Managing the new political risks in manufacturing

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Section 1: Executive summary

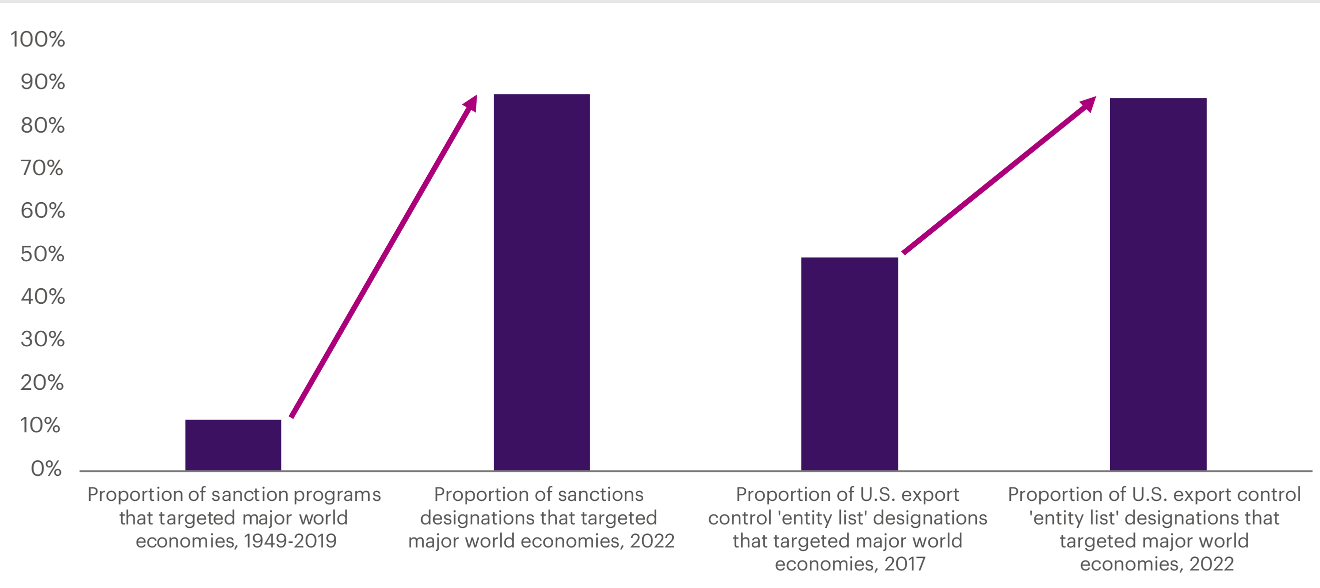
Historically, manufacturing companies appeared to fly below the political radar, operating without incident across borders, even in unstable environments. No longer: manufacturing is now in the political risk firing line, central to geostrategic competition among nations, a focus of government efforts around resilience and reshoring, and exposed to unavoidable political risk loss through conflicts such as that in Ukraine.

This study presents the results of in-depth interviews with a global panel of manufacturing executives regarding the new geopolitical challenges they face, as well as new research on sanctions, export controls and other types of economic weapons used by nation-states against each other.

Key findings from this research include:

- The top concerns of executives relate to geopolitical competition between great powers. The conflict in Ukraine has resulted in severe losses, particularly for those companies exposed via supply chains that had been integrated through Eurasia. The deterioration in relations between China and the West is an issue which is just as concerning, given that China represents the "backbone of our industry," as one panelist in the medical products sector put it.
- Second-tier concerns relate to supply chains, which have been disrupted by conflict and rearranged by government fiat. Supply chain shocks are increasingly strategic rather than operational, impacting entire classes of goods or entire countries. Executives also reported problems with inflation triggered by geopolitical events. "As manufacturers, our sales and profitability are directly proportional to the availability and cost of raw materials," one panelist noted.
- Panelists also mentioned concern with the European Union's new role in setting global standards in areas such as data privacy, climate and particularly environmental, social and governance (ESG) regulation.
- Our research on sanctions indicates several shifts in the way sanctions are used. Most dramatically, in the past few years, sanctions have increasingly targeted major world economies, which is a change from prior decades (historically, nearly 90% of sanctions programs worldwide targeted small economies).[1] This new targeting of major world economies may accelerate the division of the world into allied blocs that trade primarily amongst each other, a trend known as 'friendshoring'. It may also provoke economic retaliation from targeted states and accelerate the decline of the U.S. dollar as a global reserve currency.

Major world economies in the firing line: targets of sanctions and export controls, past vs. present



Source details and information can be found in the chapters that follow

Section 2: Introduction by WTW

By Sam Wilkin,
Director of Political Risk Analytics,
WTW

The story of Bata Shoes has launched a hundred business school essays. The company is known for operating in challenging geopolitical environments, perhaps most famously in the India of the 1970s when the country's economic nationalist policies had pushed many multinationals out. Bata, however, managed to gain a more than 60% share of the Indian market for canvas and leather shoes during that period.[2] While oil and gas or mining companies might attract intense attention from political leaders with a nationalist mindset, examples such as Bata Shoes remind us of the historical tendency for manufacturing companies to be, to some extent, viewed as apolitical.

That has changed. Some types of manufacturing, particularly high technology, are now on the front lines in strategic competition between superpowers. Other types of manufacturing, notably medical devices, personal protective equipment, and food and beverages, have attracted increased attention as the pandemic focused political leaders' minds on supply chains for vital goods.

In countries such as the U.S. and U.K., industrial policy to promote manufacturing is back in fashion after decades of laissez-faire economics. And on top of that, the world has been hit by geopolitical shocks, such as the conflict in Ukraine, that have imposed losses even the most apolitical companies have been unable to avoid.

So, how will today's geopolitical shocks reshape the footprint of globalized manufacturing companies? How can those manufacturing companies accustomed to flying below the geopolitical radar manage the associated political risks? And what risks will companies face if concerns about China's relationship with the West continue to escalate? In addition to this, what further political risk perils might be lurking under the radar?

To get answers to these questions, we worked with Oxford Analytica to convene a panel of eight external affairs and risk management professionals. These panelists represent manufacturing firms across sub-sectors including food and beverage, automotive, industrials, high technology, medical products and packaging and work in companies variously based in the U.S., Europe, India and Australia.

