seasonal flu (World Health Organization, 2020). The nature of this pandemic, combined with the high degree of global connectedness, has enabled it to spread across the borders rapidly. It is likely that most

countries will be hit by the pandemic, with direct costs to their economies related to morbidity, health care, and uncertainty.

The extreme mitigation measures to contain COVID-19 have, in turn, generated sudden and dramatic reductions in domestic and external supply and demand for goods and services, constricting the flow of goods and people. Economic contagion is spreading as fast as the disease itself.

Those countries and regions at the centre of the health and economic crises—China, the US, and the EU— are much more interconnected between themselves and the rest of the world through the exchange of goods, services, financial, and people-to-people interactions. Within countries, the virus has hit primarily large, internationally integrated production and service centres (e.g., Wuhan, Daegu, Milan, Munich, Seattle, and New York). The scale and uncertain trajectory of the infection are also reflected in financial markets, with dramatic movements in stock prices and the outflow of capital from more vulnerable economies. The rapid integration through global value chains (GVCs), enabled by the rapid evolution of information technology and finer degrees of specialization, has increased the exposure to external demand and supply shocks far more profound than even the 2008-2009 global financial crisis. However, the latter provides an instructive "benchmark" against which to examine the magnitude of the COVID-19 economic crisis.

Like the Great Depression, the global financial crisis began mainly as a financial market crisis in a single country. Accumulating defaults on mortgages and derivative products in the US, resulted in the collapse of US financial institutions, causing the collapse of equity markets as the financial contagion spread. The knock-on impacts on industrial production spread across advanced economies and spilt over to emerging markets and developing countries, particularly those integrated into global value chains. The 2008 financial crisis caused a precipitous fall in GDP across four-fifths of the world and resulted in rising unemployment (Eichengreen et.al., 2010).

COVID-19'S ECONOMIC CONTAGION AND TRANSMISSION MECHANISMS

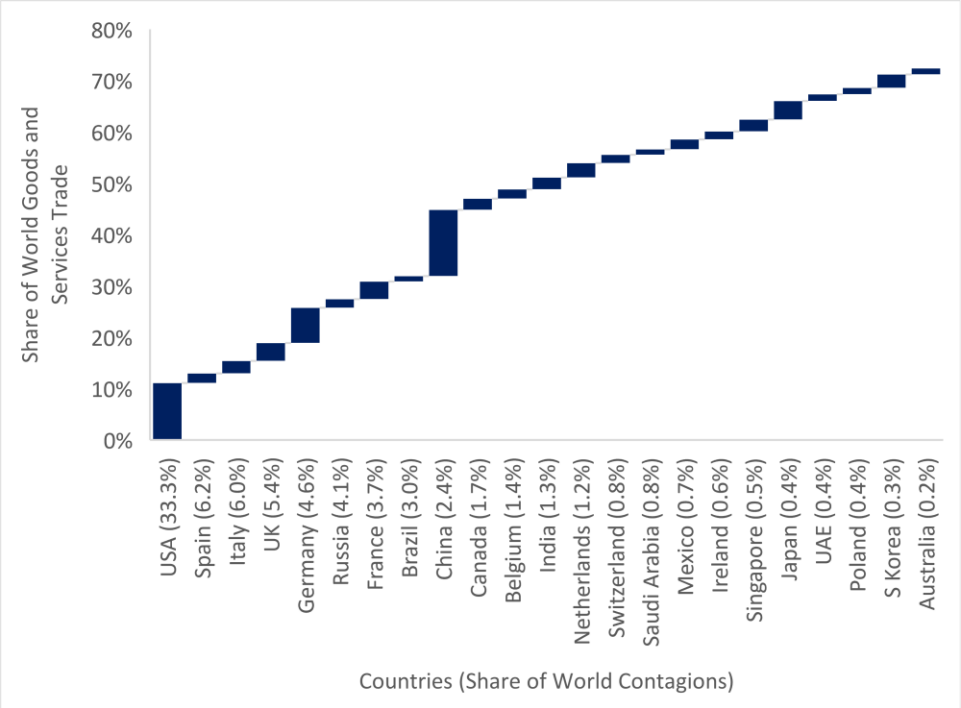
COVID 19’s Global Economic Impact

The epicentre of the crisis has shifted from China; the second-largest economy in late 2019 to the US; the largest trading nation by the end of March 2020. The top trading nations that account for 80% of world trade have contracted 70% of world contagion. Even if containment measures are limited to two quarters, the propagation effects and reverberations will likely be substantial, impacting developing and emerging markets that rely on advanced economy markets (Figure 1).

Although the world's second-largest economy China's production initially plunged at the sharpest pace in three decades, it is likely to hit an upswing very quickly as the import requirements from the rest of the world land at its doorsteps. Taking advantage of the

drastically lower energy prices, China can quickly ramp up its production capacity and flood the market to meet the unmet demand (trade, finance, commodity prices, and tourism), compounding the toll on developing countries.[1]

Figure 1: Contagion share of major traders as of 4 May 2020



Source: Author's calculations using World Bank's WDI data.

COVID-19 Impact on Global Trade Flows

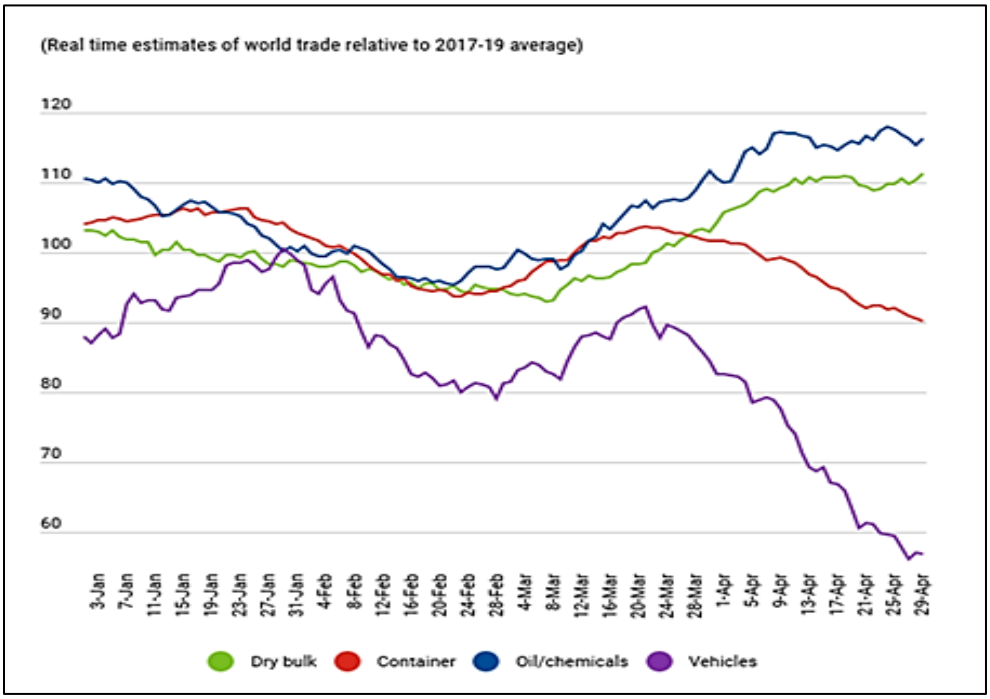
The latest global level real-time estimates show a dramatic weakness in trade. The real-time estimates of world trade for exports and imports show that, as China started reopening its economy after the lockdown, world exports initially recovered across the board (Figure 2). The heterogeneous effects at the sectoral level, classified by broad vessel categories, show oil and related product performance is especially strong but is not fully matched by an increase in world imports—in line with reports that crude oil is being

[1] A 9% contraction in China's GDP: Q1 compared the previous year and a 6% drop in US GDP in 2020: Q2. The latter is far worse than the -2.2 per cent growth recorded in 2008: Q4 (Goldman Sachs, 2020). This reflects that Europe and Japan were likely already heading into recession, given their weak fourth-quarter performance, while the United States entered the crisis with a weakened economy. These large economies account for over 55% of world GDP and trade and are therefore set to dramatically affect the rest of the world through various transmission mechanisms (trade, finance, commodity prices, and tourism), compounding the toll on developing countries.

stored at sea. Beginning mid-March, the trend reversed for less commoditized goods (those transported in containers and finished vehicles) started to dip dramatically (Figure 3), a consequence of companies halting production and households postponing purchases of durable goods (Peiris et al., 2021).

