

Geopolitical Risks & Supply Chain Review



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In recent years, many countries including Japan have been reviewing their supply chain. In the background of the reviewing, there are deliberate supply chain disruptions and geopolitical risks, based on political motivations. Japan's parliament passed the Economic Security Promotion Act in May 2022, and systems for 'supply chain resilience' and other measures came into effect on the 1st August 2022. Semiconductors, batteries and pharmaceuticals are expected to be designated as 'specified critical goods', and companies that manufacture and sell designated goods will receive subsidies from the Government for their efforts in supply chain reviews. Such supply chain reviews includes reducing dependence on certain countries such as China for supply, diversifying to third countries and will provide opportunities for Asian countries.

This article introduces political risks as a factor in supply chain disruptions, supply chain resilience policies in various countries, particularly policies and the responses of companies in Japan.

1. Political Risk as a Factor in Supply Chain Disruptions

There are a wide range of factors that can cause supply chain disruptions, such as earthquakes, typhoons, infectious diseases, terrorism, riots, strikes and logistical disruptions. These include political risks, i.e. supply chain disruptions resulting from policy decisions or decisions made by a particular country. In the past, [Countries have restricted imports and exports in order to ensure their own security, as a countermeasure to deteriorating bilateral relations or for other reasons.](#)

Countries seek to achieve their political objectives through economic means. China in particular has imposed political restrictions on exports and imports against the backdrop of a changing geopolitical environment and deteriorating bilateral relations. For example, the deterioration of relations with Norway following the awarding of the Nobel Peace Prize to a Chinese activist (2010), the deterioration of relations with Japan following a ship collision near the Senkaku Islands (2010), pressure on the new Tsai Ing-wen Government of Taiwan (2016), which was seen as independence-oriented, and the COVID-19 origins investigation, resulting in Deterioration of relations with Australia (2020), among others.

❑ Export & import restrictions by political factors

| Country (Year) | Descriptions |
|--------------------|--|
| China (2010) | Import restrictions on Norwegian salmon |
| China (2010) | Export suspension of rare earths to Japan |
| China (since 2016) | Travel restrictions for travelers to Taiwan |
| Japan (2019) | Review of export controls on semiconductor-related items to South Korea |
| EU (2020) | Restrictions on EU countries' exports of medical supplies, vaccines, etc. |
| China (2020) | Delays in land transport and reduced container shipping from China by lockdowns in cities |
| China (2020) | Ban on imports of Australian coal |
| USA (2021) | Restrictions on imports of goods from Xinjiang, China, based on the 'presumption of guilt' that forced labour was involved |

2. Supply Chain Resilience Policies in Various Countries

1) United States

Japan, the USA and the EU have identified and designated critical goods and put measures in place to deal with supply chain disruptions as a security risk.

US President Biden signed the Executive Order 14017 on America's Supply Chains for critical goods on 24 February 2021, shortly after taking office. This Executive Order requires relevant ministries and agencies to report to the President within a certain timeframe on vulnerability, risk assessments and response measures in critical sectors, with the aim of strengthening supply chains against pandemics such as COVID-19, cyber attacks, geopolitical competition such as the US-China conflict, human rights violations, etc. [The most important four sectors are designated for reporting within 100 days and additional six sectors are designated for reporting within one year.](#)

Measures to be taken after the risk assessment include: visualization of supply chains, switching supply chains (from unfriendly or unstable countries to allied or volunteer countries), returning production bases to domestic markets, strategic stockpiling (virtual stockpiling of raw materials, etc., rather than finished products), R&D support and financial support.

❑ Critical Sectors of US Supply Chain Policies

| Most Critical: Sectors for 100-Day Supply Chain Review | |
|--|--|
| Semiconductor Manufacturing and Advanced Packaging | High-Capacity Batteries including Electric-Vehicle Batteries |
| Critical Minerals including Rare Earth Elements | Pharmaceuticals and Active Pharmaceutical Ingredients (API) |
| Critical : Sectors for within 1-year Supply Chain Review | |
| Defense Industrial Base | Public Health and Biological Preparedness Industrial Base |
| Energy Sector Industrial Base | Transportation Industrial Base |
| Information and Communication Technology Industrial Base | Production of Agricultural Commodities and Food Products |

2) EU

The EU has announced a new industrial policy to analyze strategically important goods, reduce dependence on specific countries and improve autonomy. In the “Updating the 2020 New Industrial Strategy” published by the European Commission in May 2021, six key strategic sectors: [raw materials](#), [batteries](#), [active pharmaceutical ingredients \(API\)](#), [hydrogen](#), [semiconductors](#), and [cloud-edge technologies](#) are identified.