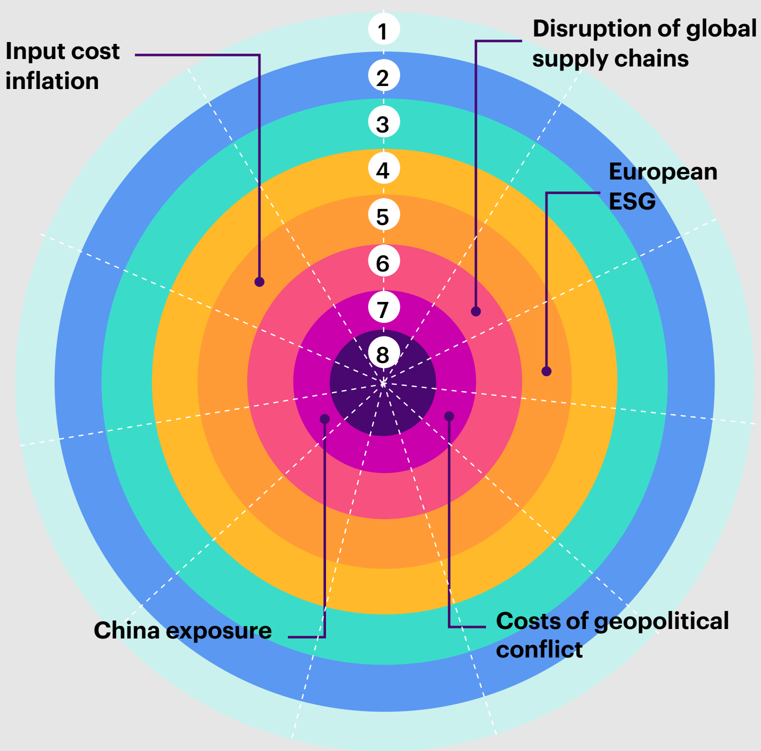
Oxford Analytica and WTW then conducted in-depth interviews with these professionals to produce a risk radar. For one of the top risks the executives identified, Oxford Analytica commissioned scholars in its expert network to produce a peer-reviewed essay: New trends in sanctions, and the risk to global supply chains.

Our aim in sharing these findings is to support manufacturers in navigating a path to continued growth against the changing geopolitical landscape.

We sincerely thank the Oxford Analytica contributors who authored the following essays, but most of all we thank the expert panel of executives for their time and insights which shaped this report.

Section 3:
The political risk radar

To identify the top political risks facing the manufacturing sector, Oxford Analytica and WTW convened a panel of external affairs and risk management professionals representing manufacturing companies. Companies headquartered in the US, Europe, Australia, and India took part. Oxford Analytica and WTW conducted in-depth interviews with this panel of executives, to produce the risk radar. For each risk on the radar, Oxford Analytica summarizes some of the interview highlights. The views expressed do not necessarily reflect those of WTW.



Source: Oxford Analytica and WTW interviews with the executive panel. 'Mentions' count the number of panelists who mentioned each risk topic.

Under the radar: Reshoring, Politics of intellectual property

Costs of geopolitical conflict

For most of the panel, the direct costs of the escalating conflict in Ukraine have been substantial. "Worldwide sanctions have cost us three cents per share," said one participant, while another panelist reported the loss of 10% of global revenues. Two other panelists reported the loss of 2-3% of global revenues, and "about 5% of our business," respectively."

Many panelists expected further costs from the conflict. "We anticipate additional expenses related to the [company's] decision to exit from Russia and Belarus," said an executive in the technology sector. Some of these additional costs relate to the process of winding-up Russian businesses, other costs were humanitarian in nature: "...we have [also] established emergency shelters in Ukraine for employees and their families who have left their homes," as another panelist, in the food and beverages sector, noted.

Panelists feared further conflict elsewhere in the world, or an escalation of conflict in Europe. "Eastern Europe is our greatest concern as we have invested heavily in this region," as one automotive sector panelist said. "With Georgia announcing its interest in joining NATO, the response from Russia on this matter is a concerning factor for us," commented one panelist who was also worried about the impact of the conflict on consumer demand, and, over the long term, on European competitiveness. "Without Russian gas, Europe's manufacturing industries are in trouble," they said.

While Russia, Ukraine and Belarus play a key role in certain supply chains (as discussed below), the contribution of these countries to world trade is limited on a purely statistical level. Russia, for instance, accounts for about 0.3% of global equity market capitalization; 0.2% of overseas direct investment by U.S. companies, and 1.5% of world trade in goods and services.[3] For other world regions subject to geopolitical tensions, including the Taiwan Straits, the South China Sea, and the India-China border (each mentioned by our panel), the costs of geopolitical conflict could be even higher.

China exposure

During the heady years of globalization, particularly during the 1990s and early 2000s, many firms found it relatively easy to manage geopolitical risk. Global companies were usually sufficiently diversified that a loss of any single market or trade route was tolerable. Even those companies dependent on certain key markets were protected by a global network of trade agreements and bilateral investment treaties that raised costs for any government seeking to take arbitrary political or regulatory action.

For better or worse – but mostly worse – those days now appear to be behind us. The conflict in Ukraine has shown there are some geopolitical tensions that no investment treaty can protect against. And some countries, particularly China, have become such a vital part of global supply chains that the losses from geopolitical disruption would be all but unimaginable. "Chinese chemicals are the backbone of our industry," as one panelist in the medical products sector noted.

China is not only a key manufacturing hub, it is a crucial source of final demand and, for some sectors, raw materials. Disruptions in China can have multiple impacts. For a packaging executive on our panel, China's COVID-related lockdowns in 2022 have been a case in point, "Last year we saw a decline in our business growth in China because of the lockdowns," they noted. On top of which, the lockdowns are disrupting the industry supply chain. "This also leads to delays in order arrival, and we are not able to fulfil our customer commitments on time and incurring considerable losses," added the packaging executive.

Alarmingly, given the vital role China plays in so many aspects of global manufacturing, many panelists were negative about the direction of travel for political risks, especially in the U.S.-China relationship. "I believe the U.S.-China trade war could cause a major impact on our operations," said one US-based panelist. Another executive in North America stated: "As a food and beverage company we tend to fly below the radar, [but] our operations in China would still be impacted by the relationship."

Another panelist, based in India, worried about the border conflict between India and China. "China has a monopoly in almost all API [active pharmaceutical ingredients – the key chemicals used in medicines] ... [and] India produces some of the most important and cheapest medicines that are being used worldwide," he said, adding, "India and China should talk and resolve their differences."

