

wiiw Spring Seminar 2021

Brave New World? The economic and political challenges facing Eastern Europe after COVID-19

**Getting stronger after COVID-19:
Nearshoring potential in Eastern Europe**

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Our forthcoming study...

- **Prepared in cooperation with:**
 - Union of Chambers of Commerce and Industry of Albania
 - Foreign Trade Chamber of Commerce and Industry of Bosnia and Hercegovina
 - Kosovo Chamber of Commerce
 - Chamber of Economy of Montenegro
 - Economic Chamber of Macedonia
 - Chamber of Commerce and Industry of Serbia
 - Chamber Investment Forum Western Balkans
 - Chamber Partnership Western Balkans
 - Germany Trade and Invest
- **Financially supported by** the Federal Ministry of Economic Cooperation and Development of Germany



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Shortage of personal protective equipment endangering health workers worldwide

3 March 2020 | News release | Geneva | Reading time: 2 min (471 words)

WHO calls on industry and governments to increase manufacturing by 40 per cent to meet rising global demand

Globalisation of production...

- During previous several decades
- Multinational companies moving activities abroad
- Looking to minimize production costs (i.e. cheap labour)
- Just-in-time production
- Minimizing inventories, and costs, additionally
- Global value chains

COVID-19...

- Revealed the weaknesses of this way of organising production
- Global production interrupted
 - Border closures
 - Restrictions on movement of people and goods
 - Lockdowns
 - Other pandemic-related disruptions
- Companies started thinking about re-organising their production, to make it more resilient to such shocks

All kind of –shorings...

- **Off-shoring:** taking production out of home country
- **Re-shoring:** bringing production back home
- **Far-shoring:** taking production far from home country
- **Near-shoring:** bringing production close to home

ERM annual report 2016: Globalisation slowdown? Recent evidence of offshoring and reshoring in Europe



Globalisation slowdown before COVID-19?

- Eurofound (2016): slowdown in offshoring, due to increased global uncertainty, but also because the previous two decades were exception, due to integration of China and Eastern Europe
- Eurofound (2019): upward trend in reshoring since 2014, the main reason being the poor quality of off-shored production

UNCTAD (2020)

Table IV.2.

The growth and slowdown of international production: key factors

1990–2010: Drivers of growth

Liberalization and export-led growth policies

Factor cost differentials and declining trade costs

Technological advances acting as enablers

2010s: Causes of the slowdown

Return of protectionism and policy uncertainty

Gradual decline in the return on FDI

Digital technologies favouring asset-light forms
of international production

Source: UNCTAD.

INTERNATIONAL PRODUCTION: A DECADE OF TRANSFORMATION AHEAD

The World Investment Report has monitored FDI and the activities of MNEs for 30 years, during which international production saw two decades of rapid growth followed by one of stagnation. Flows of cross-border investment in physical productive assets stopped growing in the 2010s, the growth of trade slowed down and GVC trade declined.

The 2010s were only the quiet before the storm. The crisis caused by the COVID-19 pandemic arrives on top of existing challenges to the system of international production arising from the new industrial revolution (NIR), growing economic nationalism and the sustainability imperative. These challenges were already reaching an inflection point; the pandemic looks set to tip the scales. The decade to 2030 is likely to prove a decade of transformation for international production.

This study...

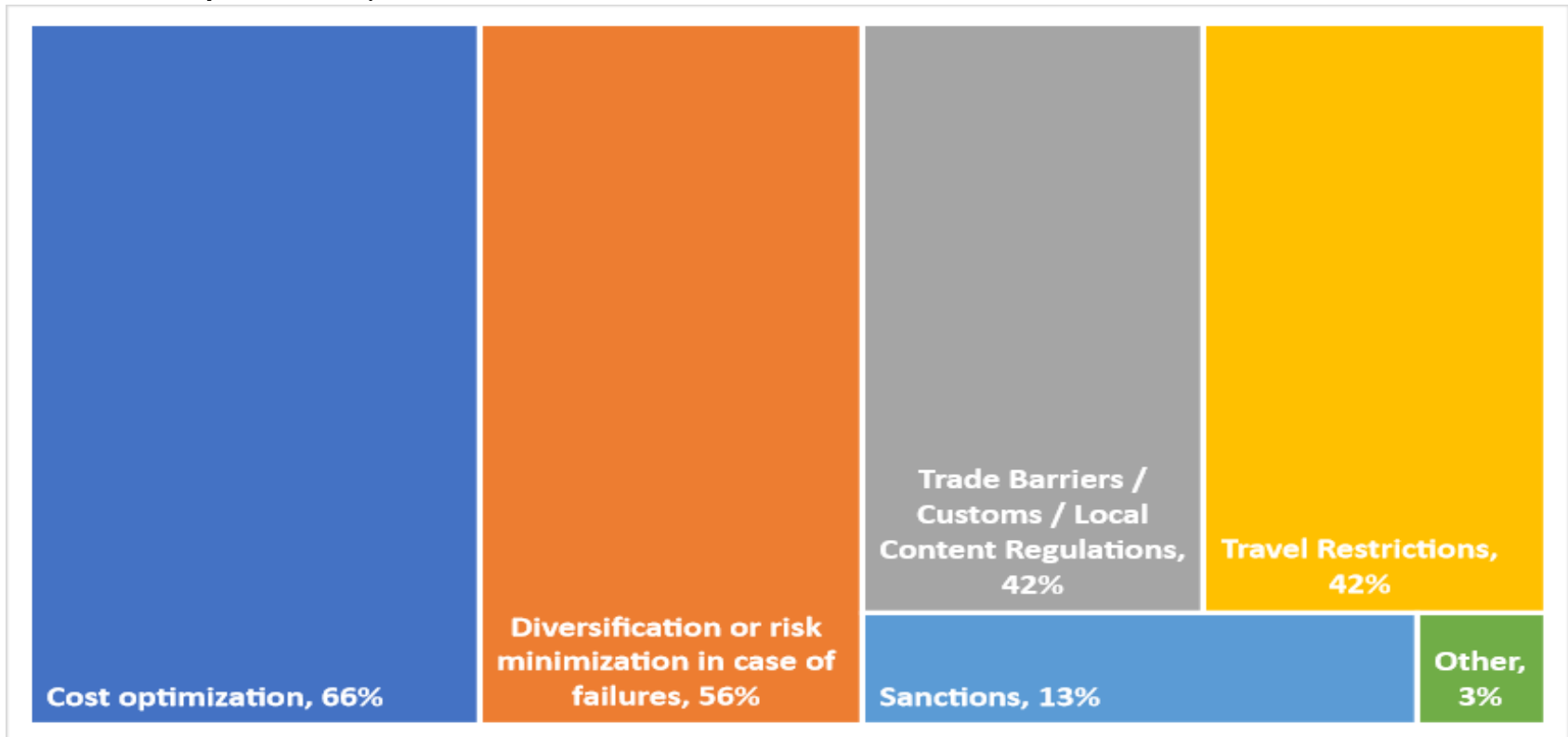
- Are there real chances for near-shoring, or is it just cheap talk?
- Can near-shoring to Western Balkans emerge?
- What should Western Balkan economies do, in order to benefit fully from these possible developments?

