

Political risk and operational resilience

The operating environment has been changing significantly in the last few years. Not only have international conflicts increased. The consensus about the means how these conflicts are meant to be settled seem to disappear. As such, businesses are confronted with new more volatile operating environments. The US tariff announcement on 2 April 2025 contributes to this.

This MITIGATION GUIDE provides suggestions to business leaders how they can increase operational resilience and protect earnings.



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Introduction

Given the recent developments in early 2025, it is time to reflect where we stand on political risk and the implications this has for businesses navigating through daily challenges.

In January 2017, at the outset of the 1st Trump presidency, we analysed political risk drivers associated with evolving policy frameworks routed in 'decreasing political consent'. At that time, we identified four main risk areas:¹

- Global free trade
- International security framework
- Stability of foreign relations and multilateral political agreements
- Regulation of financial markets

On all four areas we have already experienced the realisation of risks. What has been a risk back then has now become a reality.

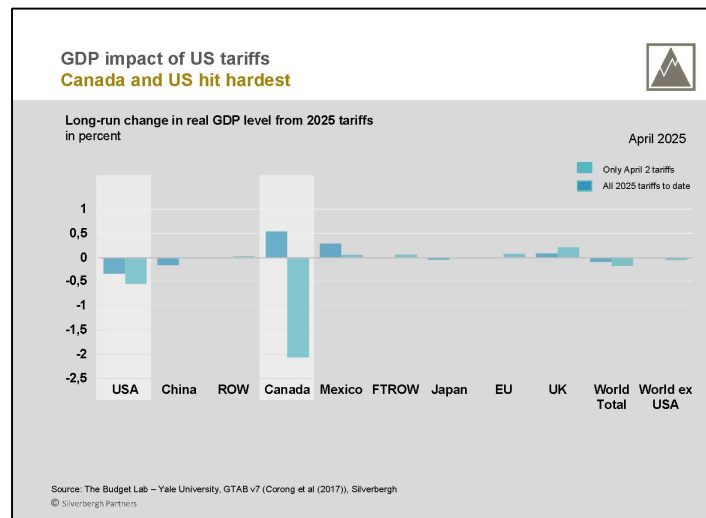
Some businesses have been prepared, several others were caught unprepared.

However, political risk has not disappeared. On the contrary, we can describe some of the risks more accurately today. At the same time, the degree of risk and uncertainty as well as the impact some risks might have (beyond the

recent tariff announcement by the US government) have increased as well. What are examples?

These would *short-/medium-term* be tariff changes and ad-hoc exemptions (beyond a new normal), new non-tariff policy measures (e.g. im-/ export controls even beyond own jurisdiction), changes of key economic parameters (GDP growth, FX, inflation/ interest rates, unemployment rates) and stability of capital markets, changes of goods and services flows with the potential to be cut out or face new competition but also with the possibility to access new business opportunities. Increasing security challenges might also expose operational vulnerabilities which have been less relevant in the past.

Longer-term, the current conflict might accelerate the development from a multilateral geopolitical framework towards multipolar geopolitical framework with regional hegemons. This then demands answers and potential adjustments e.g. on strategic market presence (and compatibility with the hegemons objectives²), operating model & manufacturing footprint, supply chain, IP protection, cyber.



¹ Silverbergh Partners, Coming to grips with political risk, Insights 1/2017, 2017 https://silverbergh.com/files/SP-Insights_1702_Coming-to-grips-with-political-risk_0627w3r9.pdf

² We have already some of these compatibility issues/ diverging policy objectives today.

The impact of the recent US tariff announcement

Econometric analysis³ shows how different countries would be affected by the tariff changes on average.

Ironically as it seems, the US next to Canada carries the highest burden (*see exhibit*).

Volatility expectation in capital markets increased by more than 100%.⁴

Additionally, inflation would be stimulated medium- to longer-term.⁵

As this tariff conflict might seem to be irrational, it only proves the point that there might be additional considerations that determined the decision to introduce them.

The good news is that European export-oriented economies seem to be quite robust with regard to US tariffs given the low tariff gap.⁶

Obviously, a certain business might be more or less impacted depending on its industry and geographic footprint. Some might even benefit.

From a business perspective, there may also be upsides. Competitive advantages might evolve due to structural conditions or the ability to act faster and with more

flexibility. New market segments might open up. New formations of trading partners might pave the way to new business opportunities i.e. closer ties between Europe and Asia, stronger alignment with Canada and Mercosur.