Disruption of global supply chains

This next peril on our list comes on the back of an unprecedented series of shocks. "We have been experiencing supply chain disruptions in sourcing raw materials...due to pandemics, natural disasters, and political issues," as one Asia-based panelist noted. It is tempting to think this recent peak in shocks might be followed by a period of calm. But none of our panelists expected such reversion to pre-pandemic conditions.

The escalation of the conflict in Ukraine has posed numerous challenges, including disruptions that compounded pre-existing pandemic-related shocks. While world grain and energy supplies dominated the headlines, behind the scenes, other key value chains have suffered. "There has been a disturbance in the supply chain of components like palladium and neon gas," said a panelist in the technology sector. An automotive sector panelist added, "Due to the sanctions imposed on Russia, we are facing a shortage of lithium [for electric vehicles]," and, "Ukraine is also a major supplier of specialized wiring harnesses; because of the disruption of supply, we had to idle some of our plants in Europe." As a result of such shocks, companies are scrambling to build resilience. "There's been a realization that just-in-time doesn't work when there's a serious shortage of components," as another technology executive put it.

Some supply chain shocks can be dealt with operationally. "Our company decided to end shipping routes through the affected region," one panelist noted. Other supply chain shocks are strategic, and arguably outside the company's ability to control. For instance, entire classes of goods, such as microchips, can suddenly become scarce, or entire countries can face sudden production disruptions.

One fact often mentioned was that without China's production capacity, recent supply chain shocks could have been much worse. "We are constantly working with China not to get affected by the shortage of semiconductors," as one executive, based in Europe, explained. Of course, China's pivotal role in value chains from semiconductors, to medicines, to renewable energy generation creates its own risks, as noted above.

The effort to comply with sanctions has created further headaches, particularly for European companies with value chains that crossed from Eastern into Western Europe and beyond. "[The conflict] has also had a larger impact on surrounding countries, such as Kazakhstan, Georgia and Ukraine," said an executive at a European industrials firm. "In Poland, for example, our business was impacted because of sanctioned suppliers."

Input cost inflation

The next two perils were tied in terms of number of mentions. 'Input cost inflation' might not seem like a political risk. In the U.S., for instance, much discussion of inflation centers around central bank policy. However, most causes of input inflation mentioned by panel members were geopolitical in nature. The manufacturing sector, if it cannot pass costs on to consumers, is highly exposed to this risk. As one panelist put it: "As manufacturers, our sales and profitability are directly proportional to the availability and cost of raw materials including energy and manpower."

The relationship between the global pandemic and inflation has been complicated and often unexpected. As the world went into lockdown, consumers shifted from spending on services to spending on goods, contributing to major shortages, and spiraling prices, in products such as microchips and automobiles.

Emerging from the pandemic, consumers shifted back to spending on services. Prices of, for instance, rental cars and airline tickets, skyrocketed as demand surged. The fact that many advanced economy households and businesses had saved during the pandemic, and therefore had money to spend, was seen as a sign of economic strength. But these savings meant consumers were able to carry on spending even as prices rose, contributing to yet higher inflation, particularly in the U.S. In Europe, wages are often set by collective bargaining arrangements, and therefore have tended to be slower to rise, hence inflation tended to sap household spending.

Many panelists referred to the escalation of conflict in Ukraine as a cause of input inflation, particularly for commodities and, of course, energy. "We are concerned about the indirect impact on our business because the increasing price of commodities will negatively impact the cost of goods sold and transportation costs," as a panelist in a bottling company put it. A few panel members reported they were still struggling with pandemic-related bottlenecks. "The shortage of semiconductors also increased costs, delays and manufacturing challenges," as one executive noted.

As with supply chain disruption, these risks are seen as increasingly difficult to manage. "Inks, solvents, polymer resins, films, fiber-based cartons, and aluminum are the essential raw materials required to produce packaging goods," said one panelist, based in Australia. "The availability and price of these raw materials are subject to market and economic fluctuations and are beyond our control."

European ESG

The increasing role of ESG issues in shaping corporate performance is a high-profile issue worldwide. Social media, for instance, has empowered disgruntled consumers and employees to reshape a company's reputation with a single viral post. As the Ukraine conflict escalated, for example, many companies facing consumer or employee pressure found themselves forced to exit Russia.

While ESG issues have featured on our risk radars for many years now, this year, for manufacturing, there was one particular focus: Europe setting the global ESG agenda. While many of Europe's ESG efforts are laudable, these efforts can create costs for business, especially as standards in Europe diverge from those in the rest of the world. "The European Union's Conflict Minerals Regulation covers importing the 3TG minerals [tin, tantalum, tungsten, and gold] from every part of the world," as one US-based technology sector panelist noted. "The main concern from a geopolitical perspective is that because our activities do not follow European regulations, negotiating and settling takes much of our time and cost."

Other panelists were worried Europe's ESG push would compound other supply chain shocks, producing unintended consequences. "The complete ban of diesel vehicles in Europe by 2035 is concerning," said one executive. While electric vehicles are "the future," as the panelist noted, current shortages of microchips and

lithium, used in electric vehicle batteries, are combining with the ESG push to result in further cost inflation.

In a similar vein, a packaging industry panelist noted, “The global shortage of polymer that is used in packaging is really affecting our business operations and with Europe’s ban on single-use plastic … we must shift from plastic to other alternatives,” which, the panelist said, is “adding up the cost for us.” Therefore, new ESG measures could add to an already serious input cost inflation problem.

Under the radar

We conclude our risk radar by looking at what might be flying below it – those risks with the potential to become tomorrow’s top concerns.

The first of these below-the-radar threats is **reshoring.** Both the perceived lessons of the pandemic and geopolitical tensions are encouraging policymakers to incentivize domestic production. Moreover, controversial legislation on climate or economic stimulus can be easier to pass with the support of domestic business lobbies.

One result of these realities is that policies to encourage resilience can have a protectionist element. Panel members based in emerging markets contended the U.S. Inflation Reduction Act was one such example. “[The Act] does mean we have to rethink our North America strategy, particularly as a lot of our footprint currently sits in Mexico,” as one panelist put it. Other executives, for instance in the medical products sector, complained that recent ‘buy American’ provisions had already led to significant losses. A panelist in the industrials sector went further, commenting, “We have operated as a globalized company, but the new reality is local.”

