ECONOMIST IMPACT

Business in an era of heightened geopolitical instability

Briefing report

Supported by

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Contents

About the report

Economist Impact has conducted a research programme, supported by Norsk Hydro, to understand the impact of increasing geopolitical instability on business. First, Economist Impact designed and fielded a survey that rendered insights from 300 C-Suite executives in the US, Europe (UK, France and Germany) and Emerging Asia (China and India). The survey explored the following key research questions: *Which geopolitical events are most relevant to businesses? What are the impacts of geopolitical uncertainty on business performance?* and *How have business strategies and decision-making processes changed as a result?* The primary data from the survey—supplemented by secondary economic, business and risk indicators—informed our analysis. This briefing paper presents the findings of the study and has been produced by a team of researchers, writers, editors and graphic designers including:

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- **Didier Cossin**—Professor, Governance and Finance at the International Institute for Management Development (IMD); Founder and Director of the IMD Global Center
- **Robert Falkner**—Professor, International Relations at the London School of Economics and Political Science
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- **Willy C. Shih**—Robert and Jane Cizik Professor, Management Practice in Business Administration at Harvard Business School
- **Prakash Wakankar**—Chief of International Operations (FES) and CEO, 2-Wheeler Division, Mahindra & Mahindra Ltd

Executive summary and key insights

Businesses are facing an era of geopolitical instability. The US, EU, China and Russia are growing further apart and the consequent fault lines are giving rise to more frequent geopolitical events. Diverging Covid-19 mitigation policies are disrupting global supply chains. Increasing economic protectionism between superpowers is complicating international trade.[1,2] Authoritarian regimes in Russia and China, meanwhile, are undermining business confidence by tightening controls on their domestic economies, and escalating their ambitions to expand into foreign territories.[3,4] The war in Ukraine has exacerbated the global commodity price crisis—particularly in Europe—and the consequent international sanctions have disrupted almost all businesses with operations or partners in Russia.[5] The growing threat of China's potential invasion of Taiwan is already shaking business confidence in Asia; a Chinese blockade of the crucial semiconductor exporter would deliver a separate and devastating global economic shock.[6]

Instability is also stirring distinct social and regulatory pressures on businesses. Issues of corporate social responsibility are increasingly embroiled with geopolitics, as consumers, capital actors and regulators are pressuring businesses to be more transparent and accountable for their activities in foreign markets—as well as those of their suppliers, partners, consumers and political and financial associations.[7] Widening geopolitical schisms are leading policymakers and regulators to structure and administer their respective economies and business environments differently. Consequently, businesses are increasingly navigating administrative, logistical and brand reputation risks.

Economist Impact's *Business in an era of heightened geopolitical instability*, supported by Norsk Hydro, investigates the impact this shifting geopolitical landscape is having on business dynamics. The findings explore which events were most relevant to businesses, what

[1] https://www.ft.com/content/9318db50-e0c3-4a27-9230-55ff59bcc46e
[2] https://www.piie.com/publications/working-papers/public-responses-foreign-protectionism-evidence-us-china-trade-war
[3] https://time.com/6048539/china-tech-giants-regulations/
[4] https://www.theatlantic.com/magazine/archive/2022/12/china-takeover-taiwan-xi-tsai-ing-wen/671895/
[5] https://www.chathamhouse.org/2022/07/geopolitical-corporate-responsibility-can-drive-change
[6] https://www.ft.com/content/c0b815f3-fd3e-4807-8de7-6b5f72ea8ae5
[7] https://www.forbes.com/sites/mikekappel/2019/04/03/transparency-in-business-5-ways-to-build-trust/?sh=5df3dec61490

Geopolitics and business

Geopolitics describes the influence of geography, economics and demography on politics and international relations between states.[8] As the global economy has become more interconnected, geopolitical developments are having an increasingly pronounced impact on businesses. Diverging ideologies and geopolitical competition are resulting in opposing policies, trade wars, economic sanctions and conflict—all of which disrupt business operations and supply chains. Differing policy stances, meanwhile, on human rights, labour practices and natural resource extraction are creating political association and brand reputation problems for businesses. More broadly, fractures within the global political order are preventing leading powers from acting on critical global issues like the environmental crisis, which will continue to affect business operations and strategies.

the impacts were on business performance and whether they have changed business strategies and decision-making processes as a result. Our research presents the following key findings:

Geopolitical instability is creating major short-term disruptions.

- **Rapidly inflating input prices are creating cost issues for businesses.** 42% of business leaders in our survey selected input price increases as the most relevant geopolitical issue to their organisation today. The emerging conflict in Ukraine has exacerbated already-elevated input prices due to the disruption of key Russian and Ukrainian exports of gas, grain, fertilisers and essential metals.[9] Price hikes are increasing business costs and disrupting the production of secondary goods, such as processed foods and manufactured goods.[10] Rising costs are weighing on profits, disrupting output and reducing export competitiveness in the worst affected areas (e.g. Europe).
- **Reduced labour flows are forcing businesses to spend more on their workforce or decrease output.** 35% of firms believe labour availability is the most relevant issue to their organisation today, slightly higher than access to finance difficulties (34%) or tightening climate-related regulations (32%). Firms are grappling with a tight global labour market owing to geopolitical barriers to international labour flows—like Brexit, the Ukraine-Russia conflict and US-China tensions—as well as post-Covid distortions

[8] https://www.merriam-webster.com/dictionary/geopolitics
[9] https://blogs.worldbank.org/developmenttalk/commodity-prices-surge-due-war-ukraine
[10] https://mitsloan.mit.edu/ideas-made-to-matter/ripple-effects-russia-ukraine-war-test-global-economies

to supply and demand for workers.[11,12] The difficulty in finding labour is forcing employers to either spend more on their workforce or reduce their output.

- **Disruptions are leading businesses—especially those in the US and China—to invest in supply-chain reorganisation.** 50% of responding businesses in our survey reported increasing their investment in supply-chain reorganisation over the past 12 months. Firms are being forced to invest in fortifying their supply chains amid ongoing and re-emerging Covid-related lockdowns, trade wars, open conflict and economic sanctions.[13] This is particularly true among businesses in the US and China, compared with firms in India and Europe—where fewer firms have recently invested in reorganisation. For firms, reorganising upstream and downstream components within supply chains often increases both opportunity and financial costs.

Social and regulatory drivers in the US, Europe and emerging Asia are putting pressure on businesses to be more responsible and sustainable.

- **In the US, consumer demand for corporate responsibility appears to have a particularly strong impact on business performance.** 71% of business respondents in the US report that improving corporate responsibility boosted their customer base in the past 12 months. Firms in the US are serving an active civil-society that is increasingly demanding action on these fronts. For some businesses, demonstrating corporate responsibility has a direct impact on consumer demand, but also an indirect impact on the criteria for access to finance and capital.[14]
- **A comparatively large portion of business respondents in China also report increasing consumer pressure for corporate responsibility.** 52% of surveyed businesses in China report increasing consumer demand for corporate responsibility as the geopolitical factor most relevant to their organisation today. Demand for corporate responsibility is a less-cited priority among firms in India and Europe—where businesses are most concerned with ongoing Covid-19 lockdowns and the Russia-Ukraine conflict, respectively. The geopolitical differences within these countries are influencing the extent to which firms are prioritising the varied pressure to be more transparent and accountable.[15]
- **Tightening climate-related regulations are a key concern for businesses in the next two years; the extent to which it is seen as a priority compared with other priorities differs by country.** 39% of responding firms view tightening climate-change regulations as the most relevant issue to their organisation in the next two years. The results vary between regions, however, suggesting that geopolitical factors are influencing the respective business environments. Despite slower regulatory action in some regions, social pressure and a sense of corporate responsibility is compelling some businesses to lead in the area of green transition ahead of policymaking and regulation.

