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The cost of resilience in a more fragmented world

Recent interviews with business leaders reflect the impact of the more uncertain geopolitical environment, both on growth and on costs. At the same time, current events are seen as a stark wake-up call for Europe to take decisive action on the essential reforms outlined in the Draghi report

The EC says it will cut red tape and simplify EU rules, building on the recommendations of the Draghi report, which one CEO describes as a 'silver lining' to geopolitical risk.

The view from business leaders

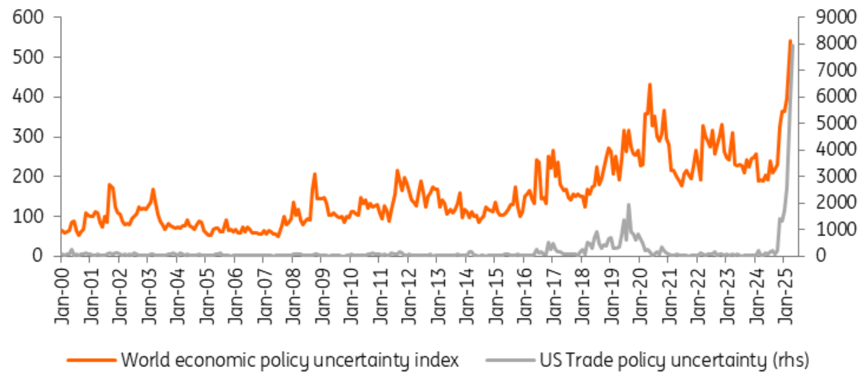
Based on its annual Global Risks Perception Survey, the World Economic Forum identified earlier this year the three biggest risks for 2025: state-based armed conflict, extreme weather events, and geoeconomic confrontation. While extreme weather events have unfortunately become more common and already figured last year in the top three, the first and the third risk can be relabelled as geopolitical risk, something business leaders increasingly have to deal with. In Marieke Blom's interviews with international business leaders, she discussed different strategies to enhance resilience in the face of a riskier environment. Understanding the risks is the first step. Then, measures can be taken to mitigate the risk or its impact, sometimes even ringfencing certain activities. Finally, a rapid response when risks materialise remains essential. We have continued the interviews* with CEOs and CFOs from mostly Belgian international companies and compared some of the insights with recent research on the impact of the changing global environment.

*Interviews were held between the end of February and early April.

Geopolitical uncertainty weighs on confidence

Over the past few years, most indicators assessing the global risk environment have increased. Since 2022, the geopolitical risk index has averaged 50% higher than the previous decade. Currently, it remains about one standard deviation above its long-term average. Research from the Bank of England indicates that this level of uncertainty has historically reduced growth in Western economies by 0.1 to 0.2 percentage points. Additionally, the uncertainty index focusing on trade policy has surged since the start of Donald Trump's second term, with US policy uncertainty indices also reaching new highs. This uncertainty impacts the economy and business activity through various channels. Consumer sentiment might be affected negatively, as seen through consumer surveys in a recent European Central Bank analysis. This risk was highlighted by the CEO of a major retailer, who noted that a slightly more fearful consumer is quick to cut discretionary spending. The business sector is also impacted by uncertainty. A business leader in a B2B entity observed an unprecedented slowdown in customer decision-making processes, with businesses adopting a wait-and-see approach and investing less. A media company mentioned that increased uncertainty is leading companies to swiftly reduce their marketing budgets. ECB research suggests that the trade policy uncertainty could reduce business investment in the eurozone by 1.1% in the first year.

Increased policy uncertainty



Source: LSEG Datastream

Direct impact

Aside from the indirect economic impacts, some companies have been directly affected by the increased geopolitical risk. Several companies we contacted faced challenges with their operations in Russia, and one even had a production facility in Ukraine damaged by Russian bombing. Another company now has a contingency plan for the evacuation of its staff from a facility in a country neighbouring Russia.

On the other hand, the current situation also presents opportunities. An international project developer highlighted the reconstruction needs in Ukraine, with the housing sector alone accounting for almost €81 billion of the total long-term needs. Additionally, increased defence spending in Europe has created future business opportunities for several companies.

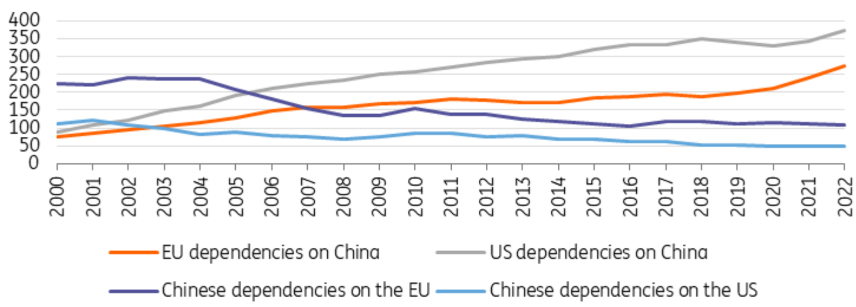
Finally, the formation of "blocs" within the global trading system has increased the importance of "connector countries", which have replaced direct trading links between the major blocs. A company active in logistics confirmed that the "China plus one" strategy has been very successful.

The China syndrome

For many companies, China represents a "love-hate relationship." On the one hand, China remains a significant market, with several companies we contacted having investments or planning direct investments there. On the other hand, China is considered a challenging market. Many local competitors, often loss-making but not allowed to go bankrupt for various reasons, keep price competition intense, while demand has been softer in recent years. A record 73% of European companies active in China reported that doing business there has become more difficult, according to the EU Chamber of Commerce in China's annual survey. "Companies are really feeling the squeeze, being pessimistic, but again finding very compelling supply chains in China that necessitate a continued presence in the Chinese market," stated Jens Eskelund, president of the chamber.