What concretely do we do?

- Descriptive analysis of trends in FDI in recent years
- Econometric analysis of FDI determinants
- Surveys of German companies
- Surveys of local companies
- Interviews with German companies
- Case studies of local companies
- Interviews with local IPAs

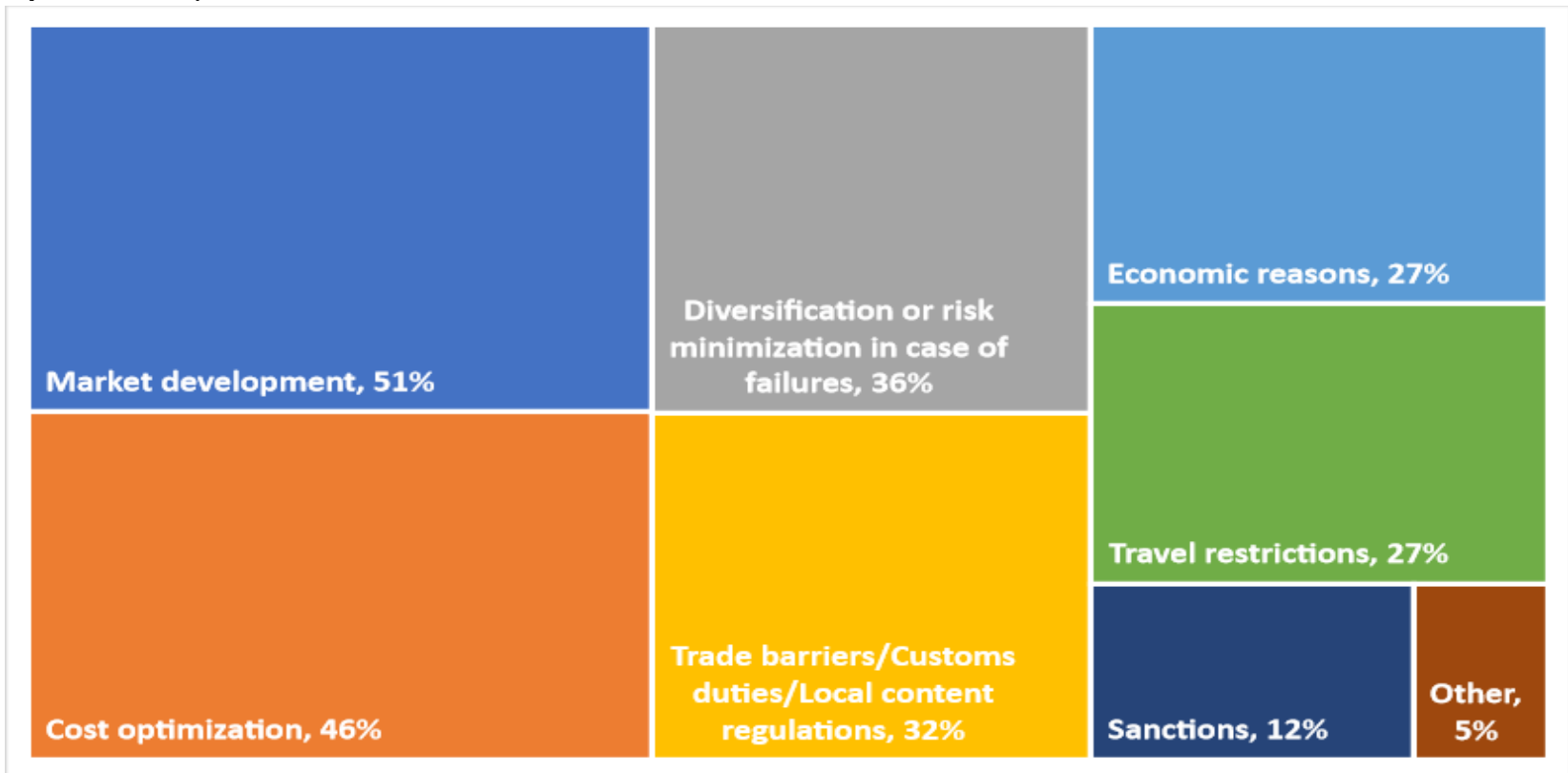
16% of German companies are planning changes in their supply chains, due to costs and risk

Reasons why companies plan changes in their supply chain (multiple answers possible)



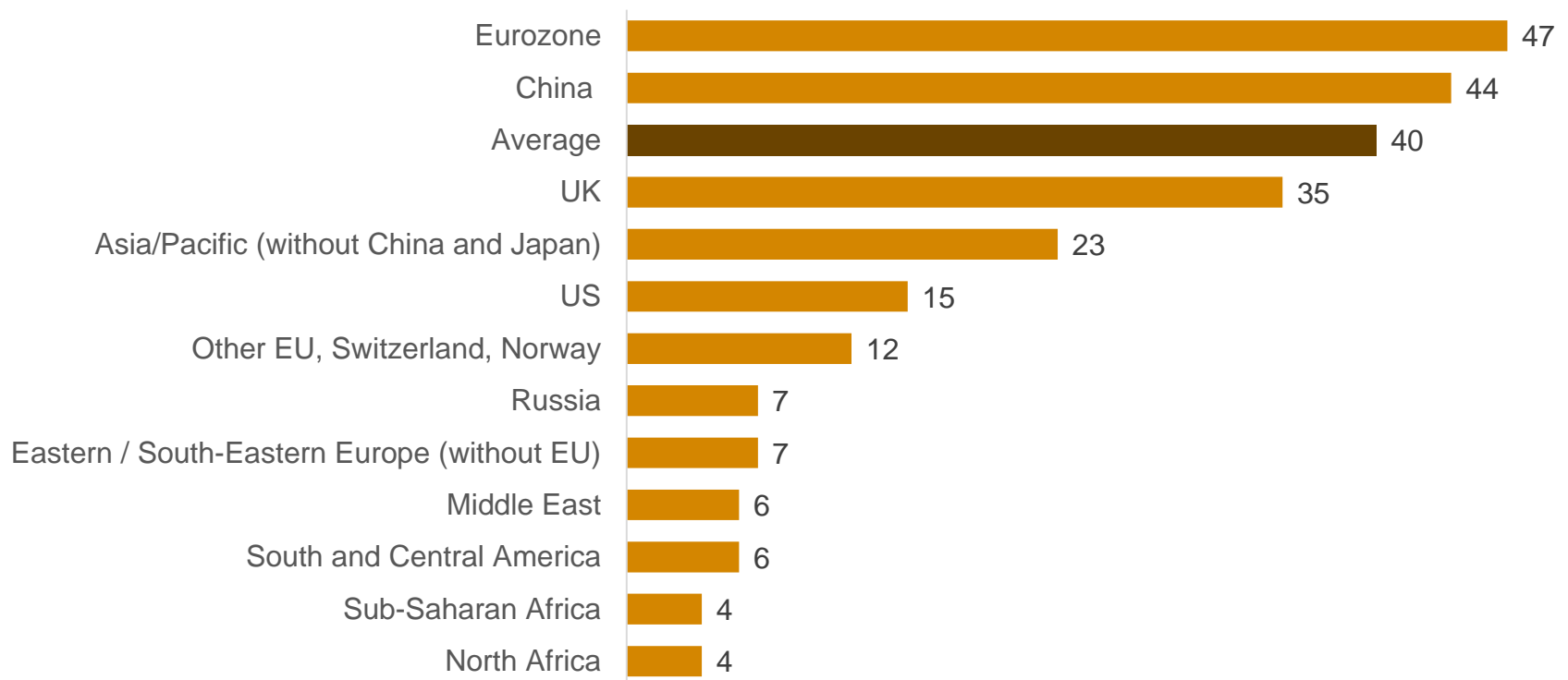
12% of German companies are looking for new locations, due to markets and costs