The next below-the-radar threat is **politics of intellectual property.** As geopolitical tensions increase, intellectual property rights could be one area where the superpowers do battle. Specifically in relation to U.S.-China tensions, one panelist worried the protection of its intellectual property, including intellectual property shared and licensed by third parties, could be weakened. Another panelist noted that intellectual property rights had become a key battleground between Asian and U.S. companies:

> **“Some U.S.-based companies are accusing … [Asian companies] of IPR [intellectual property rights] violations; we are trying to fight these allegations in all legal ways.”**

CALLOUT 2

The world may be flat, but it's increasingly fractured

Laura Burns
Political Risk Product Leader, Americas
WTW

In Thomas Friedman's 1999 best-selling book The Lexus and the Olive Tree and his subsequent 2005 book The World is Flat, Friedman chronicles three eras of globalization 1.0 (1492-1800), 2.0 (1800-2000) and 3.0 (2000 to present) and posits that globalization isn't a trend but an international system that replaced the Cold War system with the "integration of capital, technology and information across national borders, in a way that is creating a single global market."[i]

But the ground has shifted.

A December 2022 article in the Harvard Business Review details a new order, that of a "national security economy" in which country governments are viewing an increasing number of goods and services through lens of national security and the "private sector is the primary actor in this fight"[ii] Extending from the technology sector, might pharmaceuticals, industrial products, broader electronics, chemicals, apparel, and food and beverage become entangled in further export controls, sanctions, expulsions, against a backdrop of a potentially fracturing world (per research published in WTW's latest Political Risk Index[iii]), and further political and social unrest in Latin America, coup d'états in Africa, ripple effects in Eastern Europe from the Ukraine-Russia conflict, and a rising China? How should risk managers and c-suites might navigate and manage the geopolitical risks? How can these investments, assets, and contracts be protected?

How might geopolitical challenges impact multinational companies?

We consider three hypothetical future scenarios. These are not intended to refer to any specific company or historical event but illustrate potential impact on multinational companies (MNCs) of ongoing geopolitical challenges and where political risk insurance, in the case of two, and trade disruption insurance in the third case, could help mitigate the financial losses:

CASE ONE:

Manufacturer relocates to Vietnam from China, only to see conflict follow

A Western multinational manufacturer decides to diversify its manufacturing plant locations and relocates a substantial plant from mainland China to Vietnam. However, what was not fully considered was the scenario in which China and Vietnam have a diplomatic dispute over territorial claims in the South China Sea and China, or indeed a Taiwan scenario, in which regional actors are affected.

While some analysts have examined a parallel between Russia-Ukraine and China-Taiwan, others have strongly rejected such a parallel and highlight a view that China-Vietnam is the more fitting one.[iv] They have a dispute over territory in the South China Sea, share a land border, and have had skirmishes at sea which could bleed over to land. Vietnam does not have any security alliances which some have suggested is what also made Ukraine vulnerable.

Further, China did take islands in the Paracel Islands and invaded in 1979 as retaliation for Vietnam involving itself in Cambodia. In this example, a maritime skirmish erupts into a Chinese blockade of Vietnam, causing the multinational that relocated there to need to abandon its plant, causing a $80M loss.

[i] https://www.thomaslfriedman.com/the-lexus-and-the-olive-tree/; https://www.thomaslfriedman.com/the-world-is-flat-3-0/
[ii] https://hbr.org/2022/11/how-companies-can-navigate-todays-geopolitical-risks
[iii] https://www.wtwco.com/en-gb/Insights/2023/01/political-risk-index-winter-22-23
[iv] https://www.rand.org/blog/2022/03/taiwan-isnt-the-ukraine-of-the-indo-pacific-try-vietnam.html

CASE TWO:

Unrest in Latin America ensnarls packaging company

A Western multinational corporation packaging company has a substantial and profitable subsidiary operating in several countries, with Peru being one of recent continued growth. Given the protests following the ouster of Pedro Castillo, a blockade of the main road prevents its plant from operating.

While the profile of the company is not politically sensitive it is caught up in a local situation that overtakes it. In their previous analysis, its view of not being located downtown where protests occur did not factor in the blockade situation. It is not 'who ' they are, rather 'where' they are, amounting to having to close the plant for $50M loss.

CASE THREE:

Potential tensions with China create supply chain interruption

A Western manufacturing company relies on its strong partnerships in China for toll manufacturing of its goods. In a scenario where U.S.-China tensions deteriorate and China blocks the export of certain goods either in retaliation or to keep the goods for its own citizens.

The company in this scenario must find an alternative supplier in Mexico for a third more in price and incurs contractual penalties for delivering the final goods to their largest customer 90 days late, totaling $40M in extra expense and contractual penalties.

Insuring manufacturing risks in the political risk insurance market

Political risk insurance was born out of the post-WWII era as a tool for governments to promote a return to cross-border trade and investment by insuring the political and credit perils investors confronted. Today the market is robust and dynamic, able to support c.$3 billion of capacity per insured program through close to sixty private markets, multilaterals, and many export credit agencies (ECAs).

Premiums are based on the rate-online multiplied by the limit per layer. Those rates generally range from 0.30%-3.00%. Policies are multi-year, with a key benefit of coverage being the policy is non-cancellable by insurers regardless of worsening risk within the multi-year policy period.

Many manufacturing companies headquartered in the U.S. Canada, Australia, and Western Europe already utilize this market for substantial political risk insurance programs and therefore have the capacity and terms 'grandfathered in' for the life of their multi-year policy. Increasingly there are more emerging market-headquartered companies particularly in Latin America, and the Middle East also taking the insurance.

For new organizations coming to insurance markets, there may be some challenges related to obtaining China capacity (a few markets still write it, but capacity has narrowed substantially). They may also face increasing challenges around raising support for multi-country programs. However, for most risks, the market generally remains open and affordable, with plentiful capacity at the time of writing. We advise global companies take a proactive approach in their political risk management and consider political risk insurance with urgency as these risks will likely continue to increase. This means market capacity will likely continue to shrink and rates trend upwards.

Paramount in this risk and market environment is the importance of both framing the risk to underwriters and the strategic structuring of a program. Working with a strong specialist broker in political risk insurance can help ensure the nuances of the investment and bespoke coverage needs will be captured in the terms and conditions of an optimized insurance program or other risk management vehicle.

Section 4: New trends in sanctions and the risks for manufacturing

Sanctions as an alternative to war

At the end of World War I, U.S. President Woodrow Wilson expressed the hope sanctions would serve as an alternative to the use of force in international affairs. Since then, sanctions have accrued some significant successes. A popular textbook identified several cases where sanctions were the main tool a country had used to achieve an important foreign policy objective. For instance:[4]

- The U.S. convinced the government of the Netherlands to, in effect, recognize the independence of Indonesia by withholding Marshall Plan aid for European reconstruction during the late 1940s, at a time when the Netherlands was highly dependent on this aid
- During the 1980s, the apartheid government of South Africa used sanctions to convince the government of Lesotho to deport fugitive members of the African National Congress; the sanctions were estimated to have reduced Lesotho's annual economic output by roughly 5%.