The 2008 financial crisis, which originated in the United States and rapidly spread through multiple channels to low- and middle-income countries, offers clues about the impending COVID-19-related trade contraction. Global trade volumes fell from the end of 2008 through the first half of 2009 due to declining imports by developed countries, especially in the United States, which accounted for 15% of the global total (United Nations, 2009a; 2010b).

Figure 2: Post-COVID-19 Exports

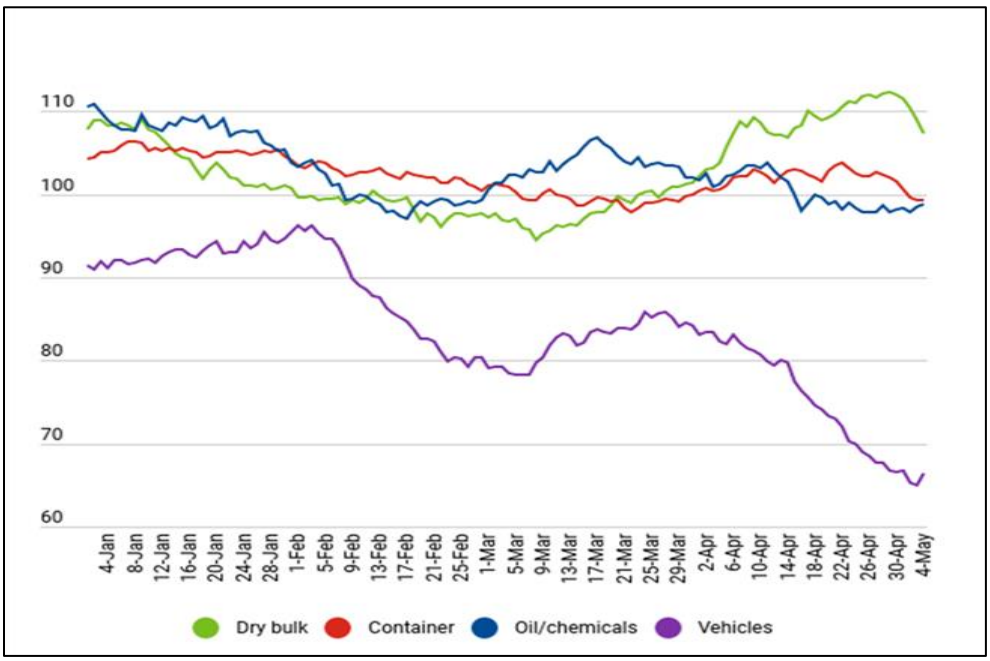


Notes: 30-day moving averages. The methodology is only designed to track trade in goods
Source: Cerdeiro, Kamaromi, Liu and Saeed (2020); AIS data from Marine Traffic

At the height of the crisis, between July 2008 and April 2009, the value of imports from the European Union, Japan, and the United States plummeted by almost 40%. They triggered a worldwide collapse in international trade. The volume of imports of the three major developed economies fell by about 18% during that period, a situation which was compounded by a decline of about 24% in import prices. The developing countries experienced a rapid 25% decline in exports from 2008 to 2009 before recovering in 2010.

Despite the gradual recovery during the ensuing period, the value of imports of the three largest developed economies was still about 25% below pre-crisis peaks by August 2010.

Figure 3: Post-COVID-19 Imports



Notes: 30-day moving averages. The methodology is only designed to track trade in goods
Source: Cerdeiro, Kamaromi, Liu and Saeed (2020); AIS data from Marine Traffic

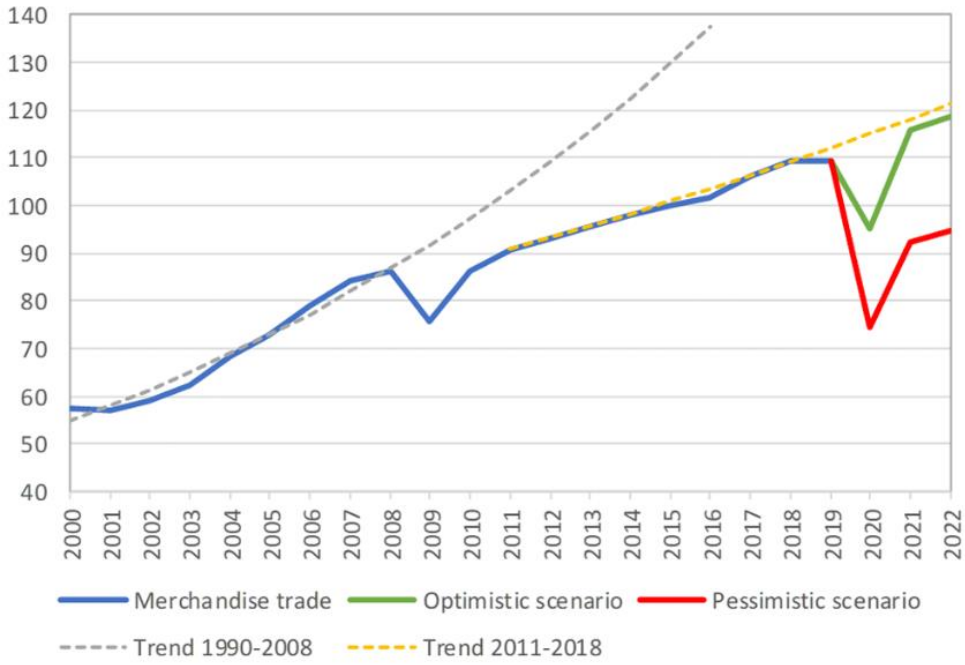
The trade never returned to its previous trend, represented by the dotted grey line (Figure 4). The trade elasticity (the ratio of trade growth to GDP growth) in the 1990s was greater than two (Bekkers et al., 2020). After the financial crisis, trade growth slowed, and trade elasticity declined, even below its long-term average. The trade slowdown was more a structural change in the relationship between trade and income than merely cyclical (Constantinescu et al., 2015). First, high-income countries, which accounted for 70% of global imports, remained weak after the financial crisis. Second, the structure of GVCs that previously propagated world trade shifted, with a higher proportion of the value of final goods being added domestically, reducing the number of links in the chain and, therefore, trade volumes.

Economic Contagion through Trade

How a country is integrated into the global economy will determine the severity of the crisis in different countries. Developing countries are deeply entrenched with developed countries through trade. This includes the impact of the crisis on aggregate demand for goods and services, particularly the impact through GVCs, reduced earnings from tourism, and the impact on commodity markets. They will also be impacted due to

financial market instability and the flow of remittances, which are an essential source of foreign reserves and serve as a de-facto social safety net for many. A protracted downturn can also affect the direction and volume of foreign direct investment flows, which, in turn, can shape their future economic growth and structure.

Figure 4: World merchandise trade volume, 2000-2022 (Index, 2015=100)



Source: WTO (2020)

The following sections discuss some fundamental transmission mechanisms for COVID-19 economic contagion, including lessons learned from previous economic crises.

Transmission through Increased Trade Costs

Trade costs impact trade in goods that rely heavily on imported inputs and the service sectors that contribute to the value-added of goods, such as call centres, product design, and after-sales service. For example, IT and business services in India are strongly tied to global manufacturing, even if these services are not all directly exported. For example, in India, business and IT are exported as part of Business Process Outsourcing (BPO) and the domestic value-added as a share of the country's total exports (18%). Sri Lanka's domestic value-added in transport as a share of total exports equals 12%.

COVID-19 is likely to have increased trade costs more than the previous crisis—some of this is already evident. Transport and other transaction costs in foreign trade include not only the cost of transportation but also the costs created by additional inspections, reduced hours of operation at ports of entry and/or border closures, and road closures. The

lockdowns and social distancing prompted restrictions on movement to slow the spread of the disease means that transport and travel were directly affected in ways they were not during the global financial crisis. The Ebola outbreak in 2014 is estimated to have increased trade costs in affected countries by 10% (Evans, 2014). Since COVID-19 is affecting more countries and the containment measures are more severe and widespread due to the efforts to contain the virus, Bekkers et al. (2020) estimated that in the case of an amplified shock due to COVID-19, would increase international trade costs of imports and exports, for most countries, by about 25%.