Reasons why companies are looking for new locations (multiple answers possible)



40 per cent of foreign-active German companies have problems in the supply chain

Share of German companies with supply chains problems, by countries/regions (in %)



Of these companies with supply-chains problems, 68% are planning changes in their supply chains

Diversification of the supply chains

Share of companies in percent, multiple answers possible



Most important factors for companies' decision where to invest are availability of skilled labour and governance

Which factors are important to you as an investor when deciding where to invest? (higher value indicates greater importance)

Availability of skilled labour	6.8
Stability of the country, good governance and functional institutions	6.7
Level of wages	6.2
Geographical location of the country	5.8
Quality of infrastructure	5.5
Size and the prospects of the market	5.1
Level of taxes	3.3
Benefits packages that the government provide to foreign investors	2.8

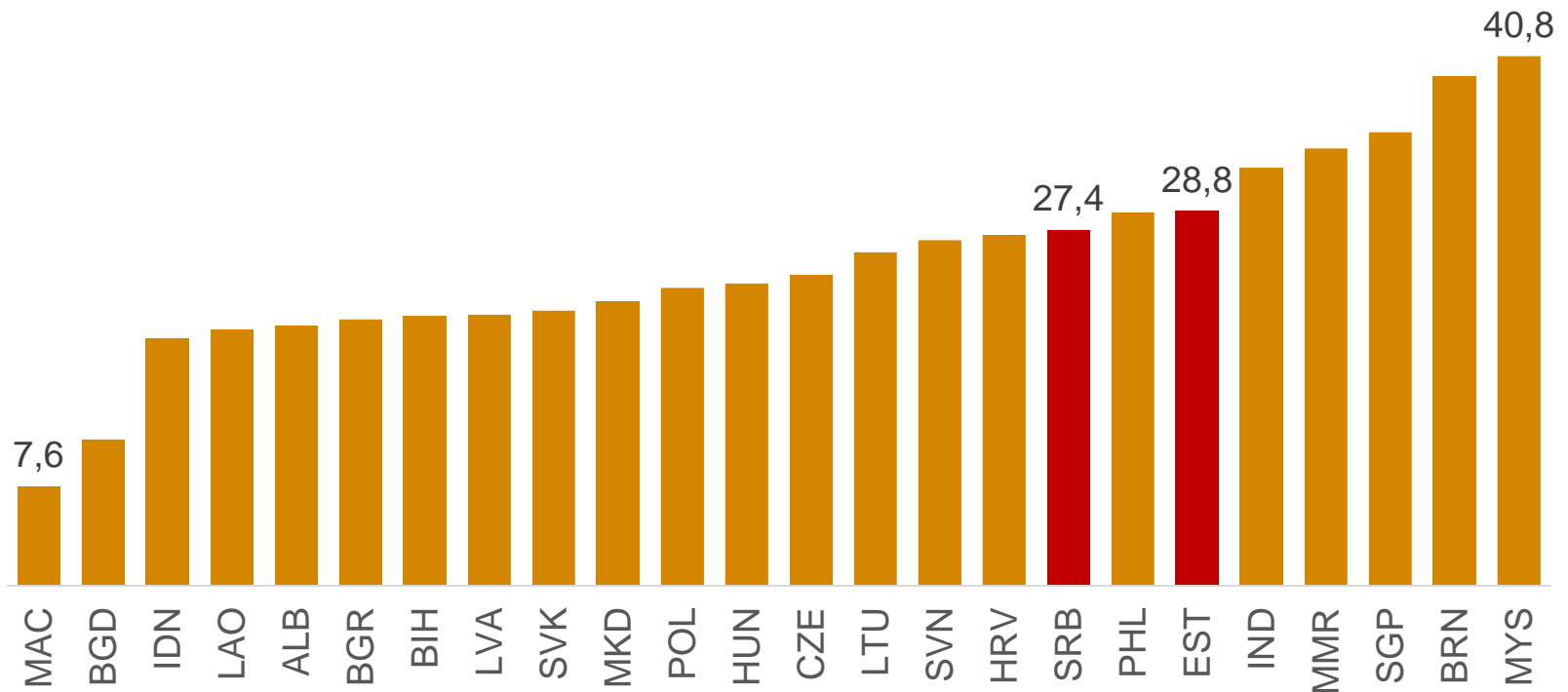
Source: Survey conducted among companies that are planning to invest abroad and are considering the WB

Econometric analysis...

- ...of **factors** that are important for FDI...
- ...with **origin** from EU and OECD countries...
- ...and **destination** to Western Balkans, Central and Eastern Europe and Asia...
- ...for the **period** 2001-2018