As a result of the analysis, the EU has identified 137 sensitive items with a high degree of extra-regional dependence (approximately 6% of total imports). Most of these are environmental/energy, healthcare and high-tech electronic products. In terms of import sources, China accounts for almost half (52%), followed by Vietnam (11%), Brazil (5%) and Singapore (4%). 34 of the 137 products (e.g. energy-related raw materials, API etc.) are identified as difficult to source alternatives.

3. Japan: Economic Security Promotion Act

1) Legal Overview

Japan is also establishing measures, including supply chain resilience. On the 11th May 2022, the National Diet of Japan approved the **Economic Security Promotion Act**. The Act establishes the following [four systems](#) as “economic measures to ensure security”.

❑ Four Systems of Economic Security Promotion Act

① Resilience of supply chains for specified critical goods

- Strengthen supply chains, such as by decentralizing procurement sources, for 'specific critical goods' that are essential to people's lives but highly dependent on specific countries.
- Companies submit plans for stable supply to the government and receive financial benefits if they are approved.

② Securing the security of core infrastructure

- The government conducts pre-screening for security risks about critical facilities, software, outsourcing service, external parties in 14 core infrastructure projects (e.g. electric power business, telecommunications, transportation).

③ Support for the development of specific critical technologies

- The public and private sectors will provide development cooperation and financial support for advanced technologies, such as those that threaten the security of the state and the people if improperly used by external parties, as 'specific critical technologies'.
- As economic security-related funds, those technologies will be the target of a future governmental investment of 500 billion yen.

④ Non-Disclosure of patent applications for sensitive inventions

- The patent applications for sensitive inventions that are at risk of possible military diversion are to be closed to the public.

Of these, supply chain resilience (①) and support for the development of specific critical technologies (③) will come into force on the 1st August 2022, with the remaining two measures to be implemented within 18 months to two years.

2) Focus of the Law: Security & Geopolitical Risks

Importantly, the purpose of the Law on Economic Security Promotion Act is to ‘secure security’. More precisely, the aim is to prevent 'situations in which the security of the state and its citizens is undermined by external acts', which are repeatedly referred to in the law.

The specifics of these 'situations' are not clarified yet, but in the supply chain sector, they could include, for example, tense bilateral relations, East Asian emergencies including Taiwan Strait emergencies, and deliberate supply disruptions or import restrictions in the event of a pandemic.

Of course, the law does not (officially) have any particular country in mind, and the possibility of any country suspending supply during a pandemic cannot be ruled out. However, taking into account the circumstances leading to the enactment of the law and the discussions among experts, it is safe to assume that most 'situations' will have China in mind.

3) Resilience of Supply Chain

The Japanese Government will designate 'specified critical goods' that are important in the supply chain. According to the Basic Guidelines for Securing Stable Supplies of Specified Critical Goods, which will be approved by the Cabinet in September, four requirements are assumed for the designation of goods.

❑ Four Requirements designated as ‘Specific Critical Goods’

| | |
|-----------------------|---|
| ① Importance | It should be an important goods that is essential for people to survive or that people's life or economic activities rely on. |
| ② External Dependency | Excessive external dependence or potential for dependence. |
| ③ Probability | The need to prevent external action from undermining the security of the State and its citizens. |
| ④ Necessity | It is deemed particularly necessary to ensure a stable supply. |

Examples of specified critical goods that meet these criteria include [semiconductors](#), [storage batteries](#), [pharmaceuticals](#), [palladium](#), [cloud service](#), [fertilizers and ship-related products](#), according to the latest government data.

The minister in charge of the designated specified critical goods establishes a 'Policy for Measures to Ensure Stable Supplies' and companies can draw up a 'Plan for Securing Supplies'. If the supply security plan submitted to the State is approved, companies can receive financial support.

The security of supply plan may include measures such as;

- Research analysis / visualization of the supply chain
- Securing alternative suppliers and production bases
- Domestic production
- Stockpiling (finished products, raw materials, etc.)
- Development of alternative products and technologies, etc.