Notably, many of these textbook success cases involved conditions when one country had unusual leverage over another (for instance, the territory of Lesotho lies entirely within South Africa), and included measures (such as withholding promised foreign aid) that might not be ordinarily thought of as 'sanctions.'

Applying less stringent criteria, a 2016 study by the Center for a New American Security found U.S. financial sanctions imposed since September 2001 to be effective in nine of 22 cases, or nearly 41% of the time.[5]

Intervention fatigue, new capabilities, and the rapid rise in sanctions since 2005

During the Cold War and for roughly twenty years following the collapse of the Soviet Union, the U.S. in many cases relied on outright military intervention to achieve its geopolitical objectives, including in Panama, Haiti, Somalia, Iraq, and Afghanistan.

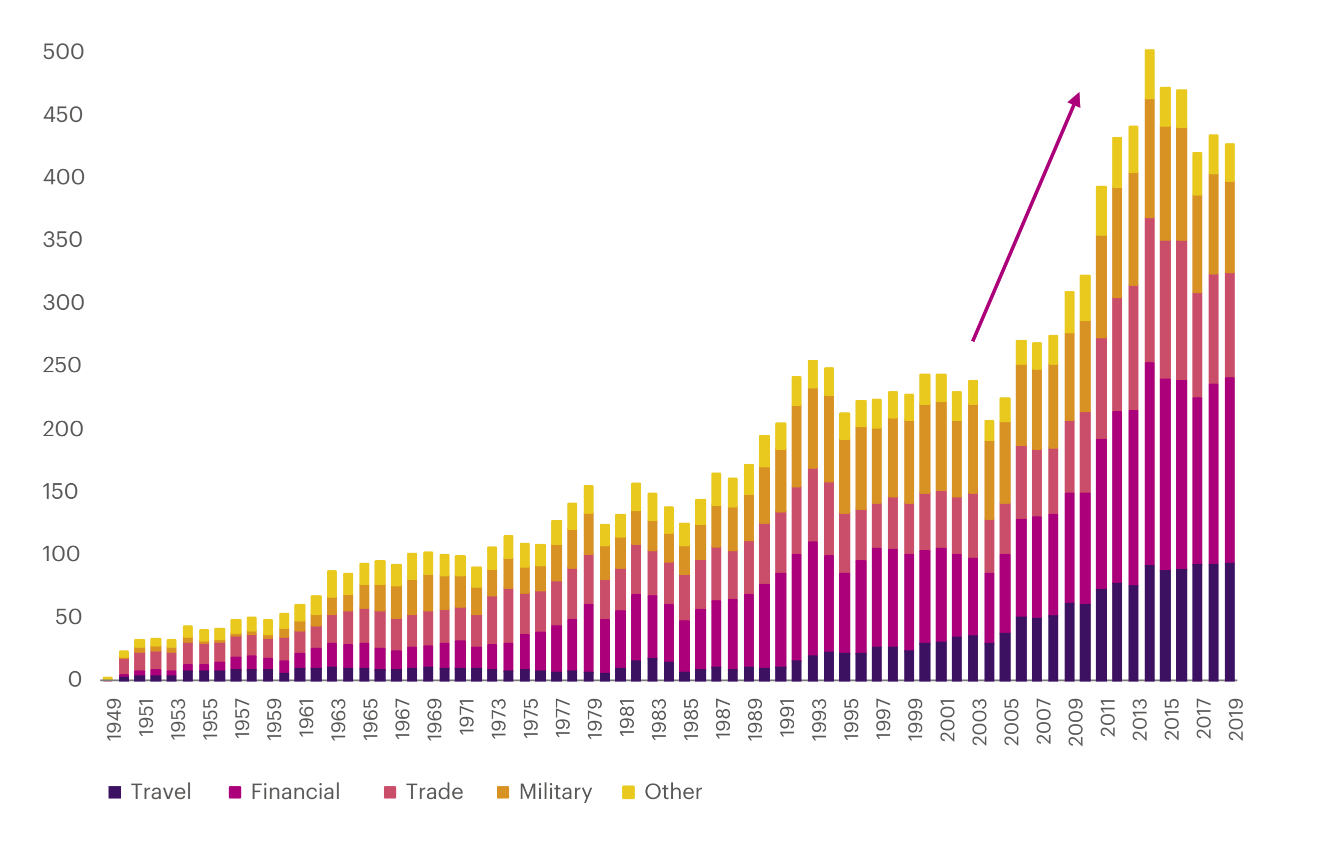
In the wake of the protracted conflicts in Iraq and Afghanistan, however, the U.S. has been seen as being increasingly reluctant to contemplate the deployment of large numbers of troops abroad. Regarding the conflict in Ukraine, for instance, the U.S. and allies have relied on economic sanctions to attempt to influence the course of the conflict, as well as on military aid to Ukraine.

Even the U.S. has become more reluctant to exercise the 'military option,' it has gained new capabilities that make sanctions more effective. Notably, new tools to track international financial flows were developed in the wake of September 11, 2001, with the intention of combatting terrorist financing. These new capabilities have had the side effect of making the U.S. more effective at enforcing financial sanctions, thus increasing the utility of such sanctions as a foreign policy tool.

Partly due to these trends, both the U.S. and its allies have increasingly turned to sanctions to pursue foreign policy objectives seen to require the use of 'hard power.' There were roughly 200 sanctions programs in place worldwide during the 1990s, and at that time the number appeared to be static or falling, in part due to the end of the Cold War. Starting after 2005, however, the number of sanctions programs in force began to rise sharply, more than doubling to roughly 500 by 2015 (see graph).

The U.S. was a key driver of this surge in popularity of sanctions as a foreign policy tool. In 2017, for instance, more than half of all new sanctions programs globally were imposed by the U.S. In 2018, the U.S. imposed sanctions on 1,474 individuals and entities, an increase of over 50% on 2017, also a record year.