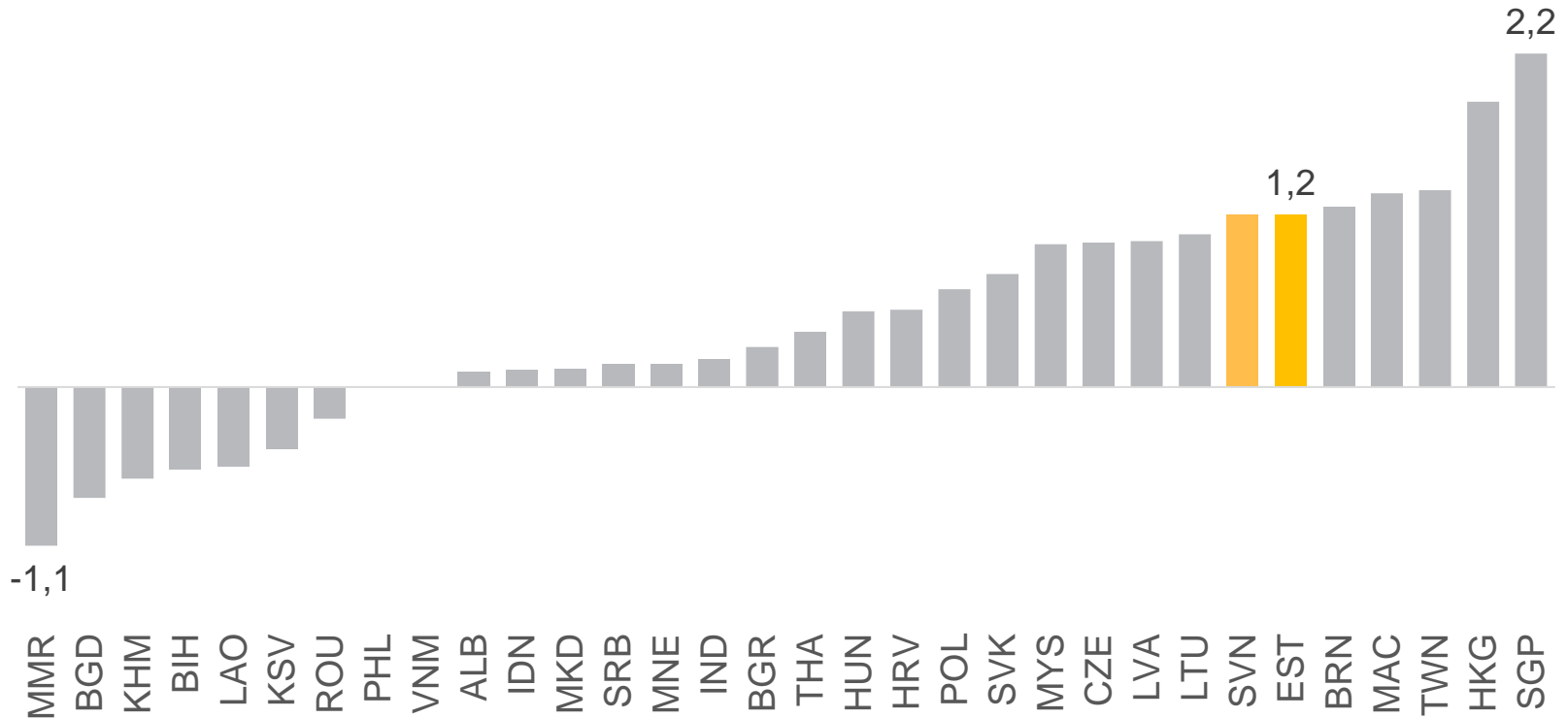
Education one of the most important determinants of FDI. Eastern European countries worse than Asia here.

STEM graduates (% of total tertiary graduates), average for 2017-2019



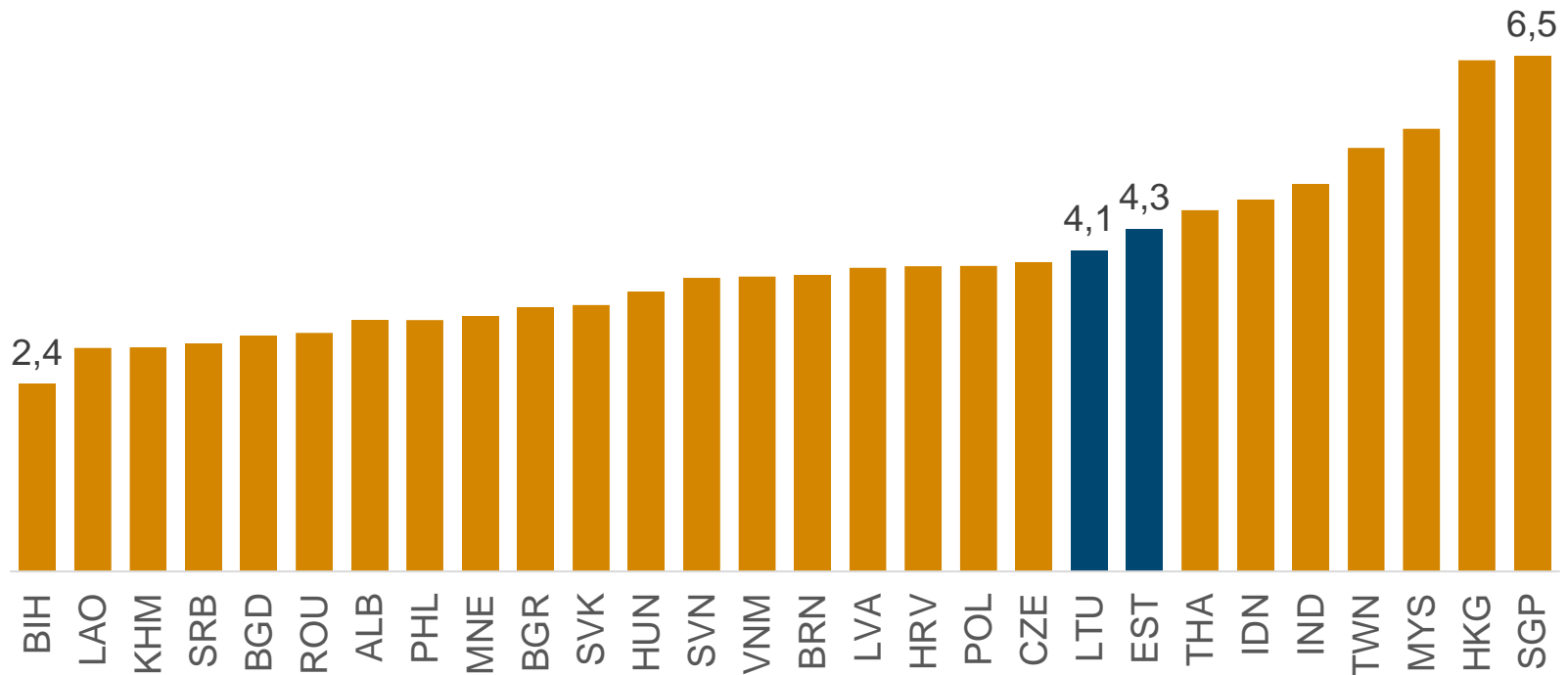
**Governance (political stability, government effectiveness, control of corruption) important determinants of FDI.
Eastern European countries again not very strong.**