[11]https://migrationobservatory.ox.ac.uk/resources/reports/how-is-the-end-of-free-movement-affecting-the-low-wage-labour-force-in-the-uk/
[12]https://www.ifw-kiel.de/experts/ifw/wan-hsin-liu/goodbye-china-what-do-fewer-foreigners-in-china-mean-for-multinationals-and-the-chinese-economy-17521/
[13]https://www.mckinsey.com/industries/travel-logistics-and-infrastructure/our-insights/how-shanghais-lockdowns-are-affecting-global-supply-chains
[14]https://www.business-humanrights.org/en/latest-news/usa-fashion-industry-explores-supply-chain-digitalisation-as-uyghur-forced-labour-ban-comes-into-force/
[15]https://www.forbes.com/sites/mikekappel/2019/04/03/transparency-in-business-5-ways-to-build-trust/?sh=5df3dec61490

Geopolitical pressures are bringing changes to business strategy, but other factors are also at play.

- **Businesses are reacting to geopolitical instability, but economic costs are also influencing decision-making processes.** Geopolitical pressures are compelling businesses to make changes, but this force is dampened by the cost of reorganisation. 60% of responding firms report that supply-chain reorganisation has increased their costs in the past 12 months. Increasingly businesses are forced to weigh the geopolitical risk in a market, like China, against the financial and opportunity costs of moving away from it.
- **The gradual reorganisation of supply chains predominantly involves fortification, rather than regionalisation.**[16,17,18] 35% of businesses surveyed are prioritising fortifying their supply chains given the current geopolitical dynamics. The complexity of supply chains makes them difficult to reorganise quickly and deep dependencies on cost efficiencies in regions like Asia will make regionalisation prohibitively expensive.[19] The most significant changes are expected to take place in countries like China and Russia, where the economic opportunities no longer outweigh the political risks or reorganisation costs.
- **Despite rising pressure for corporate responsibility, profit remains the prevailing driver of strategy for many firms.** 51% of responding businesses believe that maximising profits will always be more important to their organisation than their responsibilities to society. The ratio of businesses that agree with this sentiment increases in China and the US. Businesses with tight margins and expectant shareholders will temper their response to the increasing demand for corporate responsibility to maintain some focus on their legacy business priorities of scale and profitability—until, of course, any negative impact on consumer demand begins to have a direct impact on their earnings.

[16]https://www.dpworld.com/insights/whitepapers/trade-in-transition
[17]https://www.bloomberg.com/news/newsletters/2022-10-03/supply-chain-latest-friend-shoring-data-are-hard-to-come-by
[18]https://www.dpworld.com/insights/whitepapers/trade-in-transition
[19]https://www.bloomberg.com/news/newsletters/2022-10-03/supply-chain-latest-friend-shoring-data-are-hard-to-come-by

Context and background

The US, EU, China and Russia are growing further apart and the consequent geopolitical fault lines are giving rise to more frequent disruptive events—such as the US-China trade war, the war in Ukraine and the latest flare in tensions around Taiwan. Robert Falkner, Professor of International Relations at the London School of Economics and Political Science, argues that the "emergence of a deep ideological and political divide" in the global order is partly responsible for "the proliferation of geopolitical risks and threats".[20] The consequence of the more frequent and aggressive jostling between superpowers, according to Professor Falkner, is an "international system that no longer serves the purpose of maintaining order and stability as it was meant to do".[21]

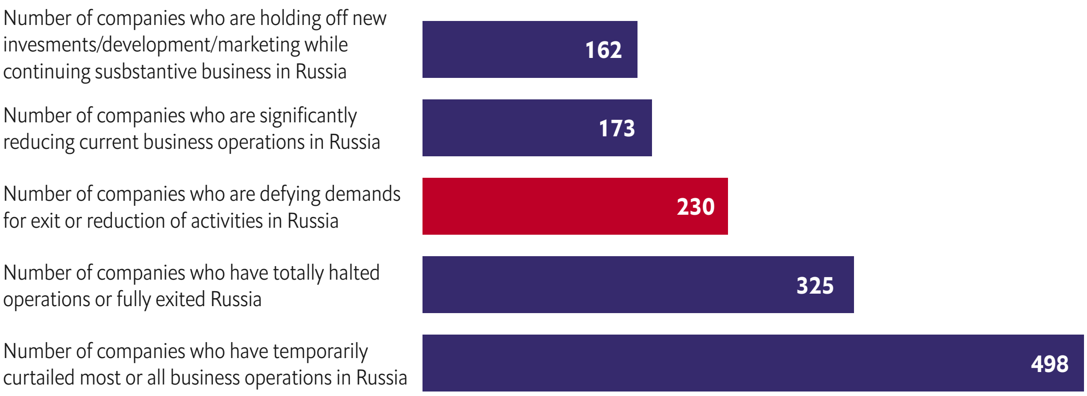
[20]Economist Impact interview with Robert Falkner
[21]Economist Impact interview with Robert Falkner

The resultant geopolitical instability weighs on businesses' performance and decision-making processes. Geopolitical events are disrupting supply chains, inflating input costs, affecting the supply of labour and limiting access to finance, among other factors.[22,23] The associated disruptions are forcing global businesses to re-evaluate their long-term positions in key markets. European business investment in China, for example, decreased by 35% year-on-year in the first eight months of 2022.[24,25] Additionally, firms are considering whether their activity in a certain market could jeopardise their brand's reputation, owing to the implied association with a certain state or its actions. University of Yale research found that over 1,000 firms have opted to withdraw, suspend or reduce operations in Russia—following the invasion of Ukraine—beyond what is required by international sanctions.[26]

Alongside the threat to brands' reputation from potential political association, firms also face increasing pressure from regulators, consumers and capital actors—albeit to varying degrees—to be more transparent and accountable for their governance and environmental impact.[27,28] Prakash Wakankar, Chief of International Operations (FES) & CEO, 2-Wheeler Division, Mahindra & Mahindra Ltd, argues that increasingly "discussions at the shareholder level specifically refer to targets on ESG (environmental, social and corporate governance) and D&I (Diversity and Inclusion)".[29] Mr Wakankar believes that although traditionally these would not have been priority areas for many firms, today "they are as material to businesses as the rate of return and rate of capital".[30]

Figure 1: In response to the Russian Invasion in Ukraine, many firms are choosing to withdraw operations from Russia (data as of 7 November 2022)

Number of companies



Source: https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain
Graphic insight: Economist Impact