'A LOOK INTO THE CHRYSTAL BALL' What might happen with the April 2 tariff policies?

Conventional wisdom

A widespread view among asset managers is a correction of the Trump administrations' tariff plans by the 2nd or 3rd quarter 2025. The reasoning is not a judicial intervention or a course correction by congress limiting administrative powers. The argument is that public opinion (as the performance of individual pensions plans in the 401k statements) and mounting pressure in the GOP due to upcoming mid-term election will force the government to change course.

Reviewing the argument

Even though this development would ease the conflict, it disregards a couple of facts:

- **Any negotiation cannot deliver against the expectations raised by the US administrations announcement.** The argument of unfair treatment of US goods is based on flawed calculations e.g. US imports vs. exports to the US.
- **The administration intends to sustain increasing pressure.** It has always been quite clear that it expects a drawdown of equity markets. The communication style does not suggest that the administration would consider giving in. It conveys that it is proud to stand strong on the issue.
- **The administration behaves according to playbook** – 'A User's Guide to Restructuring the Global Trading System'⁹– even though the implementation seems to be erratic and sketchy.
- **Critics hold back to clearly voice their concerns** – members of congress and business leaders.
- **Decisions are 'path-dependent'.** Once tariffs are being implemented, businesses are impacted immediately. 2nd order effects are not completely reversible.
- **In the recent past, we have experienced other major geopolitical events** which seemed to be irrational and unthinkable at that time (e.g. Brexit, Ukraine war). Even the severity of the current tariff conflict seemed to be unthinkable just a few weeks ago.

Outlook

There are doubts whether the tariff plans will get cancelled in the months to come, even if the administration pivots temporarily. In any case, businesses will have to cope with a higher degree of uncertainty and the consequences as global geopolitical, trade and security interest are being reshuffled, and economic conditions are being weakened. 'Genie' might be back in the bottle any time soon.

The trade & tariff playbook

On April 2, business leaders and economists were wondering how the US administration had derived their tariff table and what the longer-term plan might be. In essence, it is just the relationship of US goods exports vs. goods imports to/from a certain country, the country's trade balance as a measure for the degree of 'unfairness'. It disregards services.⁷ Hence, this is not even a tariff perspective. Imports into the EU have tariffs of 5 percent (vs. 3.3 percent for imports into the US according to the WTO)⁸ and are not double digit as the administration claims.

The hope that this might be just another spontaneous and chaotic move is not substantiated. The opposite is the case. The policy announcement is in line with plans laid out in November 2024⁹ also referred to as

'Mar-a-Lago Accord'. Author is Stephen Miran who has been confirmed as the Chair of the Council of Economic Advisers (CEA) on March 12. This document gives a flavour

³ The Budget Lab, Where We Stand: The Fiscal, Economic, and Distributional Effects of All U.S. Tariffs Enacted in 2025 Through April 2; 2025; <https://budgetlab.yale.edu/research/where-we-stand-fiscal-economic-and-distributional-effects-all-us-tariffs-enacted-2025-through-april>; tariffs modelled 'in isolation' which means not tariff responses have been taken into account

⁴ VIX index expresses the 30-day implied volatility based on options prices in the S&P 500; https://www.cboe.com/tradable_products/vix/

⁵ This poses additional challenges for the Fed. How it will react after a new vice-chair (this year) and a new chair (next year) have been confirmed, remains to be seen.

⁶ Flach/ Scheckenhofner, US Reciprocal Tariffs and their Erosion of Global Trade Rules: Implications for Germany, EconPol Policy Brief 71, 2025;

<https://www.cesifo.org/de/publikationen/2025/working-paper/us-reciprocal-tariffs-and-their-erosion-global-trade-rules>

⁷ Corith/ Veuger, President Trump's Tariff Formula Makes No Economic Sense. It's Also Based on an Error., 2025; <https://cosm.aei.org/president-trumps-tariff-formula-makes-no-economic-sense-its-also-based-on-an-error/>

⁸ World Trade Organisation (WTO), The World Tariff Profiles, 2024; https://www.wto.org/english/res_e/booksp_e/world_tariff_profiles24_e.pdf

⁹ Miran, A User's Guide to Restructuring the Global Trading System, Hudson Bay Capital, 2024; https://www.hudsonbaycapital.com/documents/FG/hudsonbay/research/638199_A_Users_Guide_to_Restructuring_the_Global_Trading_System.pdf

on the policy objectives and reads like a playbook on trade policies with the intent to break with established policy patterns.

