Managing Geopolitical Risk

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For chief executives of American multinationals long-accustomed to being "masters of the universe," with influence and resources rivaling most nation-states, the last few years have been costly and humbling. Geopolitical risk has emerged as a critical factor disrupting business strategy, and it looks poised to grow more significant in the years to come. This will upend not just supply chains and divide global workforces, but call into question multinationals' identity, values, and core strategies.

To better navigate this complex environment, executives will need to do more than simply diversify their supply chains and revamp operating models. To succeed, they will need to fundamentally reexamine their beliefs about how the world works and their place in it.[1]

Why Geopolitical Risk Fell to the Wayside

Multinationals have struggled with the resurgence of geopolitical risk for four principal reasons. First is short-termism: even before the U.S.-China trade war, many executives were willing to privately concede their ambivalence about their presence in China.[2] They nonetheless felt pressured by investors to deliver growth even if it meant risking their intellectual property and fostering eventual competitors in the long-term.

Second is the absence of geopolitical, as opposed to simply international, experience and training among corporate decisionmakers. An analysis by the authors of the twenty largest listed American companies by market capitalization finds that only six have board members with geopolitical experience.[3] Instead of situating their strategies in the context of geopolitics, companies designed their strategies *a priori* and looked to outsourced "fixers" to make the politics fit the strategy. The approach may work in most nations, but falls short in powerful regimes whose systems are less navigable and corporations' influence less pronounced.

Third is collective action. Few companies, or their leaders, however principled, are willing to push back when the consequence would be simply to cede market share to their competitors. With few mechanisms to enable a coordinated response, corporations face pressure to accommodate or risk losing out.

Fourth are the limits of ideology. Multinationals proudly internalized their role as agents of what was assumed to be "change through trade." Yet, the very worldview that enabled capitalism's success, the incisive rationalism and unwavering focus on economic value creation, often rendered its practitioners uncomprehending of regimes which would willingly subsume prosperity for power. After years of adeptly weaving webs of tax, regulatory, sourcing, and production to their advantage, multinationals are belatedly recognizing a simple truth: sovereignty still matters. Though a company may have a global presence, it is not immune to the domestic politics and geopolitical imperatives of nation states.

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Neutrality Is Not the Answer

For many American multinationals, the studied neutrality they have sought to maintain as they straddle their operations between the liberal, illiberal, and authoritarian worlds has become untenable. Both American and European policymakers are heightening their expectations of multinationals' responsibilities to secure supply chains and limit unacceptable transfers of intellectual property. Consumer and investor expectations for socially responsible behavior are also complicating decisions, as evidenced by the pressure major brands faced to boycott the Beijing Olympics over China's actions in Xinjiang.

These restrictions pale in comparison to what illiberal markets can impose. China has regularly impeded or denied market access outright to a host of companies from various countries for a host of perceived offenses.[4] But it is far from alone in forcing companies to choose between market access and the company's stated ideals and principles. In India, for instance, Twitter has famously had to balance a surge in requests from the government to suspend accounts with pressure from activists to uphold free speech.[5] The impacts will also not be limited to individual markets. Powerful nations will seek to impose their influence globally, affecting everything from how disputed territories are referenced to the use of corporations as vectors to interfere in home country politics and policy.

Navigating Geopolitical Risk

Few multinationals realistically can—or necessarily must—decouple from markets fraught with geopolitical risk. But they can undertake a range of hedging actions. First, manufacturers must invest in the resilience of their supply chains.[6] Geographic and supplier diversification is only one part of a portfolio of actions, and must be done with a mindfulness of the other risks, such as climate, to which supply chains are exposed. Improving transparency beyond multinationals' first tier of suppliers, simplifying product designs, and adopting modular and additive manufacturing are high among the approaches currently being pursued.

Multinationals can also consider restructuring their operations. Some companies in certain sectors may find it appropriate to shift from direct, local operations to a licensing, or franchise, model as Yum! Brands did when its China business was sold to a local operator. The upshot of such an approach is that it maintains exposure, while shifting the operational complexity to a third-party and making it politically trickier for authorities to target the enterprise without causing harm to local investors.

Companies can also improve investor disclosures about the extent of their direct and indirect operational presence in high-risk countries. Investors can then use this information to better price risk and engage with management when there are concerns about potential over-exposure.

Fundamentally a Company's Job?

American multinationals will also need Washington to step up in innovative ways to empower and shape the context of multinationals' behavior and defend their shared interests. One of the key reasons companies accommodate authoritarian regimes is because they do not trust home governments to effectively address their concerns. American multinationals have at times been reluctant to have the United States defend their interests because of the concern that the blunt toolkit at the government's disposal would cause consequences worse than the problem itself.

To start, senior National Security Council staff should provide group briefings for executives of strategic American companies that help them shape their strategy in a way that advances corporate and national interests. Companies should also be more willing to proactively share information with the government so that the government can be better prepared to support them in crises.

There are also potential market-based solutions Washington can encourage. One of the key reasons that geopolitical risk is downplayed by corporations is that it cannot be readily factored into formal cost-benefit analyses. Washington can help change this by giving its full regulatory imprimatur to prediction markets. These markets, in which options are traded on the likelihood of real-world events occurring, have been embraced by the intelligence community for their usefulness.[7] If Washington were to allow prediction markets to operate at scale, that may create an actionable signal for corporations to heed.