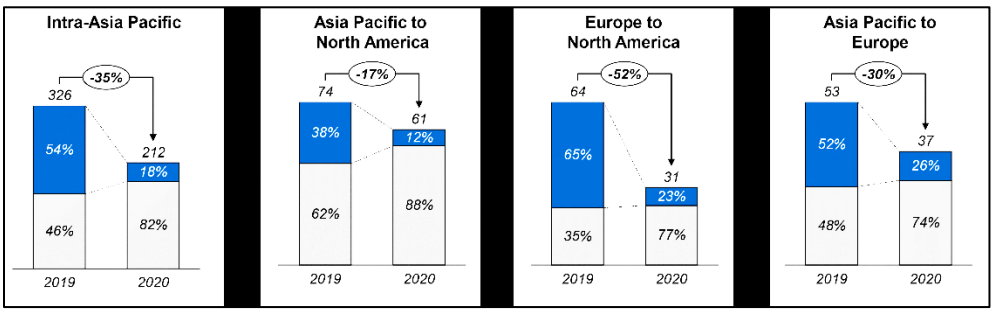
The real-time anecdotal evidence dwarfs formal estimates. First, high-frequency shipping data for the first part of April showed significant reductions in capacity on the main sea trade lines, signalling reductions in container throughput (World Bank, 2020). The reduction in capacity is more significant for Europe-Asia routes than trans-Pacific routes, amounting to 33% and 13% reductions, respectively. The sharp decline in aviation connectivity also represents substantial reductions in airborne shipping capacity. Half of all air cargo travels as "belly cargo" in passenger planes also impacted the worldwide travel restrictions—the decline in international passenger flights began in February, accelerated in March and April, dropping 59.2% YoY in the week of April 8, 2020. Seabury/Accenture reported that global air cargo capacity dropped 35% YoY (Seabury, 2020).

The unprecedented, limited belly capacity in passenger planes has led to a dramatic reduction in air freight space availability (Figure 5), fueling a very lopsided competition of merchants trying to ship their product versus the urgently needed orders of large quantities of PPE, which require fulfilment by air. This has caused airfreight prices to rise dramatically, especially in the trans-Pacific trade lane. By May 2020, China to North America spot airfreight pricing exceeded US$ 10 per kilogram, and full freighters were selling above US$ 1 mil per flight. Air shipments from London to New York that may have previously had an airfreight cost of US$3,500 increased tenfold by the end of April 2020 (Relocation Plus, n.d.). Despite the costs, the temporary demand for personal protective equipment (PPE) has kept several key cargo fleets afloat. However, the limited capacity is likely to linger as countries clamour to compete for space, putting further pressure on prices. Since the demand for PPE will remain vital for the foreseeable future, the elevated prices for airfreight are not expected to drop until COVID-19 has been contained.

With higher trade costs, the price per unit of cargo increases—substantially in the case of GVC-related trade where parts and components may be sourced from multiple countries, as well as for low-value, bulky items. The rising trade costs represent a productivity loss since additional resources are needed to bring goods to consumers instead of being available for investment or other productivity-enhancing measures. In some cases, exports of medical supplies and food have been banned, while shortages of parts and

components have interrupted production in industries characterized by complex value chains.

Figure 5: Inter-regional cargo capacity comparison, 2020 vs. 2019



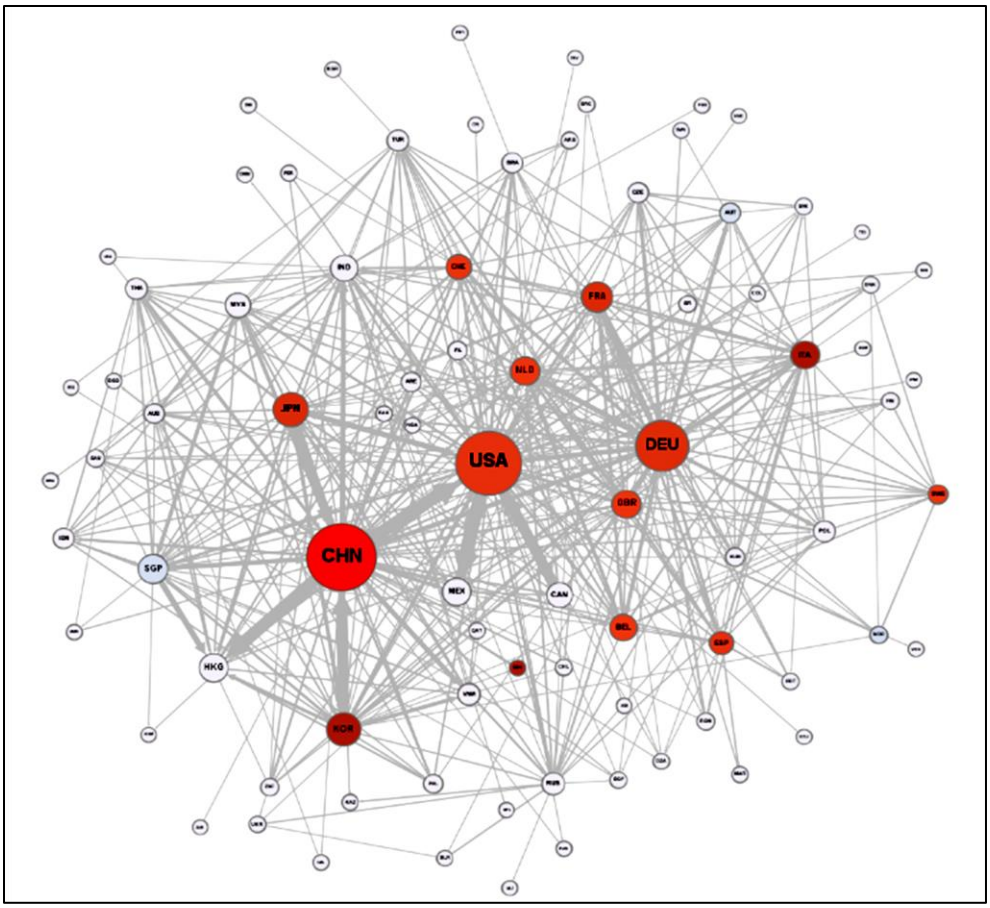
Notes: Grey=Freight, Blue=Passenger
Source: Seabury, 2020

Transmission through Global Value Chains

The world is interconnected through intricate production and service linkages within GVCs. The hardest hit initially were China and South Korea—both critical to the flow of parts, components, and assembly. The second wave of contagion hit the EU, US, and Japan—all central to the supply and demand for GVC-related products and services. The most affected countries account for about 80% of global trade and include all dominant and essential nodes of the global economic system (Figure 6). Simultaneously locked down, the advanced countries at the network's core are essential to the world trading system and developing and emerging markets. Some developing countries such as Bangladesh and Sri Lanka are directly connected to consumption nodes in the US and UK through the apparel sector, with backward linkages to East Asia, where textiles may be sourced. Others, such as Thailand's automotive sector, are connected via central nodes in China and Japan, from which advanced components are sourced, and final goods are exported. Still, other developing countries, for example, in Sub-Saharan Africa, supply raw materials to others along the value chain, such as bauxite and tantalum—so-called forward linkages.

Beyond the increased transport costs, developing and emerging markets linked through global supply chains are affected by the crisis in two principal ways. First is the demand shock, through a precipitous collapse of consumption of so-called 'postponables', i.e., purchases that can be delayed—as seen in the trade collapse of 2009, the wait-and-see demand shock impacted durable goods more than non-durable goods. Reductions in demand lead to a 'bullwhip' effect, whereby a collapse in demand for final goods leads each producer/supplier along the chain to discharge their inventories before re-ordering. Consequently, the demand shock gets amplified for suppliers further up the supply chain, including intermediate goods producers and raw material suppliers (Zavacka, 2012).

Figure 6: Global network of intermediate trade, 2018



Source: World Bank (2020)

While value chain disruptions due to COVID-19 were initially confined to China—which sits at the nexus of many global value chains, as either (or both) supplier or final producer—once the pandemic becomes more widespread, trade can be expected to fall more steeply in sectors characterized by complex value chain linkages, particularly in electronics, pharmaceutical and automotive products. Even localized disruptions such as hurricanes, tsunamis, and other crises can also affect complex value chains, as demonstrated by the March 2011 tsunami that forced Japanese corporations in the US to halt production as they could not obtain parts and components from their suppliers in Japan.