Intervention fatigue: number of sanctions programs in force globally, by type, 1949-2019



SOURCE: WTW analysis of the Global Sanctions Database[6]

Within this dramatic post-2005 escalation of sanctions, we can identify some trends:

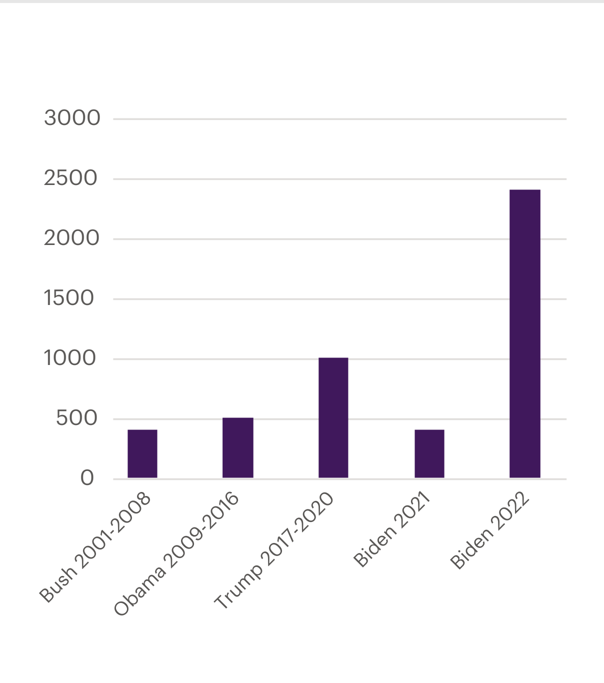
- **Growth in 'smart' sanctions.** Sanctions are increasingly 'smart' or targeted, levelled against institutions or individuals rather than nations. This shift is partly reflected in the growth of travel and financial sanctions programs, as shown in the graph. Such smart sanctions have been designed in part to minimize collateral damage, in the wake of the significant humanitarian harm seen to have been done by comprehensive sanctions programs, for instance against Iraq. Targeted sanctions also, in theory, reduce costs for businesses. In fact, however, companies may tend to 'over-comply' with these sanctions, because of the risk of accidents (identifying sanctions touchpoints can be difficult) and because limited and targeted sanctions are often seen as an indicator that further sanctions may follow. For instance, many European companies complied with U.S. sanctions on Iran even when not legally required to do so.
- **Secondary sanctions.** Rather than targeting persons under U.S. jurisdiction, secondary sanctions target third party actors by threatening to lock them out of U.S. financial markets and international payments infrastructures. Some of the third-party actors impacted by these programs include companies headquartered in states closely allied with the U.S., including the UK and Europe. As of 2021, the primary targets of U.S. secondary sanctions were Iran (68% of designations) and North Korea (22% of designations).[7]

In 2022, rapid innovation and growth in sanctions designations

Particularly since the dramatic escalation of conflict in Ukraine, the U.S. and allies have doubled down on their focus on sanctions as an instrument of national security policy. Perceived limits on the effectiveness of traditional sanctions programs have also fostered rapid innovation. These shifts can be summarized in a few new trends:

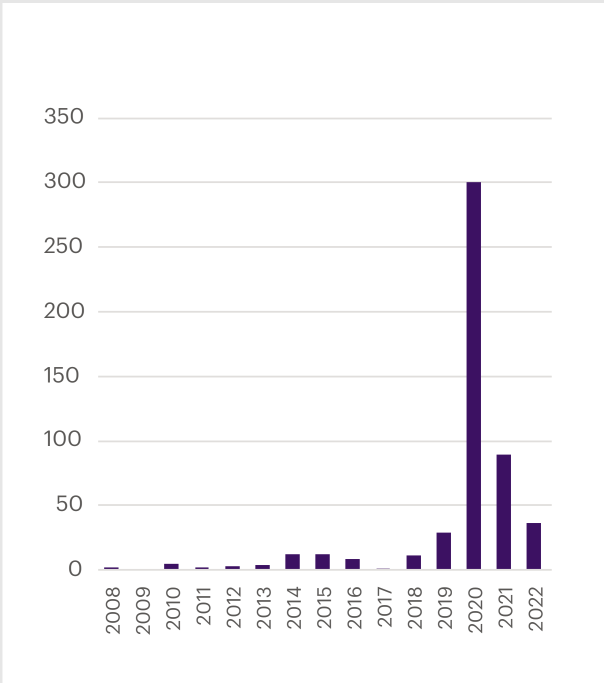
- **Rapid growth in designations.** With increasing reliance on smart sanctions, the expansion of sanctions is taking place not only through additional sanctions programs (as assessed in the previous section), but also additional 'designations' (of individuals or entities that are sanctions targets) in existing programs (see graph). For instance, as of March 2023, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) maintained 'only' 35 sanctions programs, but over the course of 2022, designated 1,716 Russian individuals and entities as new sanctions targets.[8] During 2022, U.S. smart sanctions designations increased by more than a quarter compared to 2021; EU designations increased by more than half; U.K. designations by 65%; and Canadian designations more than doubled.[9]
- **A rise in private sector sanctioning.** More than 1,000 companies chose to withdraw from their investments in Russia, in many cases even without regulatory requirements that they do so.[10] Executives explained these actions with reference to, for instance, moral imperatives or employee or customer pressure.
- **Innovation in tools.** The U.S. has long used the global dominance of the dollar as a sanctioning tool via the financial sanctions discussed in the previous section and, in certain cases, excluding countries from using the SWIFT global payments system. Following the onset of broader conflict in Ukraine, the Federal Reserve took the unprecedented step of freezing some of Russia's foreign reserves, as well as banning trading in Russian sovereign bonds. Moreover, towards the end of 2022, as it became apparent sanctions on Russian oil were being offset by higher oil prices, the U.S. and allies engaged in a novel attempt to cap on the price at which Russian oil could be sold, enforcing the cap via requirements imposed on shipping insurers.[11]
- **Growth and innovation in export controls.** While export controls, particularly in weapons, have long been a part of sanctions policy, these controls were expanded rapidly in 2022, with a new focus on technology. The U.S. expanded its existing 'entity list' program for China, adding 300 entities in 2020, 89 in 2021, and 36 in 2022, compared with an average of fewer than six per year from 2008-2018 (see graph). In addition, the U.S. placed novel restrictions on its citizens working in certain high technology industries in China.[12]

Rapid growth in designations: Average annual new sanctions designations by the U.S. during recent presidential terms



SOURCE: WTW estimates based on data from Gibson Dunn, Castellum.ai, and the Atlantic Council; rounded to nearest hundred[13]

Major world economies a target: new U.S. export control 'entity list' designations involving China



SOURCE: Atlantic Council and Castellum.ai[14]