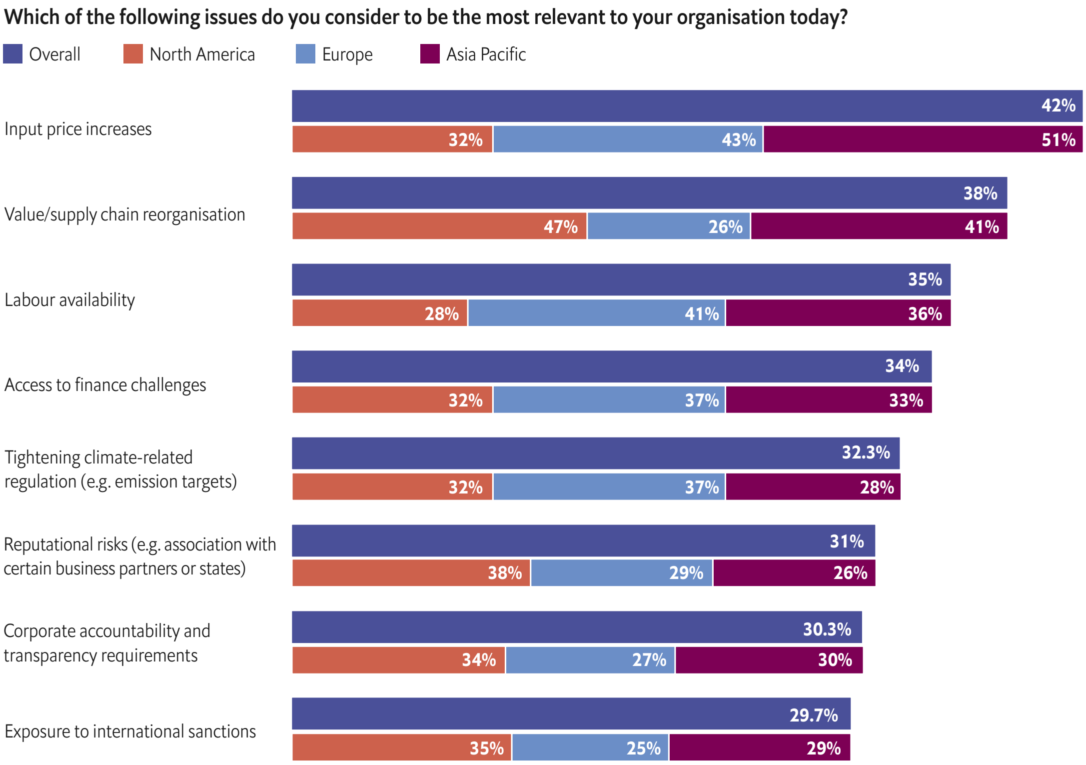
[22] https://www.swp-berlin.org/en/publication/a-new-geopolitics-of-supply-chains
[23] https://www.spglobal.com/ratings/en/research/articles/220531-geopolitical-shifts-are-exacerbating-credit-risks-12396788
[24] https://www.bloomberg.com/news/articles/2022-09-21/china-losing-appeal-as-european-firms-rethink-future-investments?leadSource=uverify%20wall
[25] https://www.fdiintelligence.com/content/news/european-chamber-raises-flag-on-doing-business-in-china-81537
[26] https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain
[27] https://www.ey.com/en_ch/law/policymakers-expect-action-on-climate-change
[28] https://www.mckinsey.com/capabilities/sustainability/our-insights/the-challenge-of-climate-change
[29] Economist Impact interview with Prakash Wakankar
[30] Economist Impact interview with Prakash Wakankar

Short-term headaches

Geopolitical instability is creating major short-term disruptions

Geopolitical instability is creating myriad disruptions for businesses in the short term.[31] The emerging conflict in Ukraine has exacerbated already-elevated input prices, primarily owing to the disruption of key Russian and Ukrainian exports of gas, grain, fertilisers and essential metals.[32] Firms are also grappling with a tight labour market. The difficulty in finding labour is forcing employers to either spend more on their workforce or to reduce their output. Supply-chain woes have been compounded, meanwhile, by ongoing and re-emerging Covid-related lockdowns, trade wars and economic sanctions in certain key export markets.[33]

Figure 2: Input price increases, global value chain reorganisation and labour availability are the most relevant issues businesses are up against today
Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

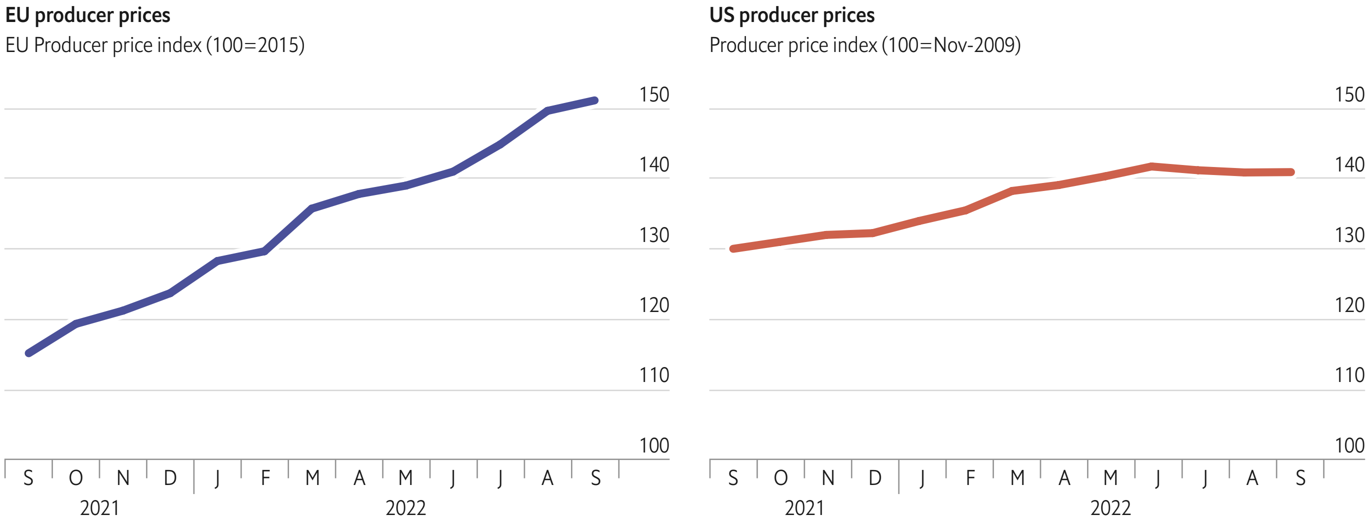
[31] https://www.ey.com/en_gl/geostrategy/when-political-disruption-surrounds-you-whats-your-next-strategic-move
[32] https://blogs.worldbank.org/developmenttalk/commodity-prices-surge-due-war-ukraine
[33] https://www.mckinsey.com/industries/travel-logistics-and-infrastructure/our-insights/how-shanghais-lockdowns-are-affecting-global-supply-chains

Input-price crisis

Europe is suffering from a particularly severe energy price crisis as international sanctions, political coercion and war-related disruptions restrict the supply of critical Russian gas exports.[34] In September, producer prices in Europe were up 30% year-on-year (yoy).[35] In the UK, businesses are facing gas prices that have risen by more than 95% year-to-date (ytd) in 2022.[36] Asia is also suffering from higher energy prices, as well as rising food prices as restricted grain exports from Ukraine inflate food commodity prices.[37,38,39] In the US, meanwhile, higher energy prices are being compounded by particularly strong demand, as a result of the US government's fiscal stimulus package launched during Covid-19.[40] In the US, producer prices were 9% higher in September than a year earlier. The US producer price index is led by energy prices which are 24% higher year-on-year (yoy).[41]

42% of respondents considered input price increases as the most relevant issue to their business today.[42] The price hikes are increasing business costs and disrupting the production of secondary goods like processed foods and manufactured goods. 68% of businesses surveyed have suffered increasing costs in the past 12 months owing to rising input prices. Energy is the driving force inflating consumer price baskets, so the cost consequences are most severe for energy-intensive sectors like manufacturing, construction and the health sector. Firms are increasingly forced

