German Council on Foreign Relations

No. 25
September 2023

DGAP POLICY BRIEF

How Germany Can Realize Friendshoring in Its Neighborhood

A Half Step Plan

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In EU member states, businesses are skeptical of moving production to the EU neighborhood, and governments are scratching their heads as to how to ensure stability and friendly investor relations there. Yes, the EU has developed liberal trade relations with the countries of the Western Balkans and Eastern Europe as preparation for their eventual accession to the bloc. Yet this liberalization is evidently not enough of a carrot to incentivize big reforms or foreign policy alignment that would mark them out as "friends" of the EU. If the EU cannot practice "friendshoring" in countries that are close neighbors and where its leaders want to engage, where can it?

- **In the context of heavy geoeconomic competition with China, the EU has deepened its internal regulation and investments and leveraged access to Europe's consumers to spread its norms. The side effect has been to expose its near neighbors to its geoeconomic rivals.**
- **Deepening the economic integration of countries in its neighborhood – by introducing a new "half step" on the way to EU accession – could allow the EU to impose greater conditionality and make better use of its economic levers, thereby binding them more closely to the EU.**
- **This half step would also unlock positive market dynamics. It would contribute to a reduction in illegal activities and fraud, providing more attractive options for German businesses looking to nearshore their activities. This would not only be economically beneficial for Germany but for the EU as a whole.**

Despite talk by foreign affairs experts about the need for friendshoring and nearshoring in the wake of the COVID-19 pandemic and Russia's war of aggression in Ukraine, EU firms invest very little in the countries of the Western Balkans and the eastern EU neighborhood[1] compared with their presence in member states located in Central and Eastern Europe (EU-CEE). Businesses headquartered in Germany and other EU member states are still skeptical of moving production to these countries. That means the countries of these regions lack the technology transfer and global value chain integration that such investment would bring, and they are consequently struggling to advance economically – even compared to those countries that have most recently joined the EU (Figure 1).

While the EU has developed liberal trade relations with the countries of the Western Balkans and some economies in the Eastern Neighborhood as preparation for their eventual accession to the bloc, this alone is not enough to attract foreign direct investment (FDI) from EU firms. Part of the trouble is that not all of them count as "friends." Some governments in those regions are not ready to align with the EU on grand strategy, while others face opposition by pro-Russian or pro-Chinese parties that raise the prospect of a change of course. This leaves suspicions that they may weaponize economic dependencies or be prone to geopolitical instability. Evidently, trade liberalization has not been enough of a carrot to incentivize big reforms or foreign policy alignment in all Western Balkan and Eastern Neighborhood countries.

These problems are amplified as global geoeconomic competition from China has increased. The EU has responded to this competition by deepening its domestic regulation and investments, and it has leveraged access to Europe's consumers in a bid to spread its norms and regulations abroad. As it beefs up its geoeconomic toolbox in this way, one might expect it to increase its leverage over its closest neighbors. But instead the effect has been twofold: to lock those countries that depend upon it most heavily out of the EU market and to expose its near neighbors to its geoeconomic rivals. Much of the Western Balkans and Eastern Neighborhood now finds itself on a fault line of this global geoeconomic competition, further increasing business uncertainty and making EU firms wary about investments.

A change is therefore needed from the EU. At a time of global bloc building and hardening geoeconomic divides, Germany and the EU must adopt a more comprehensive approach to integrating their near abroad.[2] Russia's war of aggression in Ukraine was treated by German policymakers as a repudiation of their long-standing mantra of "change through trade," the belief that trading with countries like Russia and China would induce positive political developments along Western democratic lines. But while "change through trade" may have failed in relation to a neo-imperialist nuclear superpower, this does not mean that it cannot work with other, smaller countries – especially those in the Western Balkans and Eastern Neighborhood where Germany's economic integration is strong and its potential leverage much greater than relative to Russia.

We would argue that the problem in these regions is that "change through trade" has not yet gone far enough.[3] Until now, Germany (and the EU in general) has been unable or unwilling to properly leverage its position in trade and other forms of economic integration to achieve positive political developments. The EU's record there is extremely patchy in terms of sustainable economic development, positive reform momentum, foreign policy alignment, and visible improvements in institutional quality and declines in corruption. To drive the change it wants to see and thereby increase the region's attractiveness to potential investors, the EU must increase its use of both the carrots and sticks that it has at its disposal. The way to achieve this is to open itself up to neighbors, not close off its markets.