Some key elements of this document are:

- **Aim to ‘reshaping the global [trading] system’**
- **Devaluation of the USD** for higher competitiveness of US goods and with impact on US trade balance on aggregate but also on a country-by-country basis (without risking the role of the USD as a reserve currency)
- **Revenue generation** through higher tariffs (as these are being paid by the tariffed nation) with the intention to fund the plan to retain low domestic tax rates (expected budget contribution of USD 5 tr over 10-year period)
- **Closure of package deals** on tariffs and access to the US defence shield by forcing countries from current short- /medium-term bonds to bonds with long tenors (~50-100 years) at low, near zero interest as a ‘price’ for protection
- **Intent to enter (also) into unilateral currency adjustment strategies** (beyond multilateral approaches)¹⁰ to achieve quick negotiation outcomes
- **Tariffs as high as 60% on China and min. of 10% for ROW**
- **Tariff announcements as a tool to exercise negotiation power** ‘by creating fear and doubt’ and to ‘pressure nations’ with the resolution to group countries per their currency policies (quoting Treasury Secretary Scott Bessent).
- **A list of trade and security criteria also instrumental for tariff negotiations**
- **Assumption that tariffs lead to currency offsets** of the stronger currency (as experienced in 2018-19 according to early research even though not all transmission channels have been analysed yet)¹¹

Arguments along the same lines have been made by Scott Bessent in October 2024 prior to being nominated as Treasury Secretary.¹²

Interestingly, some economic considerations are not dealt with in the document, i.e. the evolution of US businesses’ competitiveness and productivity over time, access to labour at a current unemployment rate of 4.2 %¹³ and without stimulating inflation in case manufacturing gets

relocated to the US, welfare implications for US households, domestic fiscal measures (with an influence on the trade balance and current account).

Also, behavioural aspects seem to be disregarded e.g.

- **Bond market and US treasuries:** China is a major investor into US treasuries (among other countries). That it will follow the US administration’s expectations to drop treasuries with shorter tenors for longer tenor treasuries with low interest seems not to be realistic. Additionally, the market has already been damaged. As investors reallocated capital from equity markets into treasuries, prices should have appreciated, and yields should have dropped. The opposite was the case. This can be interpreted as increasing risk premiums for investments which have been considered low risk in the past.
- **Credibility of the US as a defence partner:** The attractiveness to ‘buy’ protection from a ‘damaged defence brand’ (the US) by investing into long-term low yield treasuries has dropped as well.

In the last two months, the US has repeatedly demonstrated its unreliability. From a pure economic standpoint, asking a ‘customer’ under such circumstances to purchase a service for multiple decades can be viewed as a counterparty/ credit risk issue as the counterparty might default on its commitments. As is widely known, the price for buying credit protection is an exponential relationship over time. Beyond opportunity costs for foregone interest, this would be an economic cost to be added to ‘sourcing security’ from a partner. In economic terms, this means that the risk-adjusted costs are already quite high for outsourcing protection today. This is even more the case long-term given the exponential relation. As such, in a ‘make-or-buy’ decision, the ‘make’ gains in attractiveness.

To sum up, it is hard to see that the US administration’s policy objectives on ‘package deals’ are robust and can be implemented as planned.

How to view risk & uncertainty

Different attitudes towards political risk and uncertainty can be observed ...

¹⁰ Phrasing leaves room for interpretation. Most likely targeted at China.

¹¹ Joanne/ Son, To what extent are tariffs offset by exchange rates?, NBER Working Paper Series, 2021; https://www.nber.org/system/files/working_papers/w27654/w27654.pdf
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¹² Entering the Fall 2024, Alarming Signs? – Fireside chat with Scott Bessent; <https://www.youtube.com/watch?v=D18IRACRJio>

¹³ March 2025 (tradingeconomics.com)

1. 'How do we know what might happen. Even if we would know ... what could we really do?'
2. 'As a risk occurs, we will deal with it.'
3. 'Well, it is pretty bad right now. But it cannot remain like that, it will get better.'

We would argue the opposite. We believe decision making should be based on realities rather than hope. Even if perspectives on risk and uncertainty remain imperfect, they provide a view how to mitigate risk and how to protect a business's operational stability and profitability. This requires ongoing effort and lead time.

For illustration purposes, we suspect that everybody would agree that in this specific situation ...