Government Effectiveness (score, 2.5 = best), average for 2017-2019



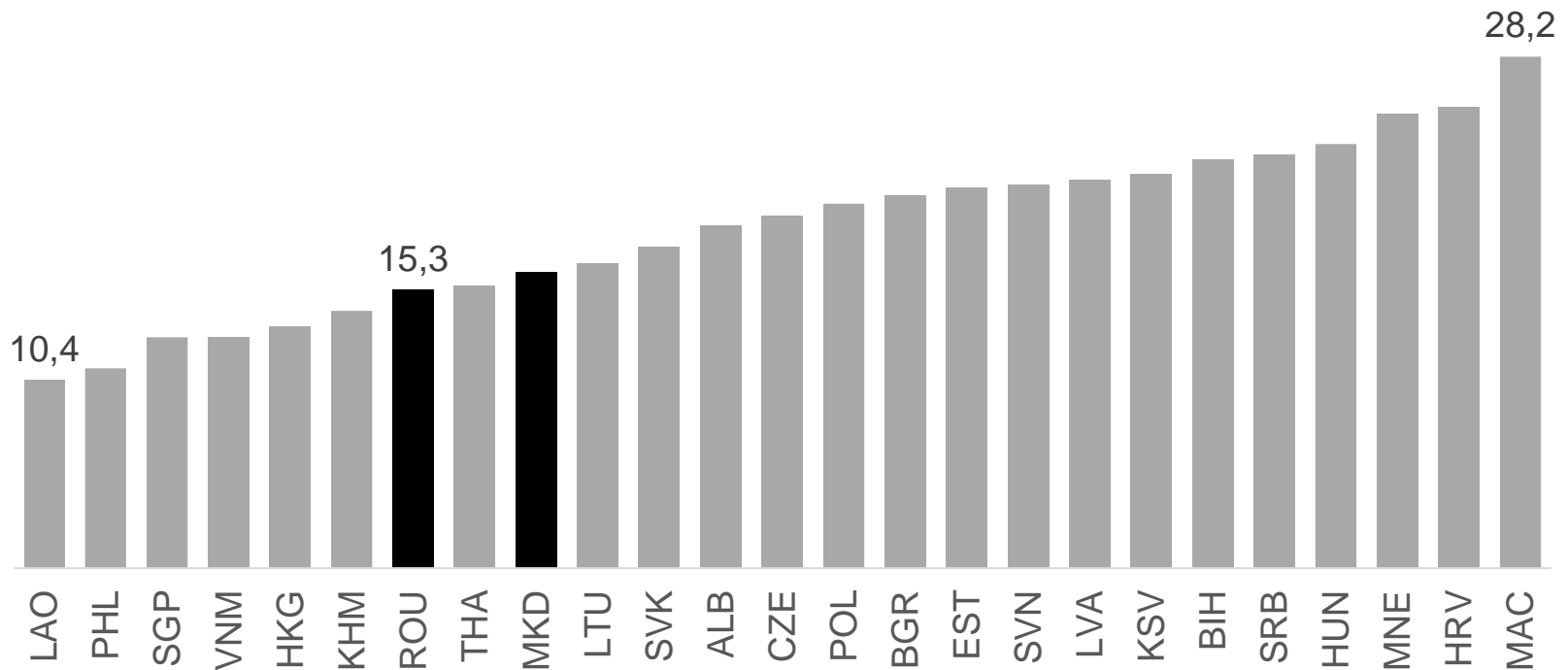
Infrastructure (overall transport, rail and particularly sea) also important. Eastern Europe again not excelling.

Quality of overall transport infrastructure (score, 7=best), average for 2017-2019



Taxes important for FDI only in the longer run (likely due to initial tax exemptions)

Taxes on income, profits, goods and services (revenues in % of GDP), average for 2017-2019



Wages, perhaps surprisingly, appear insignificant...

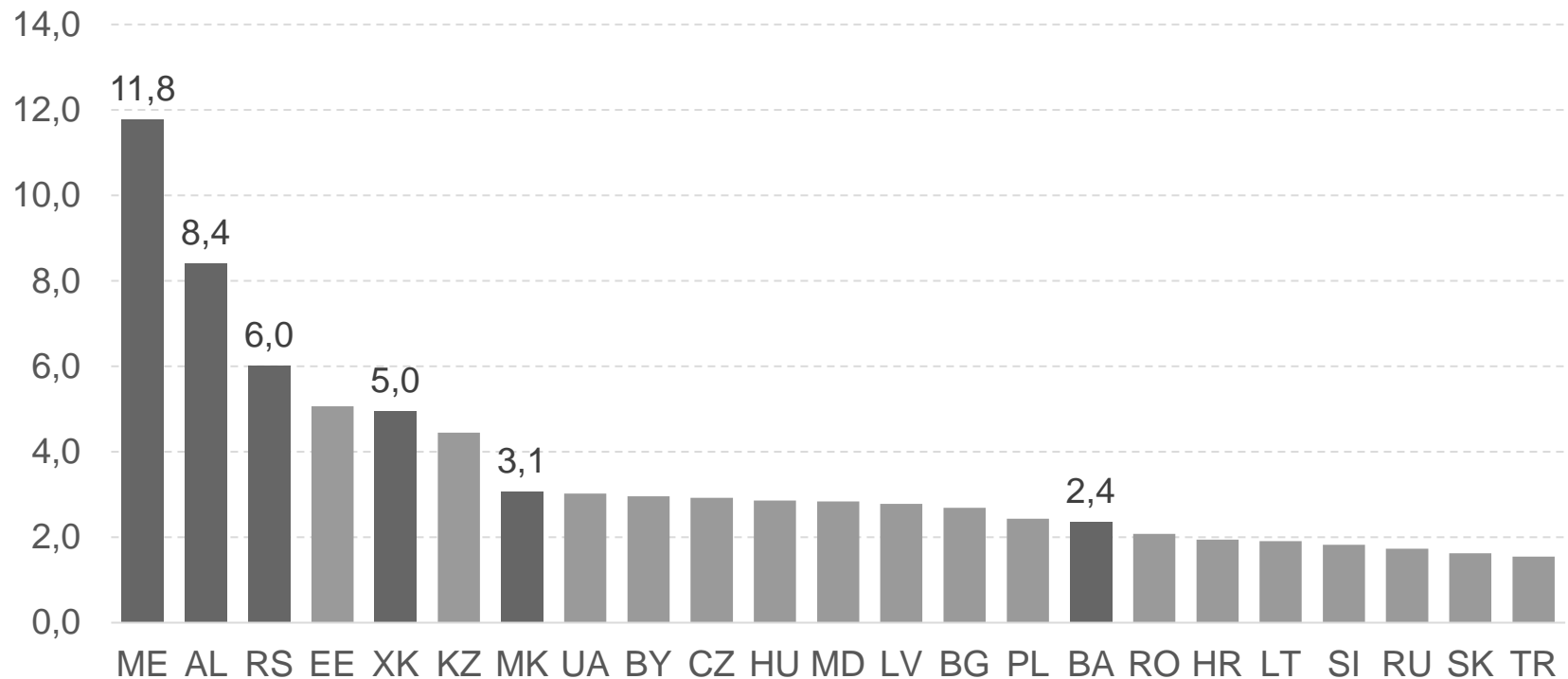
- Which we explain by the notion that all these countries have low wages (lower than Western Europe), because of what wages are not the crucial factor that makes investors decide where to go

Western Balkans

- FDI a top priority
- All countries have special state agencies focused on attracting FDI
- Some of them even have dedicated ministries
- They all provide attractive benefit packages to foreign investors (mainly tax holidays and direct financial support)
- Many of them have special investment zones

