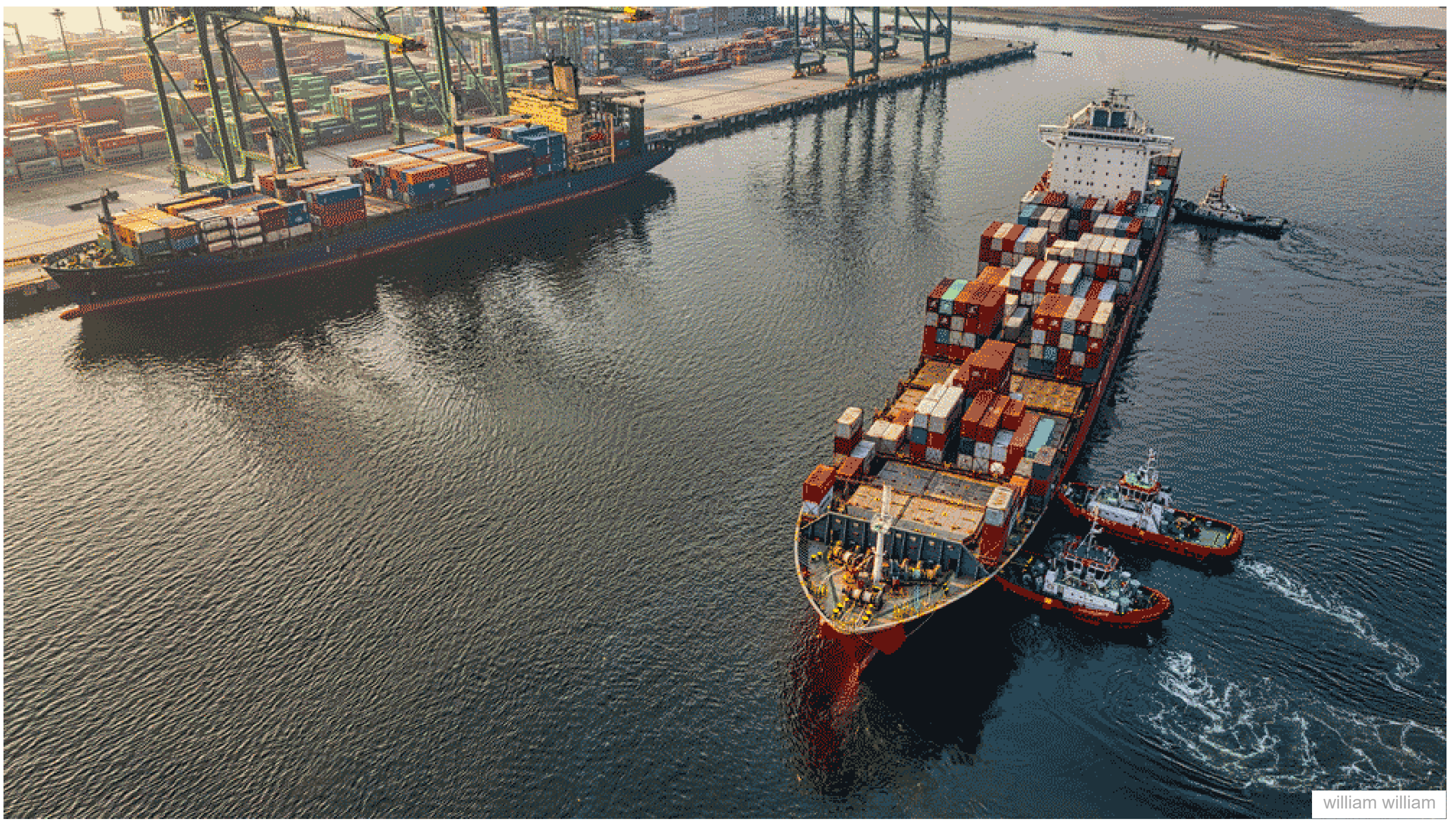
Geopolitical Risk for Supply Chains

Emerging challenges and their mitigation strategies



william william

Jonathan R. Todd

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COMMENT

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Geopolitical risk is emerging as one of the greatest challenges facing domestic and international business today. It has risen from a boardroom issue to one drawing the awareness and attention of both personnel and the general public. These days everyone knows the word “supply chain” and has some general understanding of tariffs, sanctions, and even congestion. In a world where there’s no longer a zero-risk solution, the task becomes crafting pragmatic strategies that adapt and get business done while mitigating negative effects. Recognizing how we got here and using some go-to tools will help.