Figure 3: Producers prices are increasing across regions

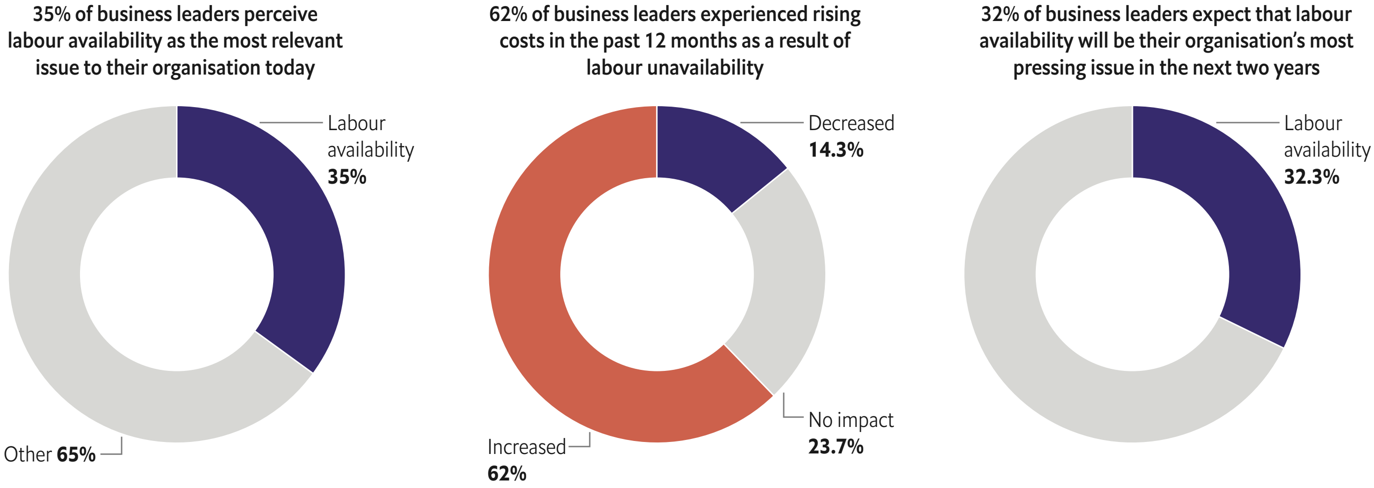


Source: Eurostat
Graphic insight: Economist Impact

Source: US Bureau of labour statistics
Graphic insight: Economist Impact

[34] https://thehill.com/opinion/energy-environment/3567769-nord-stream-is-russias-latest-tool-for-coercion-and-control-in-europe/
[35] https://ec.europa.eu/eurostat/databrowser/view/STS_INPP_M__custom_3734891/default/table?lang=en
[36] https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/czda/mm23
[37] https://www.imf.org/en/Blogs/Articles/2022/07/28/blog-07282022-apd-asias-economies-face-weakening-growth-rising-inflation-pressures
[38] https://www.imf.org/en/Blogs/Articles/2022/07/28/blog-07282022-apd-asias-economies-face-weakening-growth-rising-inflation-pressures
[39] https://www.aljazeera.com/news/2022/2/17/infographic-russia-ukraine-and-the-global-wheat-supply-interactive#:~:text=The%20creation%20of%20ports%20and,and%20Ukraine%20(seven%20percent).
[40] https://www.federalreserve.gov/econres/notes/feds-notes/fiscal-policy-and-excess-inflation-during-covid-19-a-cross-country-view-20220715.html
[41] https://www.bls.gov/opub/ted/2022/producer-prices-increased-8-5-percent-from-september-2021-to-september-2022.htm
[42] https://mitsloan.mit.edu/ideas-made-to-matter/ripple-effects-russia-ukraine-war-test-global-economies

Figure 4: Business leaders globally are experiencing labour market troubles/issues
Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

to decide between absorbing the cost internally—and potentially facing the ire of owners and shareholders watching their earnings evaporate—or passing the cost on to consumers. In doing so, businesses risk decreasing the competitiveness of their goods in global markets. The dangers will be particularly pertinent for firms in Europe—the region imported 21% of its gas from Russia in 2021—so its firms are likely to suffer from the highest price rises as supply of the critical input contracts.[43,44]

Input price increases remain the most frequently cited selection for firms (42%) when asked about the most relevant issue to their organisation in the next two years. According to our colleagues in the Economist Intelligence Unit (EIU), European gas prices will nearly treble this year, after a fivefold increase last year.[45] The prolonged period of elevated prices, however, may spur some positive reaction. In an attempt to limit rising costs, businesses will be forced to reduce energy consumption and a renewed focus will be placed on energy efficiency.

Higher prices of traditional fuels, meanwhile, are likely to encourage firms to invest in diversifying their energy supply and reduce their reliance on imports.[46] 55% of responding firms have increased investment in the past 12 months as a result of input price hikes. The survey data suggests that firms are reworking their energy strategies. Businesses may even be tempted to explore cleaner energy solutions when they are forced to reconsider their energy supply portfolio. In 2022, the European Commission proposed new REpowerEU legislation to reduce reliance on Russian gas by supporting and expediting businesses' green transition.[47]

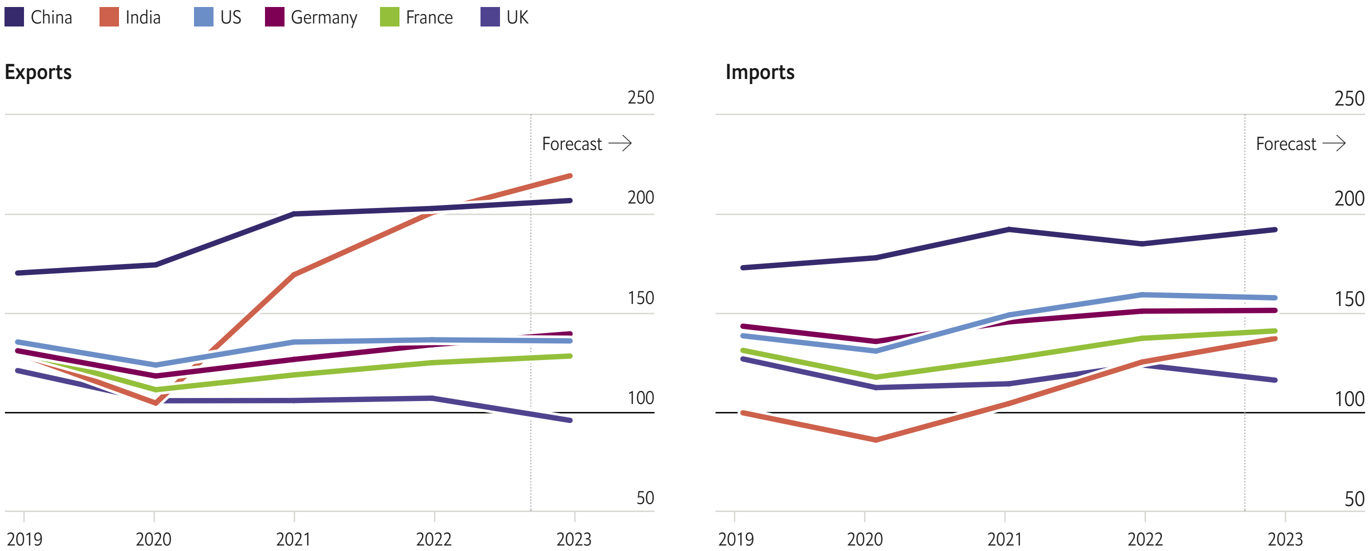
[43]https://www.eiu.com/n/energy-crisis-will-erode-europe-competitiveness-in-2023/
[44]https://www.iea.org/reports/russian-supplies-to-global-energy-markets/gas-market-and-russian-supply-2
[45]https://viewpoint.eiu.com/analysis/article/1432523726/
[46]https://www.cer.eu/insights/impact-ukraine-war-global-energy-markets
[47]https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3131

Labour market troubles are adding to price pressures

The rising price of labour is also adding to business disruptions, largely driven by a shortage of workers. 35% of respondents to our business survey believe that labour availability is the most relevant issue to their organisation currently; 62% reported rising costs in the past 12 months as a result of labour unavailability. Post-Covid distortions to supply and demand for workers, as well as the disruption of international labour flows owing to key geopolitical developments—like Brexit, the Ukraine-Russia conflict and worsening US-China relations—have resulted in a contraction in the global supply of labour for most sectors.[48,49,50] By the first quarter of 2022, job vacancies in the UK were 50% higher than before the Covid-19 pandemic.[51] In mid-2022, 11m job vacancies were posted against a pool of less than 6m unemployed.[52]

The transport sector, for example, was forced to lay off large portions of their labour force during the depths of the coronavirus-related crash in consumer demand—2.3m jobs have been lost in airlines, airports and civil aerospace since the emergence of the global pandemic.[53] Once restrictions eased globally, the affected sectors were unable to hire staff quickly enough to meet the subsequent spike in demand.[54] Concurrently, international labour flows are suffering from barriers like political association. In the agriculture, hospitality and retail sectors, which often rely on seasonal workforces, labour

Figure 5: COVID-19 restrictions distorted trade flows
Volume of goods index rebased to 2010=100



Source: EIU Data
Graphic insight: Economist Impact

[48]https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Labour_market_in_the_light_of_the_COVID_19_pandemic_-_quarterly_statistics
[49]https://www.cipd.co.uk/knowledge/brexit-hub/workforce-trends#gref
[50]https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_834081.pdf
[51]https://www.oecd-ilibrary.org/sites/f87551f1-en/index.html?itemId=/content/component/f87551f1-en
[52]https://www.oecd.org/employment-outlook/2022/
[53]https://www.ft.com/content/93736968-8fcf-425f-b8e5-fcd9736d37f6
[54]https://www.oecd-ilibrary.org/economics/the-post-covid-19-rise-in-labour-shortages_e60c2d1c-en

shortages have had a material impact on output. Businesses in the affected industries have been forced to reduce their available products or services to account for the declining productivity of their capital assets, without the labour to operate them.[55] As the price of labour continues to rise, the biggest risk for businesses is a wage-price spiral getting out of hand, although this remains a distant prospect at this stage.