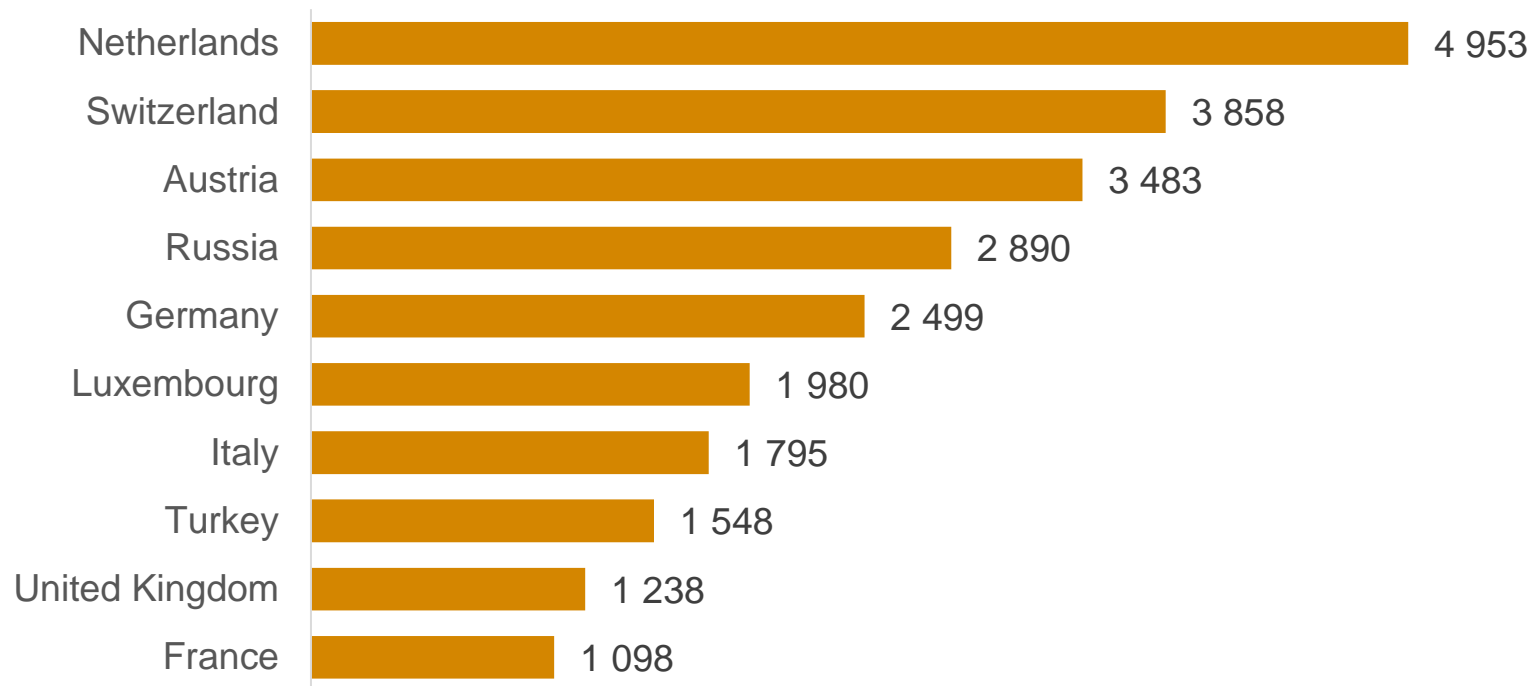
For some countries, this strategy has worked, for some not so much

FDI inflows in CESEE economies during 2010-2019 (% of GDP)



Netherlands, Switzerland, Austria, Russia and Germany biggest investors in Western Balkans

FDI inflows into the WB during 2010-2019, by countries of origin (EUR million)



Wages, location and educated workforce key reasons why investors come to Western Balkans

Why did your company invest in the Western Balkans? (multiple options)

Because of the relatively low wages	22%
Because of the geographical location of the country	19%
Because of the educated workforce in the country	16%
Because of the prospects of the new market	14%
Because of the relatively low taxes	9%
Because of the incentives scheme that the government provided	9%
Other	5%
Because of the good infrastructure in the country	4%
Because of the good institutions and governance in the country (rule of law, control of corruption, government effectiveness etc.)	2%

“We can load the truck here on Friday afternoon and it will be in the parent plant on Monday or could be with the customer. You could never do anything like that from Morocco.” (North Macedonia)

“When it is about the geographical position of the plant, we are surely more competitive than Bulgaria, because we are around 500 km closer than Sofia.” (BiH)

“What really impressed me was the honest and hard-working people who wanted to protect workplaces and wanted to work. Because the people are loyal, responsible, hard working.” (BiH)

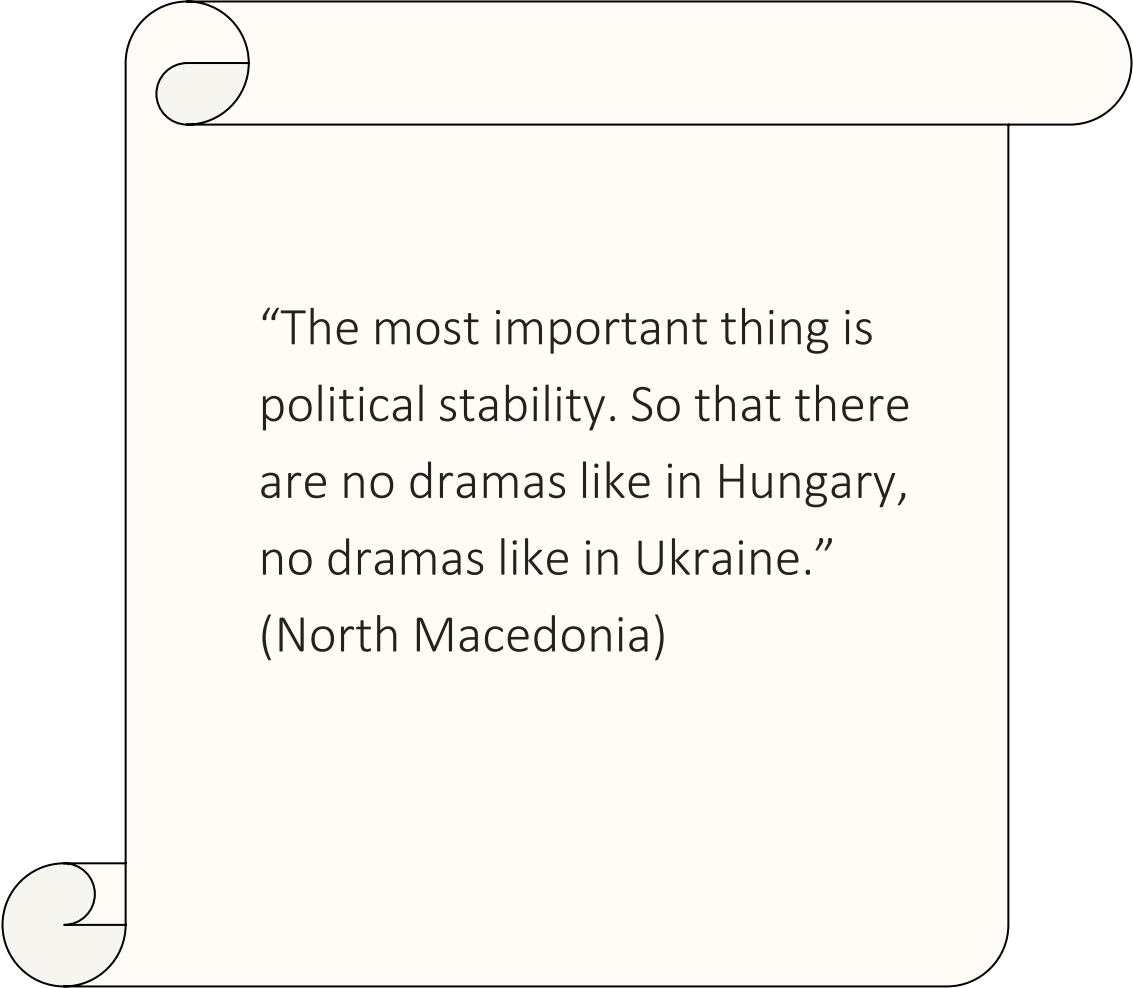
“People are flexible. The people learn fast. I think it was a good decision, at least that is how it is seen in Germany, I think.”
(Albania)