Next, the government can shape the context of multinationals' behavior by requiring them to deconsolidate their operations in countries such as China and Russia. This is not the same as divestment. Earnings from operations in authoritarian regimes would no longer appear on a company's income statement; instead, the operations in those countries would be recorded as an investment.[8] By changing how the earnings from countries such as China and Russia are accounted for, it creates a subtle, yet significant signal about the risk and temporality of doing business there. Going further, if tracking stock were issued against multinationals' China operations, the relative premium or discount of those shares would send an important signal about investor sentiment and allow executives who do reduce exposure to address criticism that they are committing malpractice in forgoing profits, however short-term they may be.[9]

Supply chain security and intellectual property rights are core areas where multinational and government interests overlap. American and European governments could adopt "smart" tariffs that apply to trade in any goods in which exports are disproportionately provided by a single, risky country to further encourage diversification. Limited authorities to restrict outbound investment are also appropriate alongside a broader reform of the country's export control system.

Finally, these efforts can be strengthened in partnership with allies. The United States should closely observe the European Union's emerging proposals for anti-coercion authorities and explore the potential for cooperative mechanisms.[10] Aligning supply chain relocation incentives, including through the Indo-Pacific Economic Framework, is another opportunity for collaboration. This would help overcome the collective action problem that makes it difficult for industries to shift shared supplier ecosystems. Coordinated stockpiles in strategic goods, harmonized standards, and emergency exemption mechanisms that allow goods to easily flow across borders during periods of supply chain stress also merit consideration.

Perpetually "At-Will"

Multinationals should be prepared for a prolonged era in which their operations straddling America's adversaries remain perpetually "at-will," permitted to operate in a market so long as they are perceived to be less of a threat than they are potentially useful. To succeed, executives will need to overcome their short-termism, redesign their strategic planning processes to directly account for geopolitical risk, and acknowledge the limits of capitalism in constraining the behavior of authoritarian regimes. They will need to be further reinforced by a mix of supportive and restrictive policies by their home governments. Geopolitical risk is manageable, but it will require executives and policymakers to finally become the sophisticated actors they long believed themselves to be.

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1 See Condoleezza Rice and Amy Zegart, *Political Risk: How Businesses and Organizations Can Anticipate Global Insecurity,* (Twelve: 2018).

2 Guy Dinmore and Geoff Dyer, "Immelt Hits Out at China and Obama," *Financial Times*, July 1, 2010, https://www.ft.com/content/ed654fac-8518-11df-adfa-00144feabdc0.

3 Analysis based on public biographies of boards of directors of American companies with the largest market capitalization as of July 24, 2022. When individuals with private-sector aerospace and defense backgrounds are included, the count increases to ten companies. Geopolitical experience is defined as former senior government official with geopolitical portfolio (e.g., Ambassador); former senior military official; or senior leadership of an aerospace and defense corporation. Does not include participation on advisory committees with geopolitical relevance (e.g., President's Intelligence Advisory Board).

[4] For example, in 2012 after the Japanese government purchased three of the disputed Senkaku Islands from a private owner, anti-Japanese protests in China led to a decline in Japanese car sales to China. H&M was shut out of mainland China for sixteen months after it raised concerns about possible forced labor in Xinjiang. See Keith Bradsher, "In China Protests, Japanese Car Sales Suffer," *The New York Times,* October 9, 2012, https://www.nytimes.com/2012/10/10/business/global/japanese-car-sales-plummet-in-china.html and "H&M Back to China's Tmall After Cancellation Over Xinjiang," Bloomberg News, August 16, 2022, https://www.bloomberg.com/news/articles/2022-08-16/h-m-returns-to-china-s-tmall-after-cancellation-over-xinjiang?sref=h3EgYmCR.

[5] Karan Deep Singh, "Twitter Blocks Accounts in India as Modi Pressures Social Media," *The New York Times*, February 10, 2021, https://www.nytimes.com/2021/02/10/technology/india-twitter.html.

[6] Susan Lund, et al., "Risk, Resilience and Rebalancing in Global Value Chains," McKinsey Global Institute, August 2020, https://www.mckinsey.com/business-functions/operations/our-insights/risk-resilience-and-rebalancing-in-global-value-chains.

[7] See Philip E. Tetlock and Dan Gardner, *Superforecasting: The Art and Science of Prediction*, (Crown: 2015).

[8] The introduction of widespread tracking stocks of multinationals' China operations would likely result in their sharing common ownership by a few major funds. This could potentially serve as a partial check against China's "divide and conquer" tactics because, from the vantage point of the common ownership, nothing is gained if market share shifts from a company that has run afoul of China to one that has not. (Critics of common ownership express anti-competitive concerns, which may be a less salient concern in an illiberal market context; see "Stealth Socialism," *The Economist*, September 2016, https://www.economist.com/finance-and-economics/2016/09/17/stealth-socialism.)

[9] Tellingly, in the wake of Russia's war on Ukraine, companies which have taken more steps to withdraw from Russia have seen their shares outperform those which have done less. Jeffrey Sonnenfeld, Steven Tian, and Steven Zaslavsky, "Businesses that Refuse to Leave Russia Are Experiencing the Greatest Costs," *The Washington Post*, April 2022, https://www.washingtonpost.com/opinions/2022/04/26/businesses-that-left-russia-not-hurting-better-off/.

[10] Marcin Szczepanski, "Proposed Anti-Coercion Instrument," European Parliamentary Research Service, March 2022, https://www.europarl.europa.eu/RegData/etudes/BRIE/2022/729299/EPRS_BRI(2022)729299_EN.pdf.