Supply-chain disruptions

The current era of heightened geopolitical instability is putting significant pressure on supply chains. 38% of responding firms view the reorganisation of their supply chains as the most relevant issue to their organisation today, 48% have significant investment planned to fortify or diversify their supply chains and 50% have significant investment planned to move operations closer to their commercial markets.[56] The steady progress of globalisation since the 1990s encouraged firms to look abroad for competitive advantage and growth opportunities. This trend of offshoring and outsourcing their operations in the name of economic efficiency has nurtured multinational supply chains that serve globally integrated markets. In recent years, however, Covid-related lockdowns, increasing hostilities between superpowers and open conflicts have made businesses question their positions in foreign markets. Firms are learning that growth opportunities in certain foreign markets are increasingly offset by greater geopolitical risk. China's zero-Covid policy, for example, led local authorities to lockdown Shanghai when cases began to rise in early 2022. The disruption to the world's busiest container terminal wreaked havoc on businesses with operations or trade partners that relied on the facility to import and export their goods.[57,58] Similarly, in 2021, lockdowns in Vietnam, Malaysia and Taiwan brought the global semiconductor industry to a halt, as restrictions disrupted critical computer chip processing and testing facilities in those countries.[59] The semiconductor shortage implicated the majority of computational electronic goods producers globally, whose goods rely on the computer chips to process information.

As geopolitical divides grow, competing powers are using economic levers for coercion. These measures deployed by jostling superpowers are badly disrupting global supply chains. The US-China trade war demonstrated the negative impact of economic protectionism on businesses.[60] Russia has leveraged Europe's dependence on its gas exports to apply pressure during the recently escalated tensions with NATO, creating supply concerns for businesses.[61] In return, extensive international sanctions imposed on Russia following its invasion of Ukraine have forced most western enterprises operating in Russia to either close, halt or redirect their operations.[62] For firms, reorganising upstream and downstream components within supply chains often increases both opportunity and financial costs.

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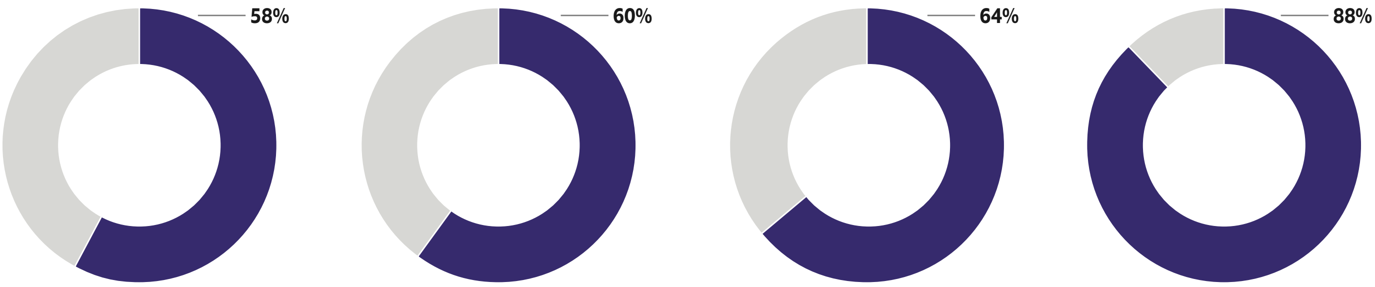
[55]https://www.ft.com/content/027ea2e9-d6c3-4a18-a735-87f92ace95a4
[56]https://www.fticonsulting.com/insights/articles/supply-chain-disruption-risk-global-economic-recovery#:~:text=Heightened%20demand%2C%20trade%20restrictions%2C%20factory,a%20threat%20to%20economic%20stability
[57]https://www.mckinsey.com/industries/travel-logistics-and-infrastructure/our-insights/how-shanghais-lockdowns-are-affecting-global-supply-chains
[58]https://www.worldshipping.org/top-50-ports
[59]https://www.ft.com/content/7b678988-53d1-4a52-8866-28f109e88d79
[60]https://www.nber.org/digest/202204/how-us-china-trade-war-affected-rest-world#:~:text=US%20exports%20to%20China%20fell,a%20statistically%20insignificant%205.5%20percent.
[61]https://www.reuters.com/business/energy/russias-gazprom-declares-force-majeure-gas-supplies-europe-2022-07-18/
[62]https://www.consilium.europa.eu/en/infographics/impact-sanctions-russian-economy/

Diverging market pressures

Distinct social and regulatory drivers in the US, Europe and emerging Asia are determining the pressure on businesses to be more responsible and sustainable.

Geopolitical instability is enhancing the social and regulatory pressure on firms to improve their corporate social responsibility, as consumers, capital actors and legislators are compelling businesses to be more transparent and accountable for their activities in foreign markets—as well as those of their suppliers, partners, consumers and political and financial associations.[63] 44% of responding firms ranked increasing consumer demand for corporate responsibility as the most relevant geopolitical event to their organisation today. When Russia invaded Ukraine in February 2022, for example, firms with operations or partners in Russia faced steep public pressures to halt business or withdraw from the market.[64] Courtney Rickert McCaffrey, the Global Insights Leader of the EY Geostrategic Business Group, highlights that many businesses withdrew to a greater degree "than what was strictly necessary in terms of cutting ties with Russia or Russia-affiliated entities, just for the reputational risk involved and the stakeholder dimension of it."[65] The 2022 Edelman Trust Barometer, which explores trust within society, found that nearly 75% of survey respondents believe that CEOs themselves should make the decision to halt business activities in regions and countries that threaten national security, rather than waiting for governments to impose sanctions.[66]

Figure 6: Stakeholders are increasingly holding businesses accountable based on their personal values and beliefs
Percentage



Source: Edelman Trust Barometer 2022 Report
Graphic insight: Economist Impact

[63] https://www.forbes.com/sites/mikekappel/2019/04/03/transparency-in-business-5-ways-to-build-trust/?sh=5df3dec61490
[64] https://www.business-humanrights.org/en/latest-news/pressure-mounts-as-list-of-foreign-companies-pulling-out-of-russia-grows/
[65] Economist Impact interview with Courtney Rickert McCaffrey.
[66] https://www.edelman.com/sites/g/files/aatuss191/files/2022-05/2022%20Edelman%20Trust%20Barometer%20Special%20Report%20The%20Geopolitical%20Business-Final.pdf

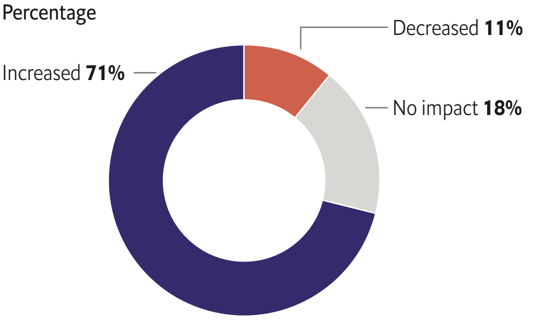
Growing consumer demand for transparency and accountability present opportunities for some markets, and risks for others