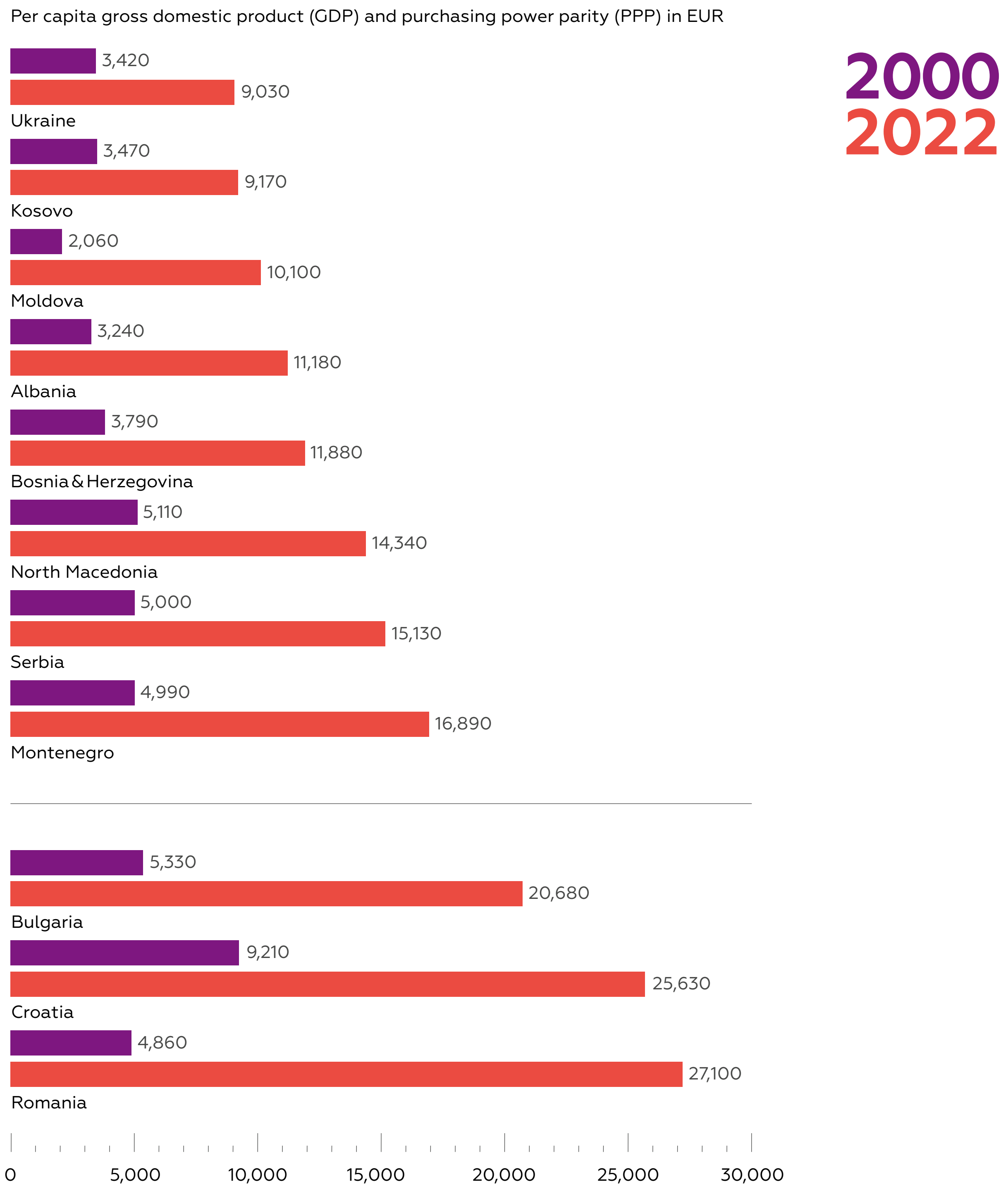
Its key carrot is a bigger offering, including much deeper economic integration ahead of EU accession. In return, the EU can impose greater conditionality on its neighbors in relation to foreign policy alignment, corruption, and reforms, and make better use of its economic levers in the region, binding it more closely to the EU. Such an offering would also unlock positive market dynamics, creating better conditions and incentives for the private sector in Germany and other EU member states to invest more there.

1 We include Ukraine in this analysis, but of course acknowledge it will take much more than economic integration with the EU to make that country a secure investment environment. Most obviously, it requires credible security guarantees by NATO members.