Transmission through Foreign Direct Investment

Changes in trade flows can, for some countries, become more permanent, transforming from an episodic downturn to a more generalized reduction in capacity and/or structural shifts, both through insolvencies and reductions in foreign investment to other countries that are better positioned to rebound from the crisis. COVID-19 has created uncertainty

in global capital flows, with a massive outflow of capital from developing countries to safer havens. COVID-19 also affects how global investment flows will behave as the emergency clears. Foreign investment has historically been a barometer of developing countries' health and ability to grow and integrate with the global economy. While the immediate crisis has frozen new investments, a spectre looms on the horizon once the health emergency subsides, with some multinationals seeking to re-shore operations that can be automated or shifting investments to other countries to lower their future risk portfolio. This may have long-lasting effects on developing countries competing for a shrinking volume of foreign investment.

Considering COVID-19, the United Nations Conference on Trade and Development (UNCTAD) revised its forecasts on global FDI flows from a conservative 5 to 15% drop to a decisive 30% to 40% decline during 2020-2021. During the financial crisis of 2007-08 and its immediate aftermath, FDI flows fell by 37% in 2009, down to US$1.1 trillion. By the onset of the pandemic, the crisis has already wiped off some US$500 billion in foreign investment, and worse is more likely to emerge as earnings are downgraded (UNCTAD, 2020).

Earnings guidance by multinational enterprises (MNEs) in UNCTAD's top 100, which rely on their foreign direct investments for an average of 50% of reinvested earnings, confirms the rapid deterioration of FDI outflow prospects. Some 61% of the MNEs have issued new statements since the first week of March. In addition to earlier concerns about supply disruptions from China, 57% have warned of the global demand shock's impact on sales, showing that COVID-19 is causing problems beyond supply chain disruptions. Besides, the top 5,000 MNEs, which account for a significant share of global FDI, have now seen downward revisions of 30% on average for 2020 earnings estimates. These sentiments were yet to capture the sudden spike in COVID-19 cases in the US, which is likely to depress earnings further. The most affected sectors are the energy and primary metals industries, with an expected 200+ % decline in earnings (see the section below on the impact of commodity markets), airlines (116% decline), and the automotive industry, which faces both demands and supply side shocks (47% decline).

The negative impact is likely to reverberate upstream and downstream supply chain investments across Asia, Central and Southern Europe, and South America, with more enduring effects on production networks. Even without further downward revisions, those losses are potentially more dramatic than at any time in modern history. The implications will range from delays in investments with long gestation periods to projects that are downsized or shelved indefinitely, including the abandonment of mergers and acquisitions—all of which may accelerate trends already in motion pre-COVID-19 to shift GVC-related operations back home to reduce supply chain risks. This also can weaken the future competitiveness of developing countries that may find it more challenging to bring private capital to finance much-needed energy infrastructure projects.

Transmission through the Tourism Sector

Economic contagion to developing and emerging markets will also be transmitted through trade in services. Some services may benefit from the crisis—this is true of information technology services, demand for which has boomed as companies try to enable employees to work from home and socialize remotely. However, with transport and travel restrictions and the closure of many retail and hospitality establishments, the services trade will take its toll. Services are not included in the WTO's merchandise trade forecast, but most trade in goods would be impossible without them (e.g., transport). Unlike goods, there are no inventories of services to be drawn down today and restocked at a later stage. As a result, declines in services trade during the pandemic may be lost forever. Services are also interconnected, with air transport enabling an ecosystem of other cultural, sporting, and recreational activities.

Tourism receipts are essential for all economies but constitute a critical share of total exports (and foreign exchange earnings) for developing and emerging market economies, particularly small-island economies (Figure 7). For Maldives, Jamaica, and St. Lucia, tourism constitutes over two-thirds of exports and GDP and around 40% of government revenues. Tourism supports many direct and indirect livelihoods than just direct tourism receipts and indirect and induced impacts through capital spending, government spending, and supply-chain activities, such as purchases of domestic and imported goods and services. Using a broadened definition to accommodate both indirect and induced impacts, satellite accounts and input-output tables show the overall impact on the economy tourism is essential even for large countries and those surrounding them (and are often part of multi-country itineraries). For example, tourism accounts for over 9% of India's GDP and generates significant spillovers to Nepal, Bhutan, and Sri Lanka.

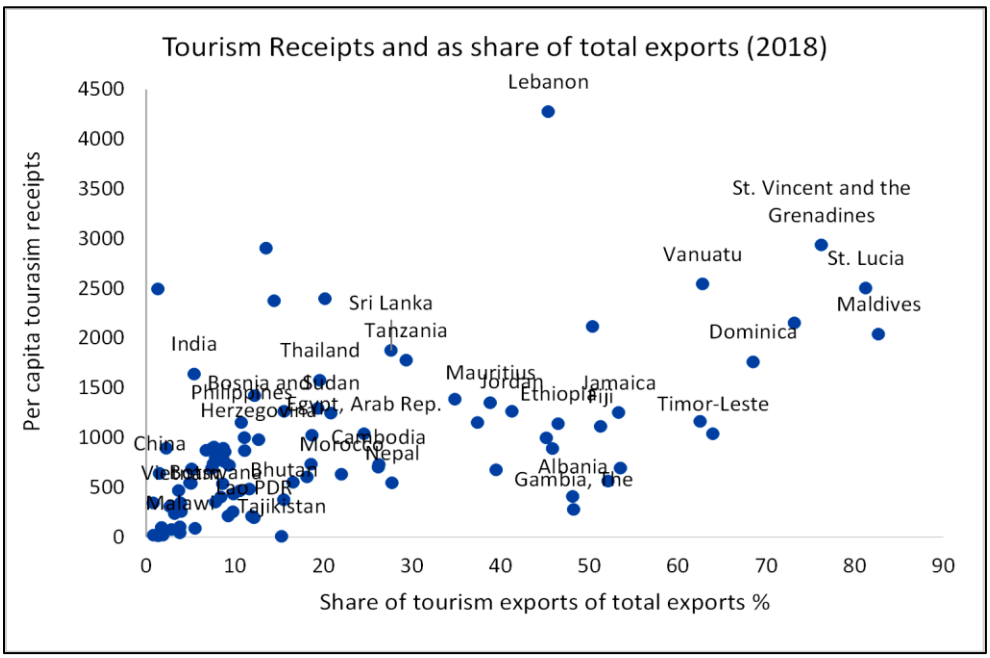
As of May 2020, tourism around most parts of the world—especially in Europe, Asia, and Sub-Saharan Africa—is at a virtual freeze, with some stranded tourists gradually being allowed back into their origin countries (Figure 8). The decline in tourism revenues will affect most of Cambodia, Lao PDR, Malaysia, the Pacific Islands, the Philippines, and Thailand—in each; tourism revenues constitute more than 10% of GDP. Fiji, Kiribati, Palau, Samoa, and Vanuatu are the most exposed to tourism. COVID-19 will hurt commodity and tourism revenues and disrupt raw materials imports and workers' inflows for infrastructure projects in many small island economies.