The degree and source of pressure depends on the region and market. 71% of business respondents in the US believe that demonstrating positive corporate responsibility boosted their customer base and revenues in the past 12 months. Harvard Business School estimates that 90% of firms on the S&P 500 index published CSR reports, compared with just 20% in 2011.[67] Firms in the US are serving an active civil society that is increasingly demanding action on these fronts. For some businesses, demonstrating corporate responsibility has a direct impact on consumer demand, but also an indirect impact on the criteria for access to finance and capital.[68] Kathryn Lundquist, Economic Affairs Officer at the World Trade Organization, suggests that the increasing demand to know more about where products are coming from is forcing businesses to be more transparent regarding their foreign operations and affiliates. According to Lundquist, "there is an awareness that not revealing this information is a risk [for businesses], as it could reduce consumer demand."[69]

Interestingly, 52% of business respondents in China report increasing consumer demand for corporate responsibility as the most relevant geopolitical factor to their organisation today. It is likely that firms in China understand that their brand could increasingly suffer from association with the political, human rights, labour and environmental conditions in China. Our survey data also indicates that firms are working to counteract reputational issues, with 72% of responding Chinese firms increasing investment in the past 12 months to mitigate reputational risks of association with certain business partners or states.

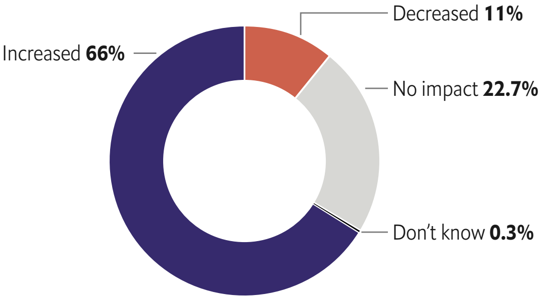
Not all consumer markets appear to be as preoccupied in these areas as their US and Chinese counterparts, however. 62% of business respondents from India report that reputational risks by association had no impact on their consumer base in the past 12 months. It could be that consumers within India are less scrutinising or more preoccupied with economic pressures. Alternatively, it may be that policymakers, legislators and regulators already keep companies in close check in these markets.

Figure 7: Corporate accountability and transparency requirements in the US have increased the size of an organisation's customer base
Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

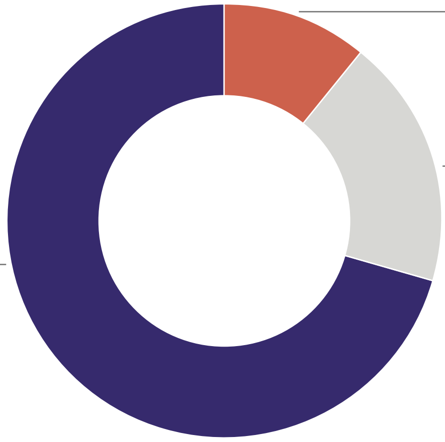
Figure 8: Most businesses surveyed agree they should be advocating for and championing social, environmental or political causes
Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

[67]https://online.hbs.edu/blog/post/corporate-social-responsibility-statistics
[68]https://www.business-humanrights.org/en/latest-news/usa-fashion-industry-explores-supply-chain-digitalisation-as-uyghur-forced-labour-ban-comes-into-force/
[69]Economist Impact interview with Kathryn Lundquist.

Figure 9: Most responding firms have a clear sense of purpose that goes beyond maximising profits for shareholders
Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

Tightening climate regulations are creating a new sphere for competition

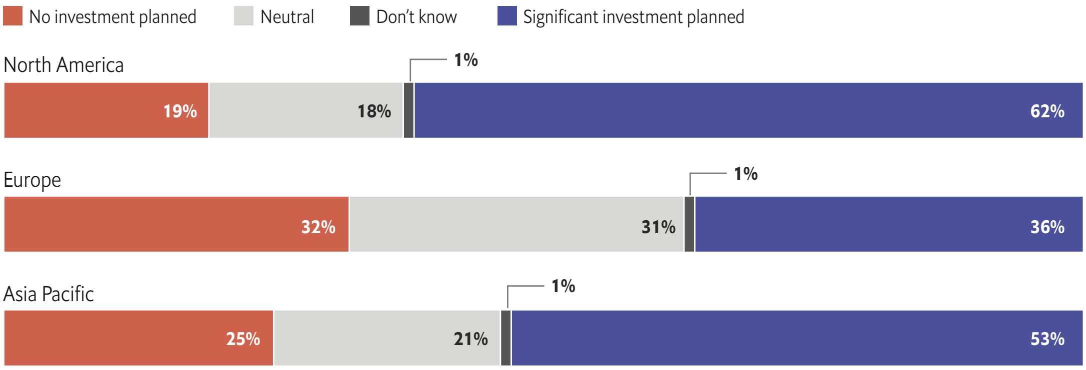
Tightening climate regulations are compelling businesses to transition towards greener practices. 50% of businesses have planned investment in reducing their emissions and to become more carbon neutral. Businesses in Europe are particularly concerned with tighter regulations, where almost 37% of firms believe it is the most relevant issue to their organisation today, while 47% believe it will be the most relevant issue in the next two years. Regulatory pace is particularly quick in European markets, like France and Germany.[70,71] The EU's proposed Carbon Border Adjustment Mechanism (CBAM), for example, would hold businesses accountable for the environmental impacts of their global supply chains by putting a price on the carbon emissions embedded in the products imported to the bloc.[72,73] The CBAM also requires businesses to identify, address and remedy parts of their operations that "could or do infringe on human rights, the environment and good governance."[74]

Regulators in the US have been slower to act on climate. In 2019, the US ranked 60th (last) in the climate change policy section of the Climate Change Performance Index (CCPI), while their European counterparts ranked ninth.[75] Only 32% of responding firms in the US ranked environmental regulations as the most pressing issue to their organisation today. A similar ratio of firms in China (34%) shared this view. China has made some policy progress, but its climate change policy score in the CCPI (which is reviewed annually) tends to lag behind EU countries.[76]

[70] https://www.forbes.com/sites/forbestechcouncil/2022/07/06/sustainability-upcoming-regulations-could-impact-every-business/?sh=1352db26d076
[71] Clapp, J & Meckling, J. (2016). Business as a global actor. In The Handbook of Global Climate and Environment Policy, ed. Robert Falkner. DOI: 10.1002/9781118326213.ch17
[72] https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/698889/EPRS_BRI(2022)698889_EN.pdf
[73] https://www.forbes.com/sites/forbestechcouncil/2022/07/06/sustainability-upcoming-regulations-could-impact-every-business/?sh=1352db26d076
[74] https://www.ey.com/en_nl/tax/how-the-eu-aims-to-enforce-sustainability-goals-beyond-its-borders
[75] https://newclimate.org/sites/default/files/2018/12/CCPI-2019-Results.pdf
[76] https://newclimate.org/sites/default/files/2018/12/CCPI-2019-Results.pdf

Figure 10: A greater share of business respondents in North America and Asia-Pacific have significant investment planned to reduce emissions in the coming year, compared to their European counterparts

Percentage



Source: Economist Impact Survey
Graphic insight: Economist Impact

Figure 11: Business concerns around tightening climate-related regulations tend to differ among regions

Percentage

Source: Economist Impact Survey
Graphic insight: Economist Impact

However, US and Chinese regulators are now making concerted efforts to narrow the gap. A greater number of business leaders from China and the US (64% and 65%, respectively) report tightening environmental regulations affecting their organisation's operating costs over the past 12 months, as opposed to those in Europe (46%) and especially those in India (33%). Rapid regulatory action is stirring economic competition between the two superpowers. The US Inflation Reduction Act, passed in 2022, focuses in large part on decarbonisation, in particular incentivising the growth of domestic renewables manufacturing and production. The climate-related provisions are designed to undermine China's dominance in the clean energy sector and to maximise the benefits to the US economy from the country's green transition.[77] The protectionism of the 2022 Inflation Reduction Act has also drawn the ire of European businesses and policymakers, threatening a broader tariff war.[78]

[77]https://www.csis.org/analysis/why-new-climate-bill-also-about-competition-china
[78]https://www.globaltimes.cn/page/202211/1279049.shtml

Businesses are not viewing climate change as a question of "will it hurt me or won't it?", but instead a case of "how soon do I need to get on the bandwagon on that net-zero transition?"