“For sure, this is and will still be for a while, a low-labour-cost country, which we use as a competitive advantage, having a plant here.” (BiH)

Poor governance, insufficient support from institutions and need to train workers are main downsides of WB

Which are the negative sides of working in the WB? (higher value indicates greater importance)

Poor governance and institutions (rule of law, corruption, government ineffectiveness)	5.7
Government does not provide enough support	5.5
Availability of skilled workforce	5.2
Poor infrastructure	4.8
Taxes are relatively high	3.8
Geographical location	2.7
Wages are relatively high	2.5



“The most important thing is political stability. So that there are no dramas like in Hungary, no dramas like in Ukraine.”
(North Macedonia)

“Somewhere in the Balkans, where there used to be a war, it always takes some persuasion at the beginning to present the factory in a positive light. For us it was important that this political stability was there.” (Serbia)

“Political Stability: This does play a role. Relative political stability needs to be in place before we decide to start a subsidiary anywhere.” (Serbia)

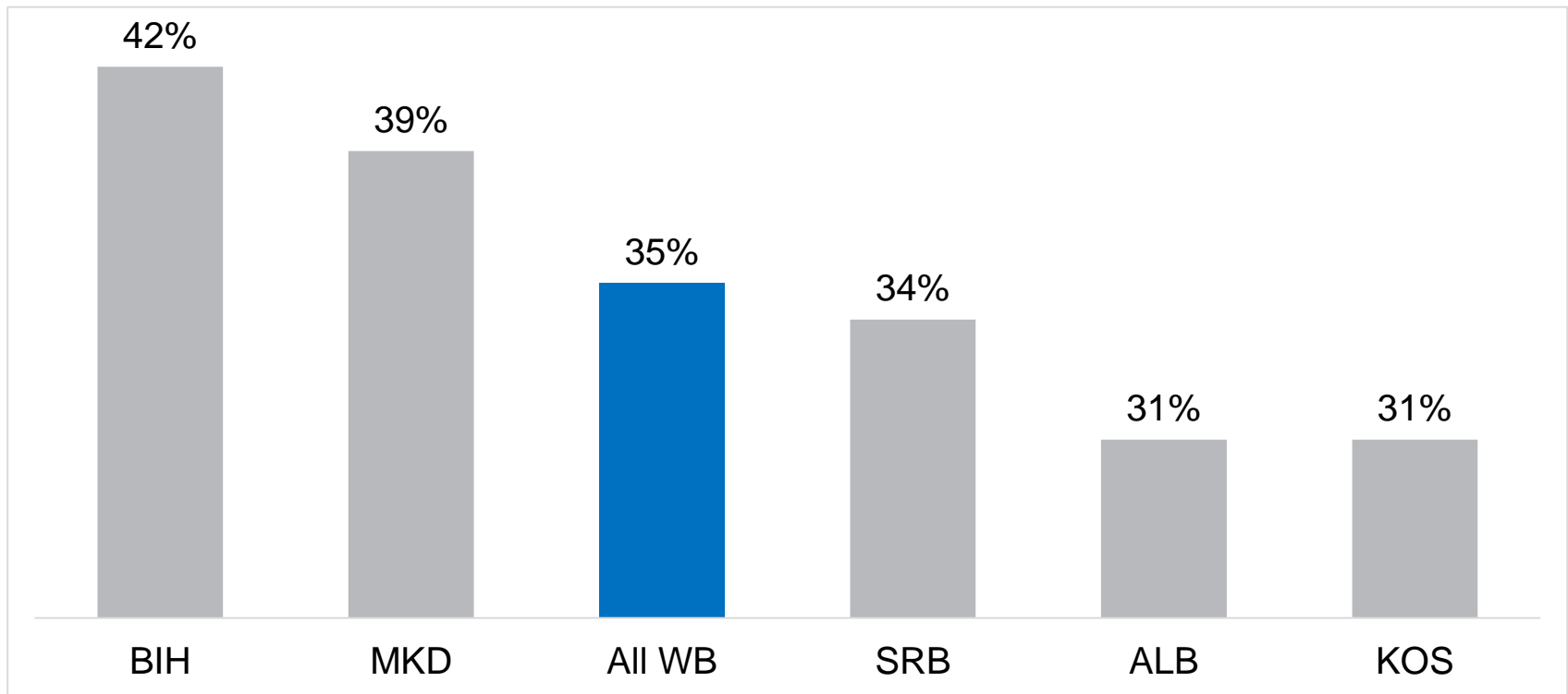
"After we closed the Bosnia and Herzegovina venture, we were harassed by the authorities and had to pay fines. Fortunately, we had the support of an excellent lawyer, but I am glad that this project is over again"
(BiH)

“And for sure, the skills set and overall, the education system need to be improved. It is easier for us that we do not use so much effort currently but we do train our people. It would be better if we had people coming to the plant with a higher skill set.” (BiH)

“You try at all costs to lure companies into the country, but you don't do your homework. The available skilled labor that you need is nowhere near there. The result is that we have to fight over the available skilled workers.” (Serbia)