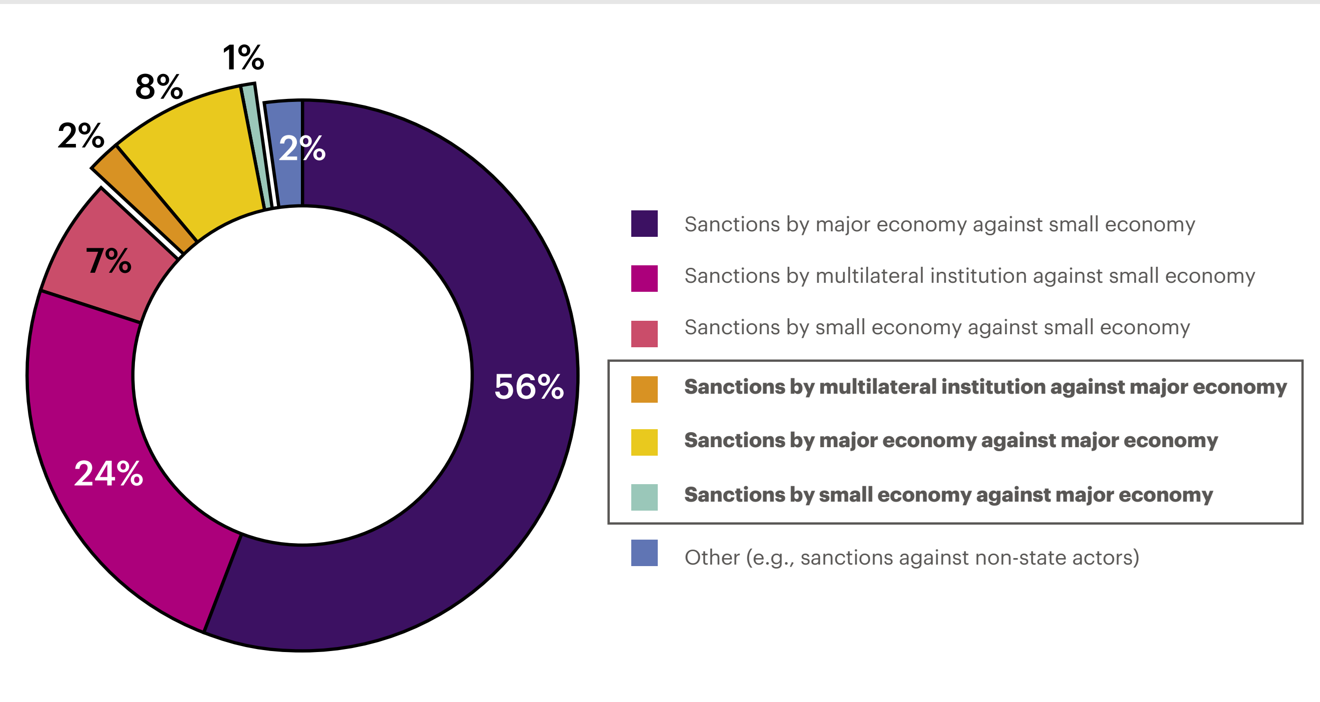
Consequences of the new trends in sanctions

Rapid escalation in sanctions, together with innovation in approaches, may have unintended consequences. For instance, some commentators have noted that the price cap on Russian oil could, in effect, lead to a large transfer of wealth from Russia to countries that are buyers of Russian oil (in particular, China and India) which would benefit from a cheaper price paid for oil. Almost certainly, providing an economic boost to China was not a primary objective of the price cap policy.[15]

Another potential consequence of the shifts in the way sanctions have been used in the wake of the conflict in Ukraine is to promote a division of the world into allied 'blocs' that trade primarily amongst each other, or friendshoring. Until 2013, most sanctions programs in place worldwide targeted smaller economies or regional powers – countries such as Iran, Fiji, North Korea, and Myanmar. In fact, only 12% of the world's sanctions programs between 1949 and 2019 targeted major world economies (see graph). Sanctions were overwhelmingly used by major world economies, or multilateral organizations, against smaller, and poorer, economies, and therefore had limited consequences for world trade flows and global economic output.

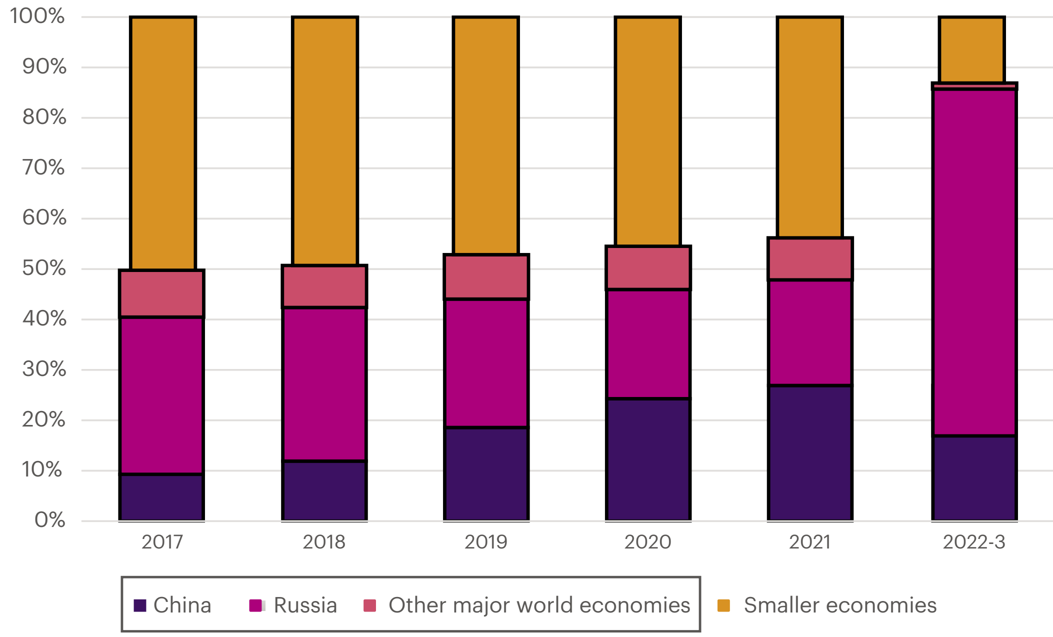
By contrast, in 2022, sanctions were deployed primarily by major world economies against each other. During 2022, 88% of new sanctions designations by the UN and major world economies targeted another major world economy (primarily, Russia).[16] Similarly, of new U.S. 'entity list' export control designations imposed in 2022 and so far in 2023, 86% targeted major world economies (primarily, Russia at 55% of designations and China at 30%, see graph for further details).[17]

That was then: Sanctioning entities and their targets, 1949-2019



SOURCE: WTW analysis of Global Sanctions Database; 'major economies' here are defined to include advanced economies and BRIC countries[18]

This is now: targets of US export control 'entity list' designations, by type of country



SOURCE: WTW analysis of the U.S. Department of Commerce Entity List; 'major economies' are defined here to include advanced economies and BRIC countries; duplicate entries are removed; undated entries are presumed to predate 2018[19]

How the resulting friendshoring effect amongst major world economies will play out in regions that are politically divided but economically integrated – particularly Asia – remains to be seen.