Transmission through Commodity Markets

Commodity markets have also been shaken by the ongoing crisis, which will have both immediate and ongoing impacts on commodity prices and, in turn, spillover effects on other traded sectors, incomes, and government revenues. Commodity markets have been and will be primarily driven by demand-side factors. However, supply-side disruptions may have spillover impacts on prices, such as through the exact transport-related costs

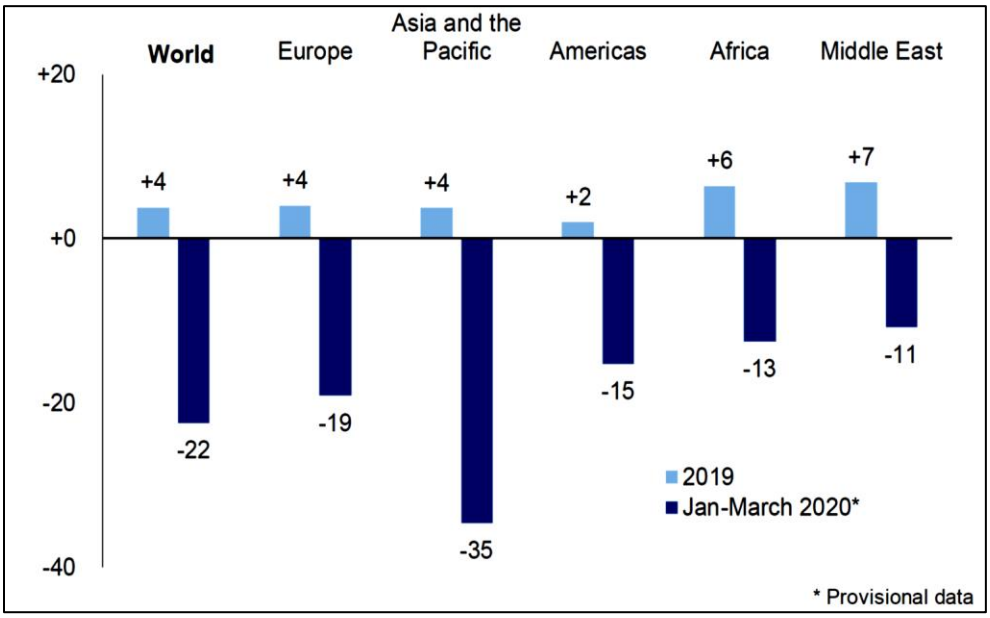
that are expected to impact GVCs, particularly for low-unit-value agricultural commodities.

Figure 7: Tourism receipts as a share of exports



Source: Author's compilation using the World Bank's WDI data.

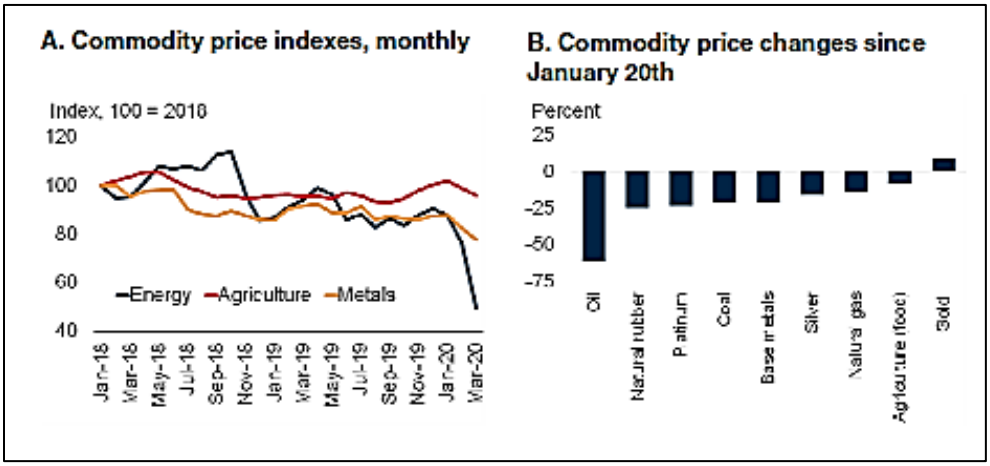
Figure 8: International tourist arrivals, 2019 and Q1 2020 (% change)



Source: UNWTO, 2020.

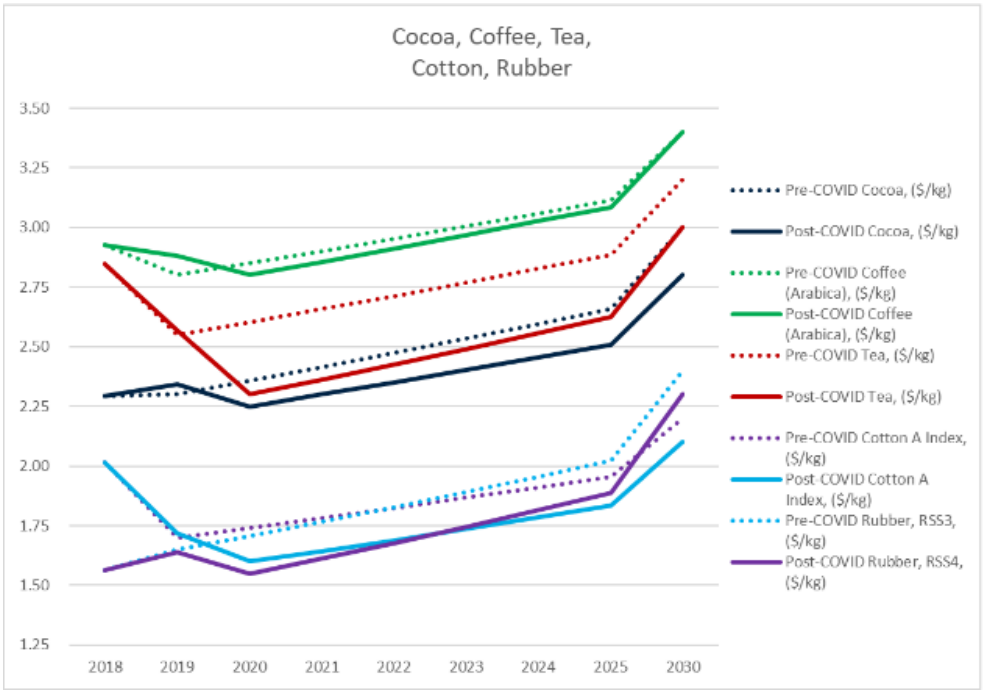
The impact of lockdowns and other mitigation measures have caused virtually all commodity prices to decline sharply (Figure 9, 10 and 11).

Figure 9: Commodity price indices



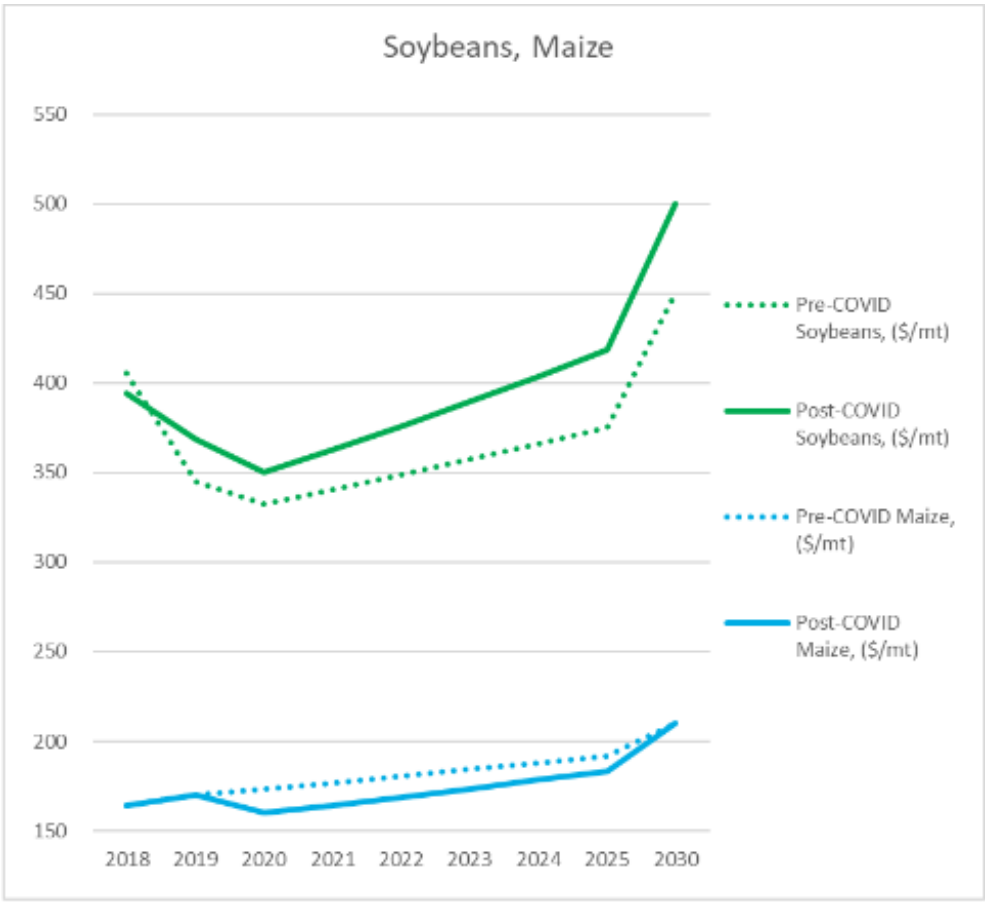
Source: World Bank Commodity Market Outlook, 2020.