2 Vasily Astrov et al., "Keeping friends closer: Why the EU should address new geoeconomic realities and get its neighbours back in the fold," Bertelsmann Stiftung (February 2, 2023): https://www.bertelsmann-stiftung.de/de/publikationen/publikation/did/keeping-friends-closer-why-the-eu-should-address-new-geoeconomic-realities-and-get-its-neighbours-back-in-the-fold-all (accessed March 10, 2023).

3 Ibid.

1 – Countries in the EU's Eastern Neighborhood struggle to advance economically – even compared to those that most recently joined the EU



Source: Authors' own compilation using data from national sources and wiiw

Contributing to a reduction in illegal activities and fraud would, in turn, provide more attractive options for German businesses looking to nearshore their activities and be economically beneficial for both Germany and the EU.

German and EU policy toward the near abroad could therefore achieve genuine "change through trade" and benefit both sides. In the Western Balkans, Ukraine, and Moldova (and potentially also Georgia), local industry is keen to engage German businesses and take advantage of signs that the private sector wants to shorten supply chains to build resilience in the wake of the pandemic and war. Businesses, civil society, and reform-minded politicians comprise a powerful potential group for the EU to engage across the region. The question is how to create mutually beneficial conditions and achieve better results than those seen during the last 20 years.

THE POTENTIAL OF NEAR- AND FRIENDSHORING

Existing global supply chains have proven to be remarkably resilient and adaptable amid the pandemic and war; European businesses retain a strong interest in outsourcing production and developing value chains to maximize efficiency. Nevertheless, as cost efficiency is gradually overshadowed by a desire for security of supply, they are giving greater consideration to options such as near- and friendshoring. European businesses perceive that tensions between the United States and China will grow and, with them, the disruption to global value chains – not least as China uses critical dependencies and economic coercion for geostrategic ends.[4] Economic bloc building will be one side effect, and they expect the EU to create closely-aligned zones of its own.

Consequently, EU-based firms are looking for nearby, friendly, and price-effective economies, creating an opportunity for the EU's near abroad. The six Western Balkan economies, Moldova, and Ukraine ("the Eight") all have deep trade agreements with the EU – specifically, the Western Balkan countries have Stabilization and Association Agreements (SAAs) and Ukraine and Moldova have Deep and Comprehensive Free Trade Agreements (DCFTAs) – with the aim of preparing them for membership and accession to the EU single market. In addition to being geographically close to the EU and having low labor costs, their markets are already familiar to many EU firms.

German firms express a particular interest in making new investments in Southeast Europe.[5] They regard the Western Balkans as a more reliable source of supplies than North Africa, Southeast Asia, or China,[6] making them attractive as potential destinations for nearshoring by EU businesses. But while there are plenty of signs that nearshoring is already happening there, it remains far below levels in the Baltic and CEE states. And German businesses are under particular scrutiny when it comes to their choices to invest in countries with poor political and governance records. The EU will need to do more to deepen its integration with the Eight to achieve its full potential.

THE NEED FOR DEEPER INTEGRATION

The overall economic integration of the Eight with the EU is far from complete. While the Eight's trade in goods with the EU as a share of its total trade is often comparable to that of an EU member state, this partly just reflects the low level of GDP in each of those countries and their limited integration into global value chains relative to EU member states. The value of exports from the Eight to the EU is on average around one tenth of the EU-CEE level (Figure 2). The Eight are not members of the single market and therefore do not enjoy the full benefits of the four freedoms.[7] FDI inflows (in per capita terms) from the EU are only around one third of the EU-CEE level (Figure 1). Even the six economies of the Western Balkans, which are relatively strong, have only limited access to the EU budget. For EU firms considering nearshoring, this incomplete integration gives rise to potential disadvantages compared with low-cost destinations within the EU.

4 Fergus Hunter et al., "Countering China's coercive diplomacy: Prioritising economic security, sovereignty and the rules-based order," Policy Brief Report No. 68/2023, Australian Strategic Policy Institute (February 2023): https://ad-aspi.s3.ap-southeast-2.amazonaws.com/2023-02/Countering%20Chinas%20coercive%20diplomacy_1.pdf?VersionId=HZDwezgnFY5eitQqtEMEU7WuFci8S75z (accessed March 10, 2023).