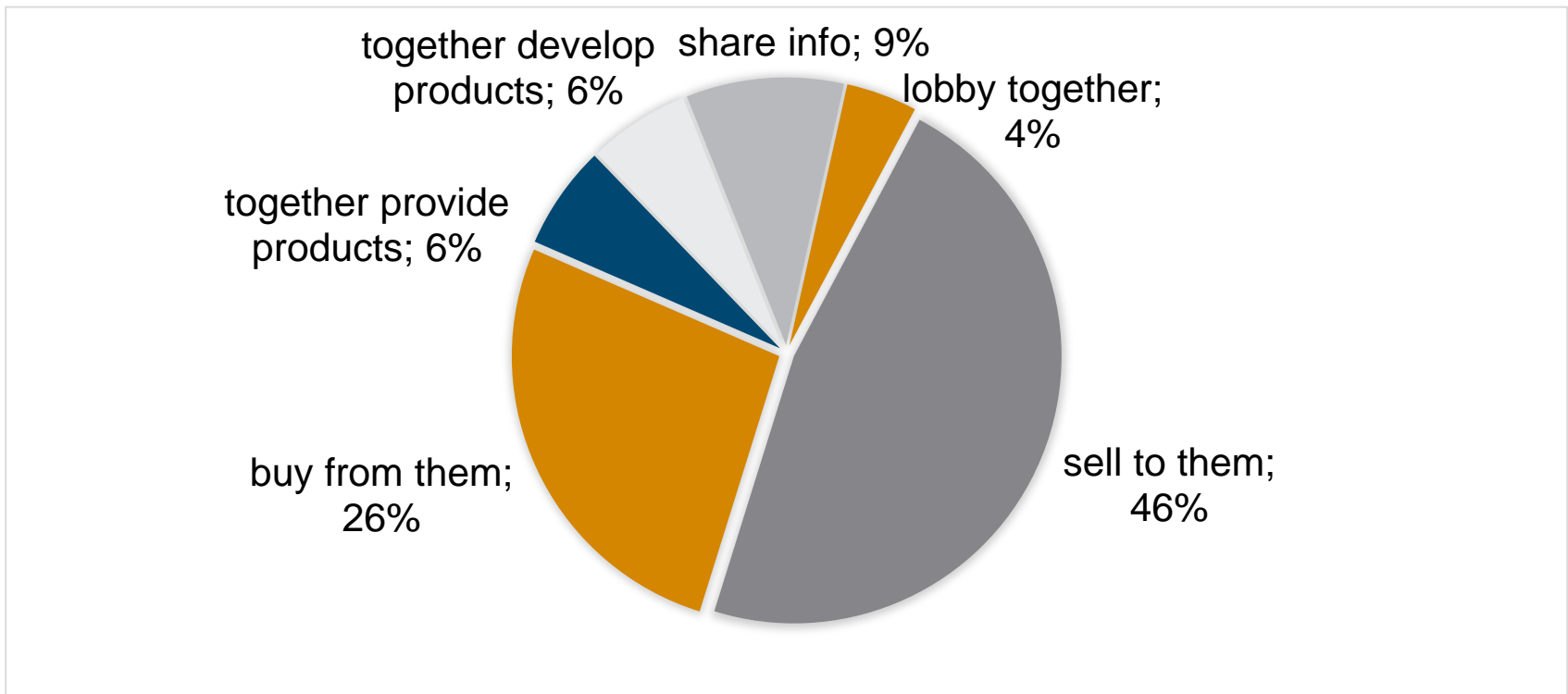
55% of the surveyed local companies cooperate with foreign investors, making 35% of the turnover with them

How much of your company's turnover is with foreign companies that are operating in your country?



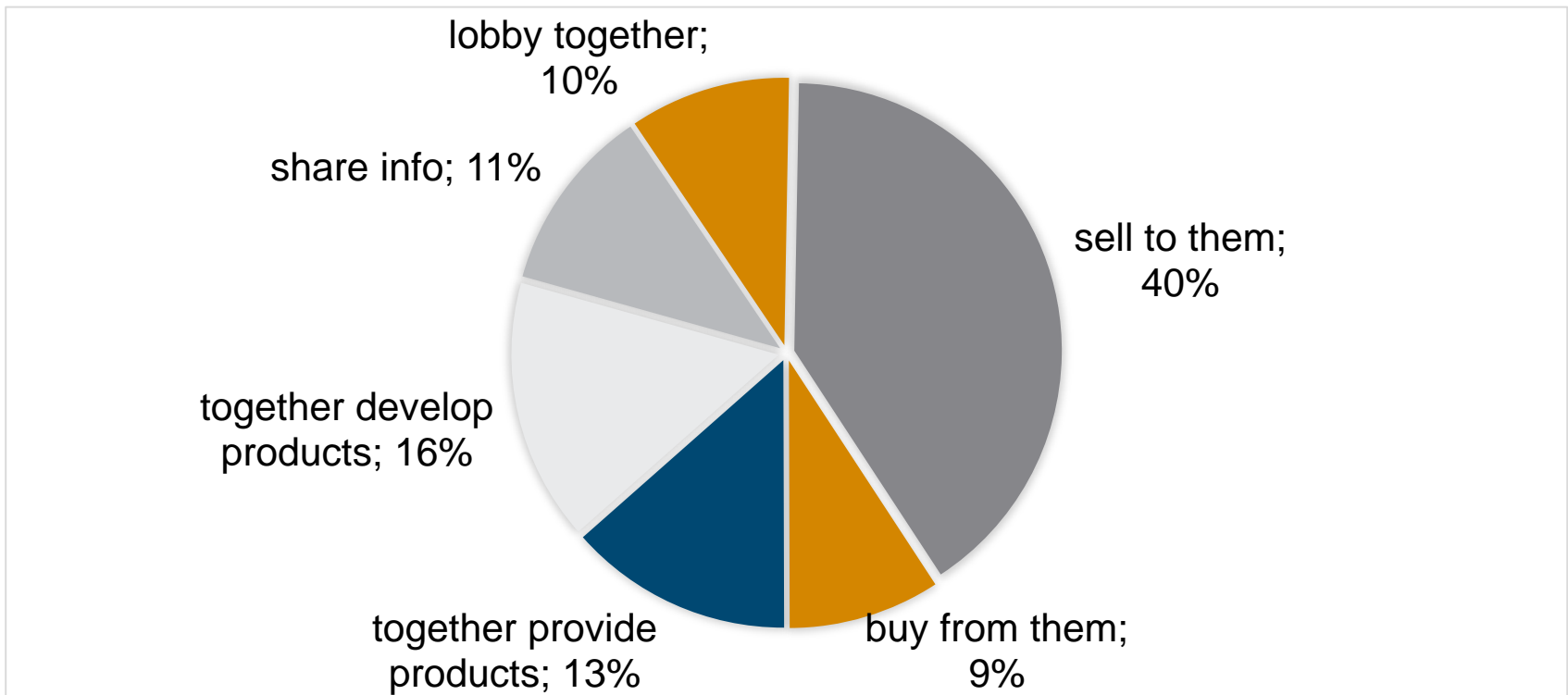
Selling to foreign companies and buying from them most common forms of cooperation

How is your company working with foreign companies?



Local companies want to cooperate more with foreign companies through knowledge exchange etc.

In which ways would you like to cooperate more with foreign companies that are operating in your country?



Take-aways

- Globalisation slowdown even before COVID-19
- COVID-19 will speed up this process
- High share of German companies with international operations thinking about supply chains changes
- Major reasons include shorter delivery times, better value for money and risk diversification
- Eastern European countries are natural first choice when considering such changes, due to geographical proximity, knowledge of the region and relatively low costs

- Factors that will be crucial are: availability of skilled labour and good governance and functional institutions
- **High quality more important than low costs**
- Eastern European countries were often relying more on low costs than on high quality
- This has to be changed, if they wish to benefit fully from possible post-COVID-19 changes
- Education, governance, infrastructure
- Plus, cooperation between foreign and local companies
- **The new world can be indeed brave for Eastern European countries, if they decide to change**

Thank you for your attention!

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