Figure 10: Agricultural commodity price forecast, pre-and post-COVID



Source: World Bank Commodity Market Outlook, 2020

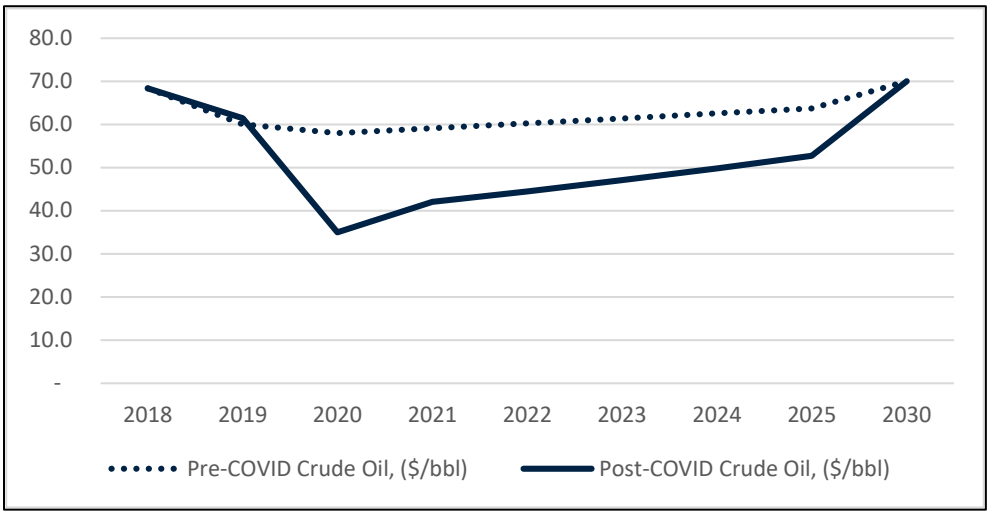
Figure 11: Pre-and post-COVID price forecast for soybeans and maize



Reduced transport and manufacturing have brought down energy prices dramatically as the pandemic spread—crude oil prices dropped 50% between January and March 2020—and are expected to continue to decline in the face of reduced economic activity. Metals and other industrial minerals are following suit. On the other hand, most agricultural commodity prices have been more stable, as they are less sensitive to economic activity and stocks of staple crops are at an all-time high. Nevertheless, in the short run, disruptions to agricultural supply chains—and increased transport costs—could imperil food security and rural livelihoods in developing countries that could, in turn, foment further instability in regions that are already security hotspots. The path to price recovery will likely vary significantly across commodities, with varying impacts on trade and economic growth outcomes in countries dependent on their import or export—far more significant shifts than other economic recessions or disruptions and longer-term impacts on trade and incomes.

The impact of COVID-19 has already taken a significant toll on energy prices, particularly crude oil. While spot prices dropped rapidly from January, U.S. futures took an unprecedented fall in April 2020, dropping for the first time below zero as overproduction and the sudden drop in demand together took their toll, as producers were forced to pay to dispose of excess production (Figure 12).

Figure 12: Crude oil price forecast



Source: World Bank Commodity Market Outlook, 2020.

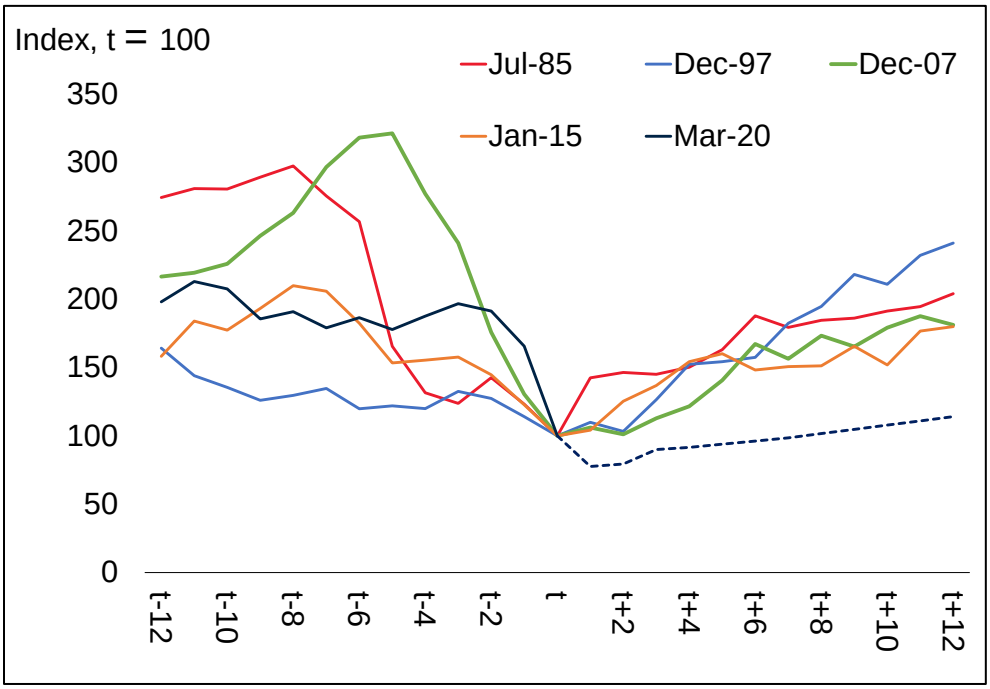
Despite commitments by OPEC, the U.S., Canada, and other oil-producing countries, it is expected that oil prices will be exceptionally slow to recover, with forecasted prices remaining below pre-COVID price trends through 2025 and beyond, following a similar, but more dramatic path than experienced after previous price collapses, such as the 1997 and 2008/9 financial crises, the 1986 OPEC price collapse, and the more recent 2016 collapse. History strongly suggests that it is not likely that OPEC+ and other large oil-producing countries will be able to shore up prices enough to offset the downward pressure from reduced global demand (Figure 13).

While the collapse in oil prices will benefit many oil-importing developing countries, offsetting, at least partially, the decline in real incomes, exporting developing countries—some already facing instability before the crisis (e.g., Venezuela, Nigeria, and Angola)—will find their primary source of foreign reserves severely constrained and reducing government revenues desperately needed to address the immediate crisis and stimulate recovery.

The price fluctuations on non-energy minerals will vary considerably. While precious metals will benefit from investors' flight to safe-haven assets, industrial metals, except for iron ore, are already under pressure from decreased demand, with expected drops in prices in 2020 and continued decline through 2025. Nickel and zinc are forecasted to fall

22% in 2020 and tin, copper, and lead will fall between 13% to 17%. Several developing countries across South and Southeast Asia, Sub-Saharan Africa, and Latin America are significant producers and will be negatively impacted, causing a similar fall in foreign reserves of domestic revenue mobilization. Like crude oil, prices of some, such as Copper and Nickel are not expected to recover their pre-COVID levels until after 2025 (Figure 14).

Figure 13: Oil price recovery Trends

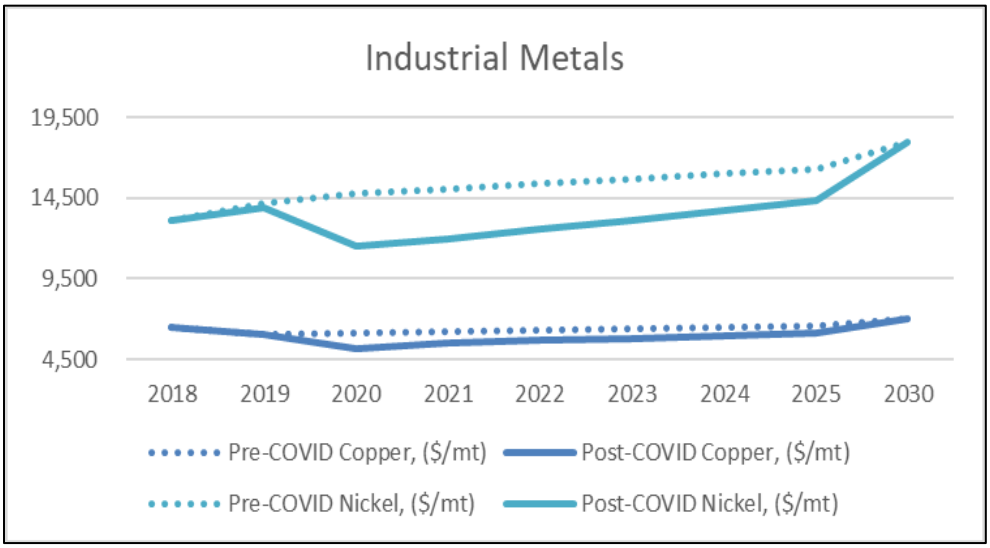


Source: World Bank Commodity Market Outlook, 2020.