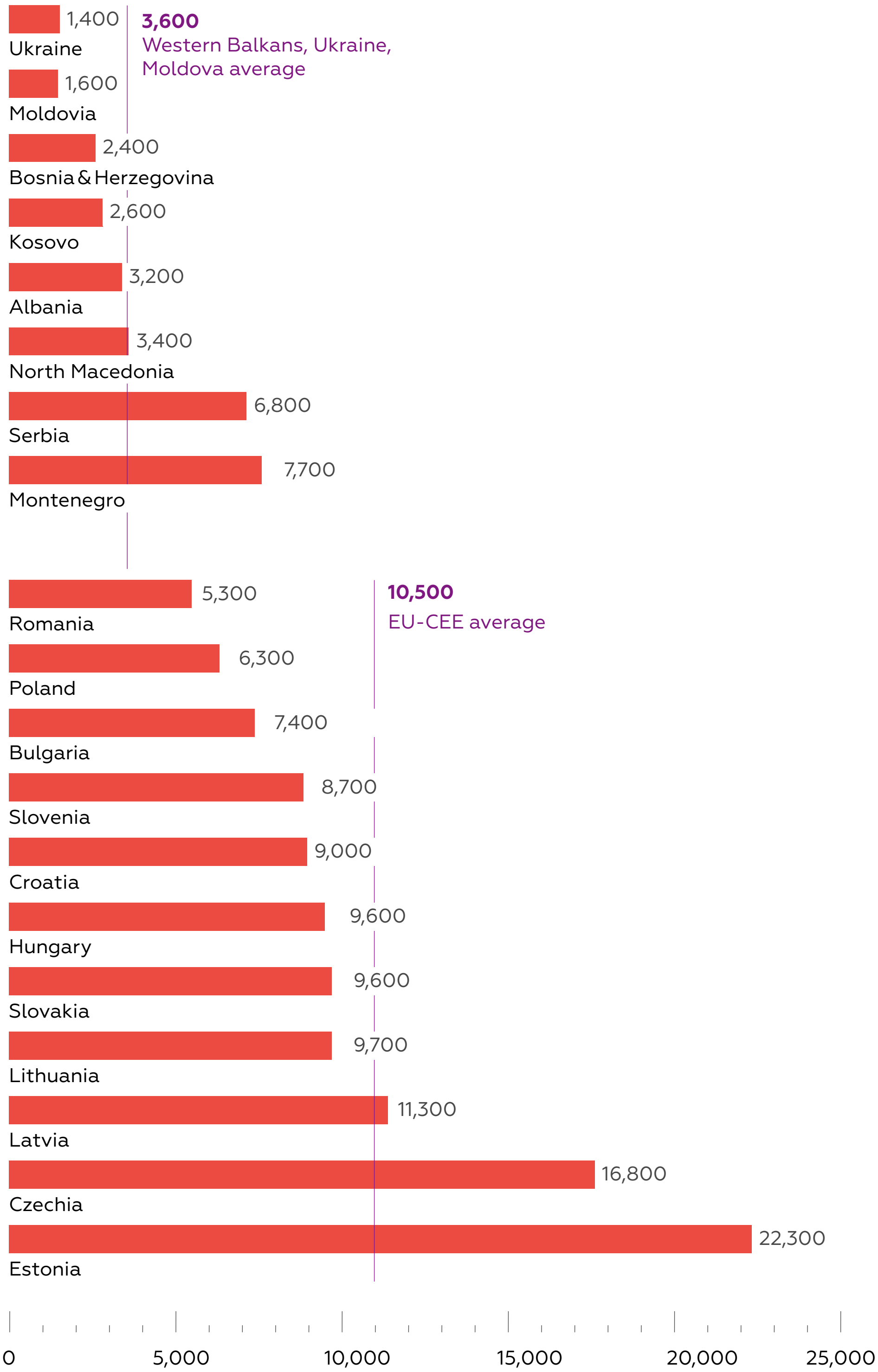
5 Balša Ćulafić et al., "Getting Stronger After COVID-19: Nearshoring Potential in the Western Balkans," wiiw Research Report No. 453, Vienna Institute for International Economic Studies (May 2021): https://wiiw.ac.at/getting-stronger-after-covid-19-nearshoring-potential-in-the-western-balkans-p-5814.html (accessed March 10, 2023).

6 European Bank for Reconstruction and Development, *Transition Report* 2022-23 (November 22, 2022): https://www.ebrd.com/transition-report-2022-23 (accessed March 10, 2023).