4) Onshoring and Friend-shoring

Of the supply chain resilience measures, 'Onshoring' and 'Friend-shoring' attract attention. 'Onshoring' refers to returning to one's home country (in this context, production in Japan). However, this policy is not limited to support for Japanese companies. An investment in a semiconductor plant (Kumamoto Prefecture) by TSMC, a major Taiwanese semiconductor manufacturer, a Sony affiliate, and Denso, Inc., up to 476 billion yen of the total investment of approximately 1.1 trillion yen, will be covered by government subsidies on a conditional basis.

Even more important than this is 'friend-shoring', i.e. the transfer of [alternative procurement and production bases to like-minded countries \(liberal democracies\), friendly countries \(countries with good bilateral relations\) and stable countries \(countries with high political stability and predictability\)](#). It is difficult to determine which countries and regions are 'friendly', but the members of the Indo-Pacific Economic Framework (IPEF) are strong candidates. This is because the IPEF has a supply chain co-operation agenda and has aspects of a de facto competitive strategy vis-à-vis China.

□ Economic Framework and Affiliated Countries for the Indo-Pacific Region

| Country/Area | IPEF | RCEP | CPTPP | APEC | ASEAN |
|------------------|------|-----------|---------|------|-------|
| Japan | ○ | ○ | ○ | ○ | |
| South Korea | ○ | ○ | | ○ | |
| China | | ○ | Applied | ○ | |
| Hong Kong | | | Applied | ○ | |
| Taiwan | | | Applied | ○ | |
| Philippines | ○ | ○ | | ○ | ○ |
| Thailand | ○ | ○ | | ○ | ○ |
| Vietnam | ○ | | ○ | ○ | ○ |
| Cambodia | | ○ | | | ○ |
| Laos | | ○ | | | ○ |
| Myanmar | | ○ | | | ○ |
| Singapore | ○ | ○ | ○ | ○ | ○ |
| Malaysia | ○ | ○ | ○ | ○ | ○ |
| Indonesia | ○ | ○ | | ○ | ○ |
| Brunei | ○ | ○ | ○ | ○ | ○ |
| India | ○ | Opted Out | | | |
| Papua New Guinea | | | | ○ | |
| U.S.A. | ○ | | | ○ | |
| Canada | | | ○ | ○ | |
| Mexico | | | ○ | ○ | |
| Peru | | | ○ | ○ | |
| Chili | | | ○ | ○ | |
| Australia | ○ | ○ | ○ | ○ | |
| NZ | ○ | ○ | ○ | ○ | |
| Russia | | | | ○ | |

5) Another supply chain resilience measure?

There is another supply chain resilience measure in the Economic Security Promotion Act. This is 'securing the security of core infrastructure'. Under this measure, when core infrastructure providers whose business is above a certain size [select, procure and use critical facilities, software, cloud services and contractors, the government conducts a pre-screening to ensure that there are no security risks](#). In view of similar measures by the US and other allies, companies with headquarters in China, Russia, Iran and North Korea, or companies with significant influence in these countries due to capital ties, are of concern.

For companies that provide products and services to core infrastructure providers, this is a matter of life and death. However, once they pass government screening, they are recognized as products and services (and operators) with low security risk, and their market value may increase.

This may lead that they may receive a reputation not only in Japan, but also in the markets of Japan's allies and friends.

4. Measures by Companies

Cases of supply chain disruptions based on political motivations and geopolitical reasons are becoming more apparent. Given the US-China rivalry and the security environment in the Indo-Pacific, such disruptions are likely to occur again and again.

Therefore [companies need to establish and deepen their supply chain management to take geopolitical risks into account in addition to traditional risks \(e.g. natural disasters\)](#). At a minimum, the following initiatives are recommended.

- ❖ **Collection and analysis of supply chain policies in each country**
 - Identification of priority sectors, critical specified goods, etc. of each country's supply chain policy
 - Analysis of security risks (specific countries / regions, events of concern) assumed by supply chain policies in each country
 - Identification of incentives, including subsidies, etc.
- ❖ **Supply chain assessment from the perspective of geopolitical risks**
 - Assessment of the potential for geopolitical risk manifestation in the upstream and downstream processes of the supply chain (e.g. whether it is designated as a priority industry, whether it has been arbitrarily regulated in the past, etc.)
- ❖ **Supply chain resilience from the perspective of geopolitical risks**
 - Consideration of whether measures such as reviewing suppliers and production base, building up stockpiles, etc., are necessary or not.

* Tokio Marine dR Co., Ltd. can provide support service for the above-mentioned initiatives.

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