While only a relatively small number of developing countries are significant metal and mineral commodities producers, virtually all rely heavily on agriculture to support livelihoods. As the crisis subsides, most commodity prices will likely stabilize as the demand-shock subsides and food stockpiles are diminished, and a reduction in input prices, such as fertilizers and energy, which were already in decline pre-COVID. Cash crops such as cocoa, coffee, and tea are expected to rebound relatively quickly, with growth returning in 2021.

Downstream sectors such as palm and groundnut oil will also remain strong, with growth prevailing in 2020. The most significant risk to the food sector is likely to be transmitted through supply chain disruptions that slow the movement of agricultural commodities within and between countries. For example, Argentina and Brazil faced shutdowns and blockades of crucial transport infrastructure within and at the ports. Future outbreaks have the potential to exacerbate these logistical challenges.

Figure 14: Industrial metal prices, pre- and post-COVID



Source: World Bank Commodity Market Outlook, 2020.

ECONOMIC CONTAGION OF RUSSIA AND UKRAINE WAR

The war between Russia and Ukraine is causing widespread disruptions to trade and investment, affecting food-importing countries in Sub-Saharan Africa, the automakers in Europe, hoteliers in Sri Lanka and Mauritius, and impacting consumers' energy supplies globally. Although the world's poor—who spend a large part of their incomes on necessities—are the most vulnerable, no country, region, or industry is left untouched by these disruptions.

A new World Bank report, The Impact of the War in Ukraine on Global Trade and Investment, forecasts that world trade and GDP will drop by about 1%. Manufacturing exporters such as Vietnam, Thailand, and Mexico see a sharp decline, especially in energy-intensive sectors. Net exporters of crops, including Turkey, Brazil, and India, and of fossil fuels, such as Nigeria and countries in the Middle East, see a surge in their exports, attenuating the adverse effects of the war.

The economic shock waves are moving through five channels: commodity markets, logistics networks, supply chains, foreign direct investment (FDI), and sectors such as tourism; all these are already felt by Sri Lanka, exacerbating volatile social unrest.

The war comes at a difficult moment for emerging markets. The recovery from the pandemic-induced recession has slowed as new coronavirus variants emerged and governments reined in spending. Rising inflation is prompting many emerging market banks to raise interest rates. Disruptions in world trade and investment will curb growth in developing countries and add to price pressures.

Food and Energy

The food crisis unfolding due to the war is the most ominous. In 2020, Russia and Ukraine combined, accounted for 26% of the world's wheat exports and 14% of corn shipments. For corn and fertilizers, their combined pre-war share was almost 15%. Supply disruptions of these critical commodities are causing prices to surge.

The price of wheat, for example, has jumped by more than 40% since the beginning of the war in late February 2022 (with futures prices rising by more than 60%). Many countries worldwide, including Sri Lanka, are heavily dependent on these flows. The Republic of Congo, for example, relies on imports from the Black Sea region for 67% of the wheat it consumes.

After food prices, energy prices are the most directly affected. Russia is one of the world's biggest energy suppliers, providing 15% of its crude oil and 10% of its natural gas globally. World Economic Forum simulation indicates a 7% increase in the price of crude oil, which in turn raises the costs of transportation and production in manufacturing, leading to a drop in exports (Figure 15). Higher prices for natural gas, a key ingredient for ammonia fertilizer, will push up costs for farmers and reduce crop yields, further exacerbating food shortages.

Forty-five per cent of Sri Lanka's wheat imports are sourced from Russia and Ukraine. Over half of soybeans, sunflower oil and seeds, and peas are imported from Ukraine. Russia and Ukraine purchase about 18% of fermented black tea (>3kg) exported by Sri Lanka.

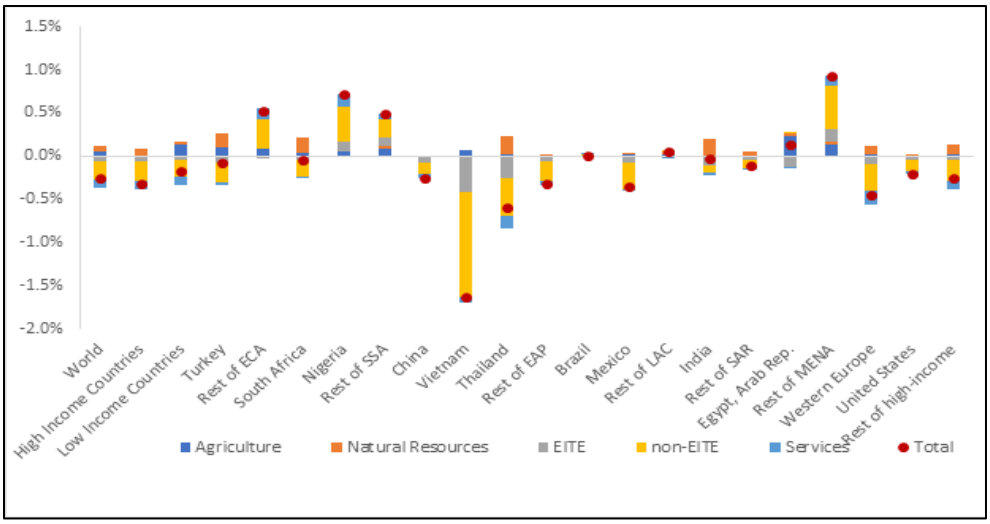
Interventions on trade risks make a bad situation worse (Figure 16). Grain exporters have restored to imposing export restrictions, further reducing global supply, while import liberalization measures and subsidies increase demand. Since the beginning of the war in Ukraine in late February 2022, 67 new trade policies have been imposed or announced. Export restrictions alone have added seven percentage points to the price of wheat and risk igniting a tit-for-tat escalation.

Supply Chain Disruptions

The sanctions imposed on Russia have severed vital transport links between Russia and the rest of the world, disrupting trade more broadly. Russia's connections to European ports have been disrupted, and commodity exports to other destinations have been constrained. Russia, in turn, has disrupted supply lines for Ukraine trade. Ukraine's Black Sea ports have been blockaded or occupied, leaving it a few routes for its commodity exports.

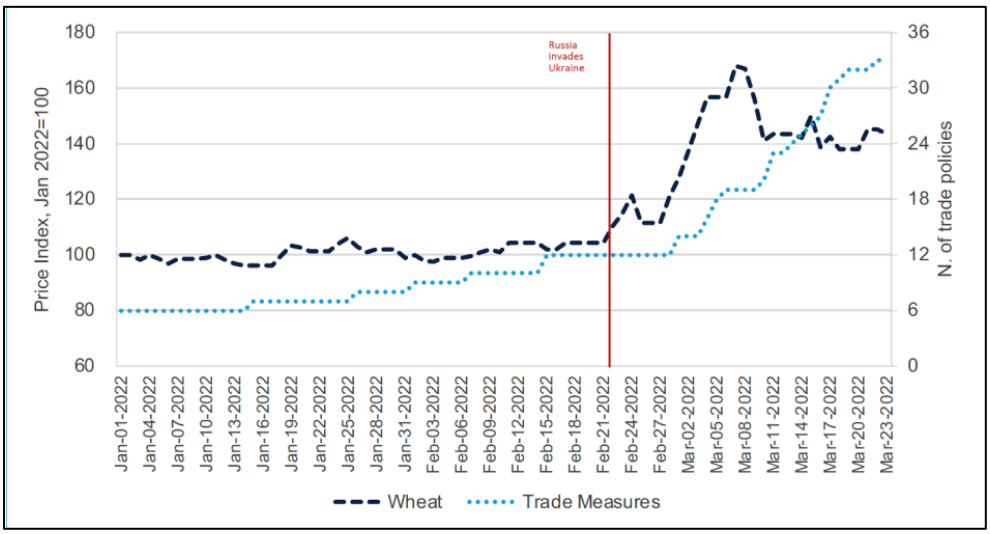
Air freight between Europe and Asia must now be rerouted to avoid Russian airspace. Rail transit through Russia is slowing due to checks for sanctions compliance, and further rounds of sanctions could risk halting rail transit entirely. Further, global, and regional supply chain disruptions are causing input shortages and price hikes.