This situation also highlights the increased dependency on China for critical inputs. One CEO mentioned that due to the continuous shrinking of the chemical industry in Europe, driven by high energy prices, their company is now nearly completely reliant on China for certain inputs. This observation was corroborated by other business leaders, who, in some cases, still had alternatives to China but at significantly higher costs. According to the MERICS trade dependency database, reliance on China in 2022 was about three times higher than 20 years ago. Over the same period, China reduced its import dependency on the EU from 235 to 120 goods. Several CEOs, therefore, feared not only the strong competition from China but also the risk to critical supplies if geopolitical events were to result in a more hostile relationship between the West and China.

Number of bilateral product dependencies (excluding textile sector)



Source: MERICS Trade Dependency

Go West!

US import tariffs have made the rationale for producing locally more appealing, provided that inputs can be mostly sourced locally. "I assumed that Trump would win the election and follow through on his promise to raise import tariffs to encourage local production in the US. Consequently, I decided to increase production in the US," says one CEO. Others are also considering (additional) investments, with cheap energy offering a competitive advantage. That said, some were relieved that overall tariffs for Canada and Mexico were not implemented, allowing continued production in those countries for the US market. This is crucial, as most business leaders view the tight labour market and the quality of the available workforce in the US as problematic. Two Belgian companies, active in industrial robotics, saw this as an opportunity. President Trump's attempt to reshore industrial activity to the US, amid a lack of qualified labour, could only succeed if more processes were automated.

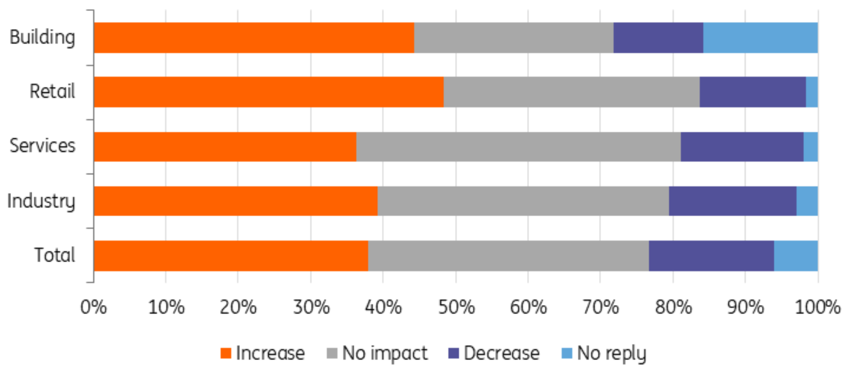
Wake up call for Europe

A common sentiment among business leaders is that the economic headwinds from the current geopolitical imbroglio serve as a significant wake-up call for Europe. The European Union has historically thrived on various dependencies, such as cheap energy imports from Russia, international free trade, and substantial military protection provided by the US. In the current geopolitical climate, these elements can no longer be taken for granted. The European Commission's initiative to expedite international trade deals, like the agreement with Mercosur, is warmly welcomed. Latin America and Asia, in particular, are considered important growth markets for European exports.

At the same time, many business leaders believe that the EU needs to reform by strengthening the single market through the removal of existing trade barriers. IMF estimates suggest that remaining intra-EU trade barriers might be as high as a tariff equivalent of about 44% on average for goods trade, which is three times higher than trade barriers between US states. For services, the estimates even suggest the equivalent of a 110% tariff.

There is also a strong call for simplification and deregulation. It is time to act on the Draghi Report. The European Commission's recent plan to cut red tape and simplify EU rules—marked by its first concrete initiatives—has been hailed by one CEO as the "silver lining" of an increasingly complex geopolitical landscape.

Effect on production or operational costs of geopolitical tensions



Source: European Commission

The cost of resilience

The new global geopolitical environment comes at a price. It is not just about the negative impact of uncertainty on growth. Companies also have to devise adaptive strategies to navigate this landscape. One CEO lamented that the agility required to manage the constantly changing environment consumes management time that could otherwise be spent on long-term strategic planning. This is corroborated by the fact that Europe relies more on global value chains, which makes it more vulnerable to fragmentation in the short run than the US or China.

Security concerns also lead to additional costs. A CEO noted that transport costs have increased, with imports from the Far East sometimes taking 60 days instead of 28 days due to Houthi attacks in the Red Sea. Similarly, most businesses have seen cybersecurity costs rise dramatically, with one CFO mentioning a fivefold increase in cybersecurity expenditure over the last five years. Geopolitical fragmentation has also prompted many interviewed companies to ringfence some of their foreign subsidiaries to prevent local authorities from accessing their company network.

Commodity prices have become more volatile due to international security risks and climate change. A Belgian food company highlighted that hedging has generally become more expensive. In the Spring Forecast round, the European Commission surveyed European companies on their response to tensions, disruptions, or policy changes in foreign markets. Nearly 40% reported increased costs. While some of these costs can be passed on to consumer prices, the proportion of companies that believe they can do so is lower than the percentage unable to do so, suggesting some margin pressure.

The world is not so flat anymore

In his 2005 bestseller "The World is Flat," Thomas Friedman described a new phase of globalisation, where the interconnectedness of many countries in the global supply chain meant they had a vested interest in maintaining stability and economic cooperation. Two decades later, it seems the world is becoming more fragmented again. For companies operating internationally, this means that some of the economies of scale and scope that multinational companies can exploit are no longer as straightforward. Many business leaders we spoke with now favour relying on local supply chains for their international subsidiaries to minimise the risk of global supply chain disruptions. While most companies still seem able to navigate this riskier environment, it is clear that agility has become crucial, limiting short-term downside effects. However, no one can deny that remaining resilient in this new, more challenging environment comes at a cost.

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