Another consequence of recent innovations in the use of sanctions is that financial sanctions – and in particular, the seizure of Russian foreign exchange reserves – may accelerate **the decline of the U.S. dollar as a global reserve currency.** While no palatable alternative to the dollar exists, the seizure of Russian reserves has provided a powerful motivation to create such alternatives, even if the cost of doing so is high. While there is little evidence yet of a decline in holdings of U.S. dollar reserves, some commentators have begun to anticipate such a development within the next decade.[20]

China, which currently holds $3 trillion in U.S. dollar foreign exchange reserves, is well-motivated to fund the development of alternatives, including elements of financial infrastructure such as an alternative to the SWIFT payments platform. Whatever efforts China makes may find a receptive audience, as more nations are using non-dollar transactions to avoid U.S. secondary sanctions. For instance, by August 2022, the renminbi had overtaken the euro as the second most traded foreign currency on the Moscow Exchange, after the U.S. dollar. On the Moscow Exchange, the share of renminbi-ruble and renminbi-dollar transactions in total currency trading volumes surged to 26% in August 2022 from just 3% in March. During the same period, the proportion of ruble-dollar transactions fell from 65% to 43%.

According to President Vladimir Putin, transactions between Russia and Chinese state oil company CNPC will use rubles and renminbi in future. To facilitate trade with China, the two largest Russian banks, Sberbank and VTB, are launching renminbi-denominated loan products. Oil major Rosneft will follow Rusal (the aluminum giant) and Polyus (gold) in issuing renminbi-denominated bonds on the Moscow Exchange. In April 2023, Brazil agreed to pay for some Chinese imports in yuan.[21]

If a multipolar global currency regime does emerge, this development is likely to lead to a less stable exchange environment with higher costs and risks, accelerating the trend towards friendshoring.

Another possible consequence of recent escalation and innovation in sanctions is **retaliation by emerging economies.** As noted above, historically most sanctions have been applied by richer countries against poorer countries. From the dissolution of the USSR to 2019, Russia imposed only 30 sanctions programs, China only nine. The U.S., by contrast, imposed 366 programs; the EU, 123; and Norway, the U.K. and Canada about 50 each.[22]

Poorer countries have been reluctant to use sanctions against the rich world, at risk of cutting off their own so-called 'catch-up growth' efforts. Catch-up growth tends to occur when countries trade and invest with each other, resulting in the natural transfer of skills, technologies, and business methods from richer countries to poorer. Catch-up growth has in the past produced economic progress in poorer nations, including Japan and the Asian Tigers, that was far more rapid than the growth of the West itself. For instance, it took the U.K. more than 50 years to double its per capita income from $5,000 to $10,000; it took the U.S., trading with the U.K., less than 40 years to accomplish the same feat; it took South Korea less than 12 years.[23]

Partly as a result, emerging markets tend to use sanctions primarily against other emerging markets – especially those poorer than themselves, as was the case for many historical Russian sanctions programs, for instance, against Albania, Belarus, Eritrea, and Kazakhstan. More recently, India levied trade curbs on Turkey and Malaysia, which both have majority Islamic populations, after they sided with Pakistan over contested Kashmir in 2018.

More recently, however, China has made innovative use of economic pressure in pursuit of its foreign policy objectives. In some cases, China has been willing to use such pressure against wealthier countries. In 2010, Beijing appeared to restrict exports of rare earths to Japan, in the wake of a collision between a Chinese fishing boat and a Japanese coast guard vessel. In 2016, China curbed tourism to South Korea and forced South Korean retailers in China to close, following a dispute over Korean deployment of a U.S. anti-missile system. In 2020, China appeared to target Australia with extensive restrictions on imports, following controversial comments made by the Australian government regarding the origins of the novel coronavirus. In 2021, China restricted trade with Lithuania, apparently in relation to a diplomatic dispute involving Taiwan.

Many of these measures were not, however, formal sanctions; indeed, in some cases, China's government contended that measures were imposed for unrelated reasons, such as protection of public health or the environment. In early 2023, the Chinese government was reported to be considering restrictions on exports of technologies used for manufacturing solar panels, although commentators disagreed on whether these measures could be considered retaliation.

A final consequence of rapid innovation and escalation in sanctions is likely to be the **erosion of multilateral trading rules,** particularly disputes and enforcement. In the postwar era, global institutions have to a large degree managed to keep trade tensions in check. Average tariffs have fallen from 22% to lower than 5% since global rules were introduced in 1947 under the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO).

While sanctions such as those described above have been raised in WTO member complaints, it appears unlikely that multilateral institutions will be able to manage these tensions. The WTO's disputes resolution system has been weakened since the U.S. withdrew its backing in 2019. Erosion of the WTO's authority has weakened legal protections that businesses and smaller countries could potentially use to withstand coercive pressures. Stronger economies like China and the U.S. are filling the vacuum by writing their own laws and then imposing them on trade partners. Corporations may have to cope with multiple sets of operating rules.

Conclusion

Overall, by some indicators, the world remains at or near historic peaks of globalization. However, recent developments in use of sanctions – particularly the deployment of sanctions by great powers against each other – suggest that further economic integration is most likely to occur within blocs aligned by common security interests.

Other trends are more uncertain with questions over the following areas:

- Will the increasing use of sanctions against major world economies reduce cross-bloc levels of economic integration?
- Will the global supremacy of the U.S. dollar be challenged within the next decade, for instance by the Chinese renminbi?
- Will poorer countries that are sanction targets retaliate, for instance through disruption of supply chains?

While much will depend on developments in Ukraine and elsewhere, each of these scenarios indicated by these questions appear plausible and may be worth considering when developing strategic plans and reviewing risk management.

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