7 The "four freedoms" pertain to the movement of goods, persons, services, and capital within the EU.

2 – Comparing inward FDI flows from the EU between the countries of "the Eight" and EU-CEE

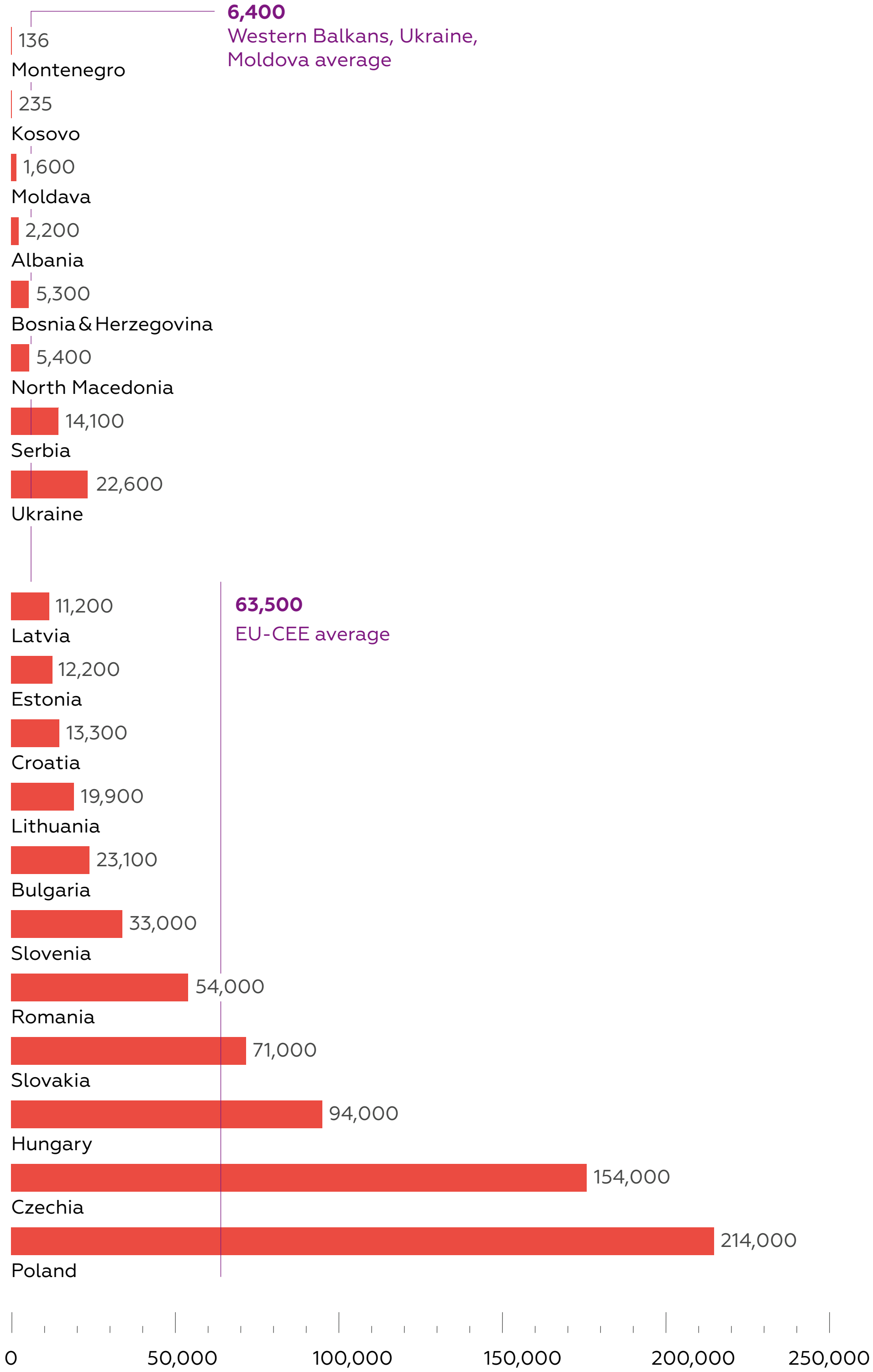
In EUR per capita, 2021



Source: Authors' own compilation using data from national sources and wiiw

3 – Comparing the value of merchandise exports to the EU from the countries of "the Eight" and EU-CEE

in millions of EUR, 2021



Source: Authors' own compilation using data from national sources and wiiw

This disparity leaves these countries vulnerable to geoeconomic competition, making it harder for the EU to enforce conditionality on the path to accession as they explore alternatives outside of the EU. **Three underlying problems explain why the lack of economic integration makes the Eight insecure as investment spots**, locking them into a policy of hedging and keeping equidistant to EU and non-EU powers. Yet exploring these problems also points to major potential upsides for German and EU firms looking to invest in the region if the right incentives can be put in place.