Figure 15: Change in exports relative to reference year as a share of real GDP



Source: World Bank, 2022

Figure 16: International wheat prices and trade policy measures



Source: World Bank, 2022

Ukraine is a major supplier of crucial inputs, including ignition cables for autos, neon gas for semiconductors, and iron ore for steel mills. Furthermore, firms making machinery, electronics, transport equipment, and food products rely on Russian metals, chemicals, fertilizers, and other commodities. Russia and Ukraine are significant import sources for

asbestos, semi-finished products of iron and steel, copper (cathodes), and potassium chloride for fertilizer.

Russia and Ukraine are not among the major players in the world's FDI networks. Nevertheless, they have an impact on some countries and industries. Armenia, Moldova, and the Kyrgyz Republic depend heavily on Russian investment. Moreover, European countries, including Finland, Germany, and Norway, have significant stakes in Russia's energy sector. Similarly, the war is significantly impacting the tourism industry in Sri Lanka, and Egypt, which are major recipients of Russian and Ukrainian tourists. Georgia and Montenegro are highly dependent on Russian and Ukrainian visitors. A decline in global tourism will temporarily stall the industry's post-pandemic recovery as scheduled flights are disrupted, and consumers reassess their travel plans.

CONCLUSION AND POLICY RECOMMENDATIONS

For Sri Lanka as a net commodity importer, higher prices will pressure already adverse external accounts and weigh on currencies. For the rest of the emerging market, the effects will vary by the economy and the specific commodities exposures. Some of the immediate measures that should be directed at alleviating the impact on the most vulnerable include enabling access to nutritious food through humanitarian assistance mobilizing the governments, NGOs and international organizations. This calls not only on governments but also on the private, civil society and philanthropic sectors to help the most vulnerable populations to be proactive actors in the pursuit of collaborative solutions. Second, increasing availability through reductions in loss and waste of food throughout supply chains can help. When necessary, supply chains should be kept fully operational, including capacity for seeding, protecting standing crops, rearing livestock, and infrastructure for processing food.

In the short to medium term, policymakers can take action to accelerate structural changes that alleviate upward pressure on energy prices, including promoting energy efficiency and incentivizing new low-carbon sources of energy production. These policies would also protect economies from future energy price volatility and accelerate the transition away from fossil fuels. The response to a crisis should not be a trade-off between short-term expediency and long-term resiliency. In the short run, options that incentivize domestic industries (through efficient industrial policy that promotes exports) may be undertaken with clearly defined objectives and criteria that generate efficiency and minimize welfare costs.

Amidst the downturn, rapid digitization and the servicification of the manufacturing and agricultural sectors present a window of opportunity. To harness such opportunities, national trade policy strategies would need to be centred around encouraging new technology diffusion and enhancing human capital. Openness to goods, services, and ideas remains the conduit for access to technologies and allows countries to specialize in what they do best. Encouraging science, technology, and innovation (STI) policies

through grants, credit, and tax breaks should be a cornerstone of any trade or industrial policy strategy. Trade policy may still not be the only instrument in addressing market failures when tax policy, training, and marketing are less distortionary options to choose from. Moreover, reducing constricting regulations and red tape, inefficiencies, and rent-seeking at Customs, together with soft and hard trade-related infrastructure, remains a significant part of transaction costs that affect SMEs and should be part of a comprehensive approach to recovery and resilience.

In this context, medium- to long-term recovery must be centred on a pragmatic outward strategy. Sri Lanka should not miss out on forging a well-thought-out FTA strategy with neighbours through BIMSTEC and extended engagement with ASEAN members. Despite the COVID-19 setback, these countries remain poised to grow into the future consumer markets. This does not have to compromise on the existing model but complement it by reaping the efficiencies and market access. It can also stimulate FDI to upgrade further and diversify Sri Lanka's exports. The opportunity costs of complacency and inaction are likely to be substantial, especially when there is compelling evidence that transforming a country like Sri Lanka into a maritime, logistics, and trade hub is likely to be boosted with well-designed preferential goods and services agreements with larger and fast-growing neighbours.

As far as future global value chains are concerned, some reshoring can be expected to ensure supply chain resiliency and the tendency to regionalize GVCs closer to final demand, as observed from the global automotive value chain. That would put further pressure on those outside or the fringes of GVCs, such as Sri Lanka. The options for exports, therefore, depend on offering a specific niche product—expanding high-end branded apparel, for example through existing relationships, leveraging unique agriculture segments to market differentiated products and quality features (such as in tea, spices, and other selected agricultural commodities), as well as services (such as knowledge-process outsourcing or hub-based logistics and other services). The latter can serve new GVCs that will emerge in Asia. Differentiation takes time, but preparation can begin now. In the shorter run, global demand for PPE is expected to remain high, offering new market opportunities for those that can meet the enhanced quality control, testing, and standards to meet developed country standards.

On the supply side, even as some aspects of GVCs may be permanently dislocated, supply-chain risks will remain for Sri Lanka in the short term. The crisis has put into the stark light of the day the risks associated with the over-reliance on one region or country that can compromise operations. Three parallel initiatives are not mutually exclusive to mitigate such supply chain risks. First, Sri Lankan producers should identify opportunities to diversify their supply base to enable rapid shifts, as needed, to address future shocks—including the likelihood of near-future COVID-19-related lockdowns. Second, as higher-end brands and retailers in the U.S. and EU are likely to demand less frequent changes in styles, producers may identify opportunities to increase supply inventories. Third, as a

medium- to longer-term strategy, Sri Lanka may identify opportunities to onshore selected suppliers through FDI to promote greater vertical supply chain capacity.

To emerge from the crisis, hurried investment promotion is unlikely to materialize results in the types of investment that will serve Sri Lanka's long-term economic development objectives. The government's effective handling of the COVID-19 and the recovery itself would be seen favourably by the depleted pool of prospective investors. In the interim, prioritizing remaining regulatory reforms, such as streamlining investment entry and strengthening legal protections, among others, would be essential. On the "soft" side, this includes streamlining and reducing the cost of market entry and reassessing incentives and tax policy. In terms of hard infrastructure, investment-ready facilities are required, including new state-of-the-art zones, industrial estates, and business parks, including biotechnology parks exploring public-private instruments and investment. These hard infrastructure investments will require significant investments in Sri Lanka's ability to structure public-private partnerships.

Sri Lanka also needs to look beyond its current offerings to invest in public works and basic infrastructure, capital investments, and measures that will serve them for the longer term and mitigate the risks associated with trade-related transmission mechanisms of future economic crises. Capital investment projects have the highest multiplier in terms of economic stimulus (versus tax cuts and/or other types of spending), creating jobs rapidly. In addition, digital technologies need to be used to increase security and boost travellers' confidence. It is also time to step up digitalization among companies and the tourism workforce, upskilling the sector to become more resilient. At the same time, we must look beyond the immediate restart of tourism. This crisis is an opportunity to rethink tourism. For instance, so-called "overtourism" had been a concern in many places prior to the pandemic. Now is the moment to redesign and adjust tourism policies and management, including through greater diversification, more innovative products, and the revitalization of rural areas.

Similarly, investments in other backbone infrastructure and accompanying policies can position Sri Lanka for the future of work and the digital age. As working from home becomes more accepted, there will be a higher demand for internet bandwidth and greater concerns around cybersecurity, which could ultimately push the government to boost the speed and resilience of digital infrastructure. This must be coupled with labour market reforms that formalize flexible work. Furthermore, platforms for contactless services will increase demand—from mobile money to e-government services to e-commerce. The latter can be a crucial mechanism to link smaller producers to markets, both at home and abroad. Building on the expansion of digital services such as telemedicine, mobile banking, and digital business platforms using Artificial Intelligence can produce sustained development at lower costs and high efficiency. This is also an opportunity for governments to invest in digitization and automation of government services to increase public sector efficiencies and ease the burden on private sector actors.

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