Only 22% of responding firms in India ranked environmental regulations as the most pressing issue to their organisation today. Although climate-related regulations are tightening more slowly in India, our survey data suggests that some firms are still taking action. 40% of responding firms in India are planning to reduce their emissions and to become more sustainable. The implication, therefore, is that social pressure and a sense of corporate responsibility is compelling some businesses to lead in the area of green transition ahead of policymaking and regulation. Professor Falkner believes that businesses are not viewing climate change as a question of "will it hurt me or won't it?", but instead a case of "how soon do I need to get on the bandwagon on that net-zero transition?".[79] However, Professor Falkner also admits that some companies "will need to be dragged along through regulation".[80]

[79]Economist Impact interview with Robert Falkner
[80]Economist Impact interview with Robert Falkner

Outlook for global businesses

Geopolitical pressures are bringing changes to business strategy, but other factors are also at play.

Geopolitical instability is stirring change in business dynamics and strategies, albeit gradually. 35% of businesses surveyed are prioritising fortifying their supply chains given the current geopolitical dynamics. These firms are shifting the focus of their operating models from efficiency to resilience. Geopolitical pressures, however, are only part of the broader economic equation that influences decision-making. Many firms will shoulder the increasing risks to preserve their economic opportunities or efficiencies within the current systems. Other businesses will be deterred by the associated costs.[81] 60% of responding firms report that supply-chain reorganisation has increased their costs in the past 12 months.

Diversification more than regionalisation

At this stage, the gradual reorganisation that is taking place within supply chains is mostly focused on diversification and fortification rather than redirection and regionalisation.[82,83,84] This is likely because near-shoring, friend-shoring (redesigning supply chains to countries that are political allies) and reshoring strategies would apply even greater upward pressure on business costs, and ultimately reduce the competitiveness of most goods in the short term.[85] In fact, even the costs of diversification and fortification are likely to put some firms off. Only 36% of responding firms in Europe and only 30% in India plan to invest in fortifying or diversifying their supply chains. The data suggests that businesses in these countries either perceive their operations to be less at risk, or they are more accepting of the increasing risk premia to maintain their economic opportunities.

The mood on China

There are some markets, however, where increasing geopolitical pressure and decreasing economic opportunities are beginning to merit investment in contingencies. 60% of firms in China have significant investments planned to fortify and diversify their supply chains. In China, increasing geopolitical risk coincides with some

[81]https://www.dpworld.com/insights/whitepapers/trade-in-transition
[82]https://www.dpworld.com/insights/whitepapers/trade-in-transition
[83]https://www.bloomberg.com/news/newsletters/2022-10-03/supply-chain-latest-friend-shoring-data-are-hard-to-come-by
[84]https://www.dpworld.com/insights/whitepapers/trade-in-transition
[85]https://www.bloomberg.com/news/newsletters/2022-10-03/supply-chain-latest-friend-shoring-data-are-hard-to-come-by

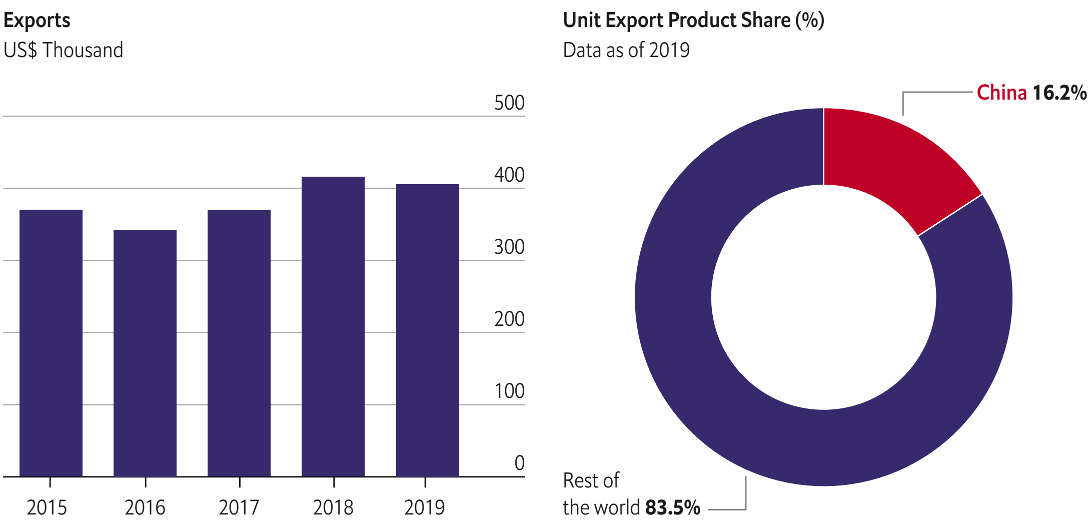
declines in the economic opportunities that originally attracted corporations in the 1990s. Today, firms with operations or partners in China are negotiating the disruptions of an increasingly involved state with a zero-Covid policy, and the potential brand-reputation implications of China's cooling relations with the West in relation to its sustainability, labour rights and human rights practices. Adding to this, businesses in China are now facing the increasing cost of labour, capital infrastructure, electricity and water.[86]

If the growing geopolitical disincentives and shrinking economic incentives associated with operating in China continue to converge, businesses are likely to reconsider their position in the market altogether. There are some very early signs of this taking place in the textile industry, for example, with some firms moving their less complicated production processes (that are easier to move) from Southern China to Cambodia.[87] Similarly, tech giants Apple and Google have begun moving the production of some of their flagship products from China to India.[88] The quantities remain small, with the majority of production remaining in China, but the signal is clear: the risks in China are now sizeable enough to merit the cost of supply-chain diversification.

Even in the event of a sudden rupture in confidence in China, however, businesses would not be able to sever ties with the important market quickly. "The Chinese economy and the world economy are much more deeply integrated than people appreciate", according to Professor Willy C. Shih, Robert and Jane Cizik Professor of Management Practice in Business Administration at Harvard Business School.[89] Often, globalised supply chains depend on Chinese operations or partners at multiple levels; in 2019, China

[86]https://ins-globalconsulting.com/news-post/labor-cost-china/
[87]https://fdra.org/latest-news/wary-of-china-companies-head-to-cambodia/
[88]https://www.ft.com/content/d5fc0566-9916-449d-953f-85b4d325bcc0
[89]Economist Impact interview with Willy C. Shih.