Global relative risk spectrum

Supply chain professionals have grown accustomed to navigating a spectrum of risk across the world. Some countries are riskier for a company’s lines of business, and others carry less risk. Until recently, the risk-side of the spectrum was bookended by Iran, North Korea, Cuba, and for some trade, Russia. China was less risky from the perspective that most trade outside of critical technologies was permitted, although cost volatility presented risk due to tariffs. Vietnam, Cambodia, and even countries like Italy were still less risky, although claims of customs-duty evasion and forced labor were a challenge. Canada, Mexico, and the European Union stood on the safest side of the risk spectrum.

The risk-spectrum worldview drove nearshoring, friendshoring, decoupling, and several other euphemisms for geopolitical risk strategies. That worldview ended in November 2024, when president-elect Donald J. Trump announced his intention to impose tariffs on our North American allies, Canada and Mexico. The European Union has also been moved to the risk-side of the spectrum. The only region where sourcing or sales don't suffer actual or potential risk today is the domestic United States. The threat of retaliatory tariffs on imports of raw materials and other inputs for domestic production challenges even that safety zone.

Enterprise planning and investment face challenges in this environment due to a level of uncertainty that threatens even 30 years of NAFTA and then USMCA investment. The simple truth is that we're now working through a volatile and higher-cost operating environment. Our toolbox is full of approaches for navigating this era of ever-present and nonzero risk. The task for professionals is to choose the right tool for the task and to deploy it strategically, understanding that there's no one, single supply chain solution.

Supplier and customer diversity strategies

Concentration risk is a well-known concept in business. Now many companies are applying the same concept to their procurement and sales organizations. A few years ago, it was common for China to hold a singularly large place in procurement and even sales. Today a number of companies have dramatically expanded supply and delivery lines to avoid the cost volatility that began with the Section 301 tariffs of 2018. Diversifying supply and delivery is helpful for minimizing acute risks (such as the sanctions swiftly placed on Russia in 2022) and for the more generalized risk of country-specific tariff actions. The strategy can also help to diversify traffic lanes so that, for example, the Houthi rebel attacks in the Red Sea or low water levels in the Panama Canal have less of an effect on the supply chain.

Risk-appropriate contract strategies

Thoughtful approaches to balancing risks in contracts are also emerging. The days of using boilerplate purchase orders as the only documentation for a purchase or sale are over. Many of those weren't negotiated, let alone reviewed.

Instead, there’s now a need for clarity between contracting parties on exactly what the expectations will be due to geopolitical risk. On its most basic level, this involves determining how shocks to the system will be communicated between parties and what the effect will be. This is similar to the root cause analysis and corrective action plans developed in some technical trading relationships, although it’s focused on outside factors rather than performance alone. Certain clear risks also merit their own provisions. Those include the risk of U.S. Customs detention and seizure, dramatic change in duty rates, and a party’s swift appearance on denied parties lists.

Indexing and dynamic rate strategies

Cost volatility was one of the most widespread challenges during the early days of the global pandemic. One of the tools leveraged during that time is again appearing in some trading relationships. Some companies are recognizing that variance is a fact that requires pragmatic approaches to keeping parties honest and working with one another. For some industries, there are go-to price indexes that can serve as a guide for whether and when price adjustments are appropriate. This essentially normalizes the cost of a good or service against the relative change in the same or similar purchases. It’s not unlike a PPI or CPI cost adjustment provision with a definitive cap. The rationale for this approach is acceptance that costs may be higher, but if they are, the sell-side is compensated to account for higher operating costs, and the buy-side doesn’t pay more than it would otherwise pay going to market. Clearly establishing how these rules apply, when they apply, and the ways in which parties will communicate through that process is nearly as valuable as the benefit of price visibility.

Sanctions risk mitigation strategies

Companies in the United States face unique compliance obligations when doing business in certain parts of the world. Economic sanctions affect domestic operations and, in many instances, the foreign branch or subsidiary operations of domestic companies.

Awareness training is a critical factor for procurement, sales, and financial professionals, but it's important to take that effort many steps further. We're not living in a time where merely producing a "policy" to collect dust is sufficient. Real-time screens of new customers, their banks, and parties to outbound shipments is just as crucial as proper item-level export classifications and clearance. It's also available in many ERPs or other operating systems and in stand-alone platforms. When done well in risk-appropriate fashion, these efforts can empower personnel rather than hinder their performance. They also limit company and personal risk for the civil and criminal penalties that may follow violations, not to mention negative press.

Many "known unknowns" exist in this operating environment that make calmly maintaining perspective critical. We want to be strategic, not reactive. We want to work, not rely on wishful thinking. We understand that contingency plans might be needed, or they may need to be modified. We know that unforeseen circumstances can still exist. In truth, this is the time when supply chain professionals shine by crafting the best solution for their enterprise based on experience and the best available data.