First, the incomplete integration model leaves some problematic economic imbalances. All the countries considered here (except North Macedonia) run substantial trade deficits with the EU. This is in stark contrast to, say, the four countries of the Visegrád Group (Czech Republic, Hungary, Poland, and Slovakia), perhaps the most obvious point of comparison. The Western Balkans, Moldova, and Ukraine have struggled to attract higher quality FDI to increase their competitiveness, further integrate themselves into global value chains, and create high levels of income. The low level of per capita inward FDI stock in the Eight shown in Figure 2 indicates that deepening trade access via SAAs is not enough.

Second, links to third powers are growing. The share of imports from the EU to the Western Balkans has declined since 2009. China has rapidly expanded its share of high-tech imports and has also scaled up its infrastructure investments. China (including Hong Kong, Macao, and Taiwan)[8] has, for example, become the biggest investor in Serbia by far. In 2022, Chinese FDIs were worth more than EUR 1 billion, approximately four times more than the second and third biggest investors – the UK and Germany, respectively. Chinese investments often conflict with EU standards on public procurement and the environment. In extreme cases, they can cause debt dependency.[9]

Third, the growth model of the whole Eight continues to rely to a large extent on charting a "middle way" between the EU and at least one of the other great powers. Taking Serbia as an example, it can be argued that this middle way has been extremely successful in recent years. Pursuing an open policy toward international integration, especially in FDI attraction, has helped Serbia to achieve one of Europe's strongest growth rates from 2018 to 2021. In the energy field, Russia remains a systemically important supplier for many of the countries of the Eight. However, given the greater geoeconomic bloc building and rivalry that has resulted from Russia's large-scale invasion of Ukraine, this model has naturally come under more strain.

THE BENEFITS OF AN INTERIM ECONOMIC STATUS

This incomplete economic integration can be remedied in a way that would make the region much more attractive for private sector investment. The EU could increase its economic offering to the Eight ahead of accession in return for reforms, especially those related to the rule of law and alignment on foreign policy and regulation. Given that the accession process now takes decades (as opposed to less than a decade for most of the countries that joined the EU in 2004, including those of the Visegrád Group), there is a clear justification for breaking with old habits and creating an interim economic status as detailed in the next section. The effects of not doing so will become increasingly drastic considering the huge "brain drain" to the EU that the countries of the Eight suffer as young workers seek opportunities abroad that seem unlikely at home.[10]

Certainly, many politicians and experts in the Western Balkans and Eastern Neighborhood fear such an interim step; they worry that it will lead to permanent second-class non-membership in the EU. It is clear, however, that the limits of their "middle way" are starting to be reached. Even much bigger countries such as Turkey have been confronted with the limits of such a strategy.[11] Firms, for example, will be more cautious about making large investments in countries seen as being close to Russia to avoid the risk of US sanctions.

The three NATO allies currently negotiating EU accession (Albania, North Macedonia, and Montenegro) are at 100 percent alignment with the EU's Common Foreign

8 This is the official nomenclature used by the National Bank of Serbia. See: National Bank of Serbia, "Republic of Serbia: Foreign Direct Investments in Q1–Q3 2022": https://www.nbs.rs/export/sites/NBS_site/documents-eng/statistika/ino_ekonomski_odnosi/platni_bilans/fdi_by_country_22.xls (accessed March 10, 2023).

9 Zoran Nechev and Roderick Parkes, "How Germany Can Prevent a Balkan Debt Trap," DGAP Online Commentary, German Council on Foreign Relations (August 26, 2021): https://dgap.org/en/research/publications/how-germany-can-prevent-a-balkan-debt-trap (accessed March 10, 2023).

10 "Opposition protestors surrounds the Parliament, Rama holds a press conference with the Bavarian PM," Euronews Albania (February 13, 2023): https://euronews.al/en/opposition-protestors-surrounds-the-parliament-rama-holds-a-press-conference-with-the-bavarian-pm/ (accessed March 10, 2023).

11 