- Less US exposure or an existing US domestic manufacturing footprint (provided international supply chains are not damaged by prohibitive tariffs) would be beneficial for an export oriented European business.¹⁴
- Fighting of increasing hybrid attacks, protect business systems stability and intellectual property (IP) is a 'must' as US agencies redefine their foreign policy, cyber defence and intelligence priorities.

So, what is different in this trade conflict today?

- **Flawed baseline:** The hike in taxes on multiple fronts is based on counterfactual arguments and the sheer size and speed of implementation is unprecedented.

Businesses are immediately affected.

- **2nd order effects also for the domestic economy are tolerated:** As the conflict remains, economic 2nd order effects are initiated which are hard to understand ex-ante and hard to control.

Businesses will have difficulties to evade changing economic parameters.

- **Integration of policy frameworks:** Trade and security policies are no longer treated separately. As trade policies are being implemented, adjustments on

US national security and defence policies are already ongoing.

Negotiations will have impact on businesses on both policy fronts not only with US operations but also with operations outside the US.

- **Lingering uncertainty:** The willingness to bluntly exercise power, threaten partners, 'throw established litigation procedures under the bus' and to leverage uncertainty for negotiation outcomes will lead to a trust erosion and stimulate uncertainty beyond the core conflict.

This will incur additional transaction/risk cost for businesses.

Just recognizing new realities in the operating environment in a business's risk inventory will not be sufficient. It is advisable to derive specific initiatives from a set of considerations.

How to increase operational and economic resilience

There are four areas which demand attention for increasing operational and economic resilience with mounting political risk (*see exhibit*).



- **Cost position** – It is always good to have an attractive cost position. This is not the reason this is mentioned here. Tariffs (but also not tariff based trade barriers) imply changes to relative prices. As a result, a business might find itself priced out of a market. Alternatively, it would need to swallow some of the tariffs (reducing its export price) to remain competitive. This would be a drain on a business's profitability.

A loss of profitability would trigger a set of cost improvement considerations to stay competitive and profitable.

¹⁴ On the contrary establishing production capacity in the US to cope with the tariff regime would incur additional costs and potentially stranded investments if the tariff regime is revised afterwards.
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- **Operating model** – In order to cope with external shocks creating optionality in the manufacturing portfolio and supply chain allows to adjust quickly by ramping or swapping capacity between different sites. In theory, this sounds easy but is associated with numerous challenges as own resources and skills, suppliers and customers would need to be organized around this objective. Commercial frameworks would need to be synchronized with technical capabilities. The trade-off between low unit costs in stable operations vs. potentially elevated unit costs in flexible operations would need to be managed. Flexibility comes at a cost and additional flexibility costs would need to be justified against the potential benefit.

Flexibility might already exist and might only be identified. 'Producing' (additional) flexibility would require a cost-benefit assessment. Operational flexibility within given capacity constraints (e.g. workforce) would contribute to inherent operational resilience.

- **Portfolio** – Companies operating across borders have a well-established rationale how to integrate own operations with partners and supplier. Under the influence of political risk, the conditions under which this scheme was established might no longer hold. Business conditions and/or target capital productivities might be changing.

Reviewing underlying assumptions for the current portfolio set-up from time-to-time employing a political risk angle avoids being caught empty-handed with little room to manoeuvre once political risk hits. Capital productivity expectation and buffer can be maintained.

- **Financial management** – Exposure to financial markets within the liquid horizon¹⁵ needs to be closely

managed as political risks initiates volatility. As such this might be a strain or an opportunity to optimise a business's financials.

Thorough management of exposure to financial markets can provide downside protection to a business's earnings. If risk appetite and capabilities allow, seeking targeted exposure might also contribute to profitability.

Summary and outlook

In the past, companies were also confronted with trade policy changes and security threats. They however operated within the respective policy frameworks negotiated between governments over time. Businesses could adjust to expected outcomes.

Today, established rules of conduct seem to have eroded already for years in some areas and seem to hit a new low of acceptance. Even though governments still act, they have less room to manoeuvre as they are confronted with a faster paced environment. This puts more burden in businesses to cope with the consequences.

Going forward, there is limited evidence today to believe that we will go back to a more stable policy environment that we have experienced in the past. Therefore, businesses need to take a proactive stand with the aim to anticipate political risks and be prepared once they materialise.

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¹⁵ Time frame in which financial instruments have a sufficient liquidity and are therefore tradable without incurring liquidity risk and premiums.
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