Figure 12: China continues to dominate global intermediary goods exports



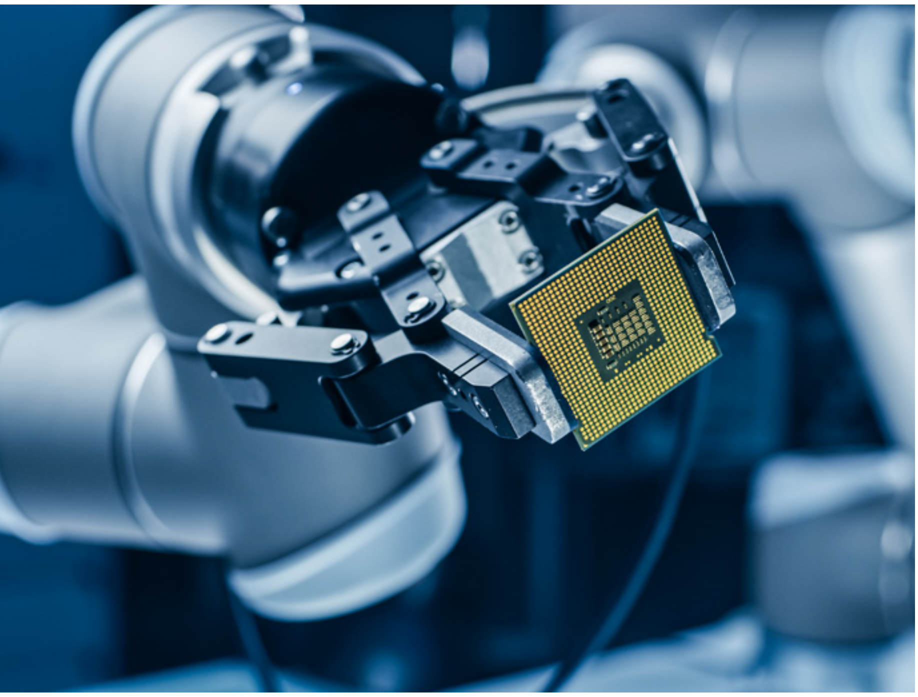
Source: World Integrated Trade Solution
Graphic insight: Economist Impact

exported US$405bn in intermediary goods (roughly 16% of global supply).[90] Considering the scale of China's presence in global supply chains, untangling from the market would be slow and painstaking. China is also a vital consumer market for most global businesses—a feature that is likely to become more prevalent if the country supplants the US as the world's largest economy by 2030, as expected.[91] Consequently, firms will be keen for their operations to maintain some form of proximity to such an important market.

Any change will be gradual

The shifting business confidence in China demonstrates that some major changes to business dynamics are possible within the new geopolitical context, but also that any alterations will take place gradually. Business strategies are more likely to respond to increasing pressures from geopolitical instability when structural factors, like rising transport costs and declining economic opportunities, move in lock-step. These changes are likely to be costly in the short term, and as such larger firms will be more empowered to make them. 61% of respondents from businesses with more than 500 employees have invested in reorganising their supply chain in the last 12 months, compared to only 40% of firms with less than 500 employees. Business leaders are likely to re-evaluate their positions, where possible, at future decision-making junctures. Courtney Rickert McCaffrey believes that "supply chains are sticky—they do not change overnight unless there is an absolute need to do so—and so it is when [businesses] need to expand production capacity or are looking for a new set of suppliers that they have started to diversify and build more resilience."[92]

[90] https://wits.worldbank.org/CountryProfile/en/Country/CHN/Year/2019/TradeFlow/Export/Partner/all/Product/UNCTAD-SoP2
[91] https://www.pwc.com/id/en/not-migrated/shift-of-global-economic-power-to-emerging-economies-set-to-cont.html#:~:text=When%20looking%20at%20GDP%20measured,in%20the%20world%20by%202050.
[92] Economist Impact interview with Courtney Rickert McCaffrey.



The tension between profitability and responsibility

Similarly, many businesses will be unable to respond immediately to the growing demands for corporate responsibility and climate action. Our survey data demonstrates that firms tend to agree that businesses (in general) have a responsibility to take a stand on key societal issues (71%) and to support civil society institutions in the markets they operate in (74%). Furthermore, 66% of business respondents feel that their organisation (specifically) considers its role in society in all decision-making processes. When asked about their firm's priorities, however, corporate responsibility becomes a less cited option. Only 26% of responding firms ranked corporate responsibility training as a matter of high priority for their respective organisations given the current geopolitical dynamics. More businesses cited priorities like investing in innovation (45%) and redesigning product strategy (43%). In fact, 51% of responding firms feel that maximising profits will always be more important to their organisation than their responsibilities to society. Our survey data suggests that the majority of businesses understand that they should be more responsible and sustainable, but for many firms, the costs of implementing the change will be untenable. Businesses with tight margins and expectant shareholders will temper their response to the increasing demand for corporate responsibility to maintain some focus on their legacy business priorities of scale and profitability—until, of course, any negative impact on consumer demand begins to have a direct impact on profitability.

Once again, larger businesses will be more empowered to act on these issues, and thus benefit from satisfied stakeholders and revenue growth.[93,94] Only 41% of respondents from smaller businesses have significant investments planned to reduce emissions and become more carbon neutral, compared with 60% of larger firms. Moreover, a survey of business leaders conducted by Gousto in the UK found that one-third of business owners stated that environmental sustainability was not a pressing priority for them at the moment, given the rising energy costs and inflation.[95] Mahinthan Mariasingham, Senior Statistician and Project Officer at the Asian Development Bank argues that businesses are unlikely to spend money on adopting positive initiatives like the "green agenda" until it becomes an economic imperative for them to do so.

[93]https://businesschief.eu/sustainability/why-prioritising-esg-in-uncertain-times-matters
[94]https://greeneconomy.media/its-now-or-never-why-businesses-must-prioritise-environmental-action/
[95]https://www.edie.net/cost-crisis-are-businesses-backtracking-on-sustainability-just-as-they-need-to-step-up/

Increasing geopolitical instability does not appear to be diverting the legacy priorities held by businesses. Historically, periods of heightened geopolitical risk have often suppressed innovation; a 2022 Harvard Business Review study found that from 1985-2017, a 1% increase in geopolitical risk (based on the monthly index published by the US Federal Reserve) resulted in a 0.2% decrease in the number of patents submitted (a basic output measure on investment in innovation).[96] Despite the current instability, however, our survey findings indicate that investing in innovation and R&D remains at the forefront of priorities for business leaders globally.[97] 57% of responding business leaders are planning significant investments in the digitalisation of workflows in the near future. Business respondents in India, for example, are particularly interested in investing in innovation and R&D, with 70% ranking it as their top priority. For many firms, automation and digitisation will offer opportunities to offset the rising costs of inputs, labour and supply chains with productivity increases.

[96]https://hbr.org/2022/03/research-when-geopolitical-risk-rises-innovation-stalls
[97]https://hbr.org/2022/03/research-when-geopolitical-risk-rises-innovation-stalls

Conclusion

The current era of heightened geopolitical instability is rendering supply-side disruptions for businesses in the short term, and is exacerbating more structural shifts to the business environment in the long term. Increasing geopolitical pressures are resulting in gradual shifts, but economic costs are also bringing change to current business strategies and practices. Considering the broader economic equation that guides a firm's decision-making processes, it is likely that many will shoulder the heightened instability (and associated risks) in the continued search for economic efficiencies and growth opportunities. In broad terms, business strategies remain mostly guided by the legacy goals of efficiency, growth and profitability.[98]

With this in mind, Economist Impact offers the following recommendations as potential strategies to help businesses navigate the current geopolitical landscape:

Prudence. As geopolitical instability continues, and possibly deteriorates further, businesses will benefit from being able to spot developing risks early on and understanding how best to mitigate them. Businesses could consider bringing geopolitical risk analysis in-house to support leaders with their strategic, long-term decision-making processes. Alternatively, firms should ensure that their senior leadership teams have the necessary geopolitical risk analysis skills to identify and mitigate upcoming risks and opportunities.

Agility. In addition to the ability to identify and develop mitigation strategies for geopolitical risks, businesses should ensure they have the operational agility to implement changing strategies and adapt to the new state of play. At their next decision-making juncture, businesses should be accounting for the increasingly unstable geopolitical environment and planning appropriately to fortify and diversify their operations.

Collaboration. Finally, businesses could strongly benefit from engaging actively and collaborating with employees, industry peers, policymakers and wider society to understand issues and share best practices. In particular, in navigating the structural shifts that geopolitical instability is exacerbating, firms should be collaborating with stakeholders at all levels to ensure they are more responsible and sustainable.

[98]https://www.ey.com/en_gl/purpose/why-business-must-harness-the-power-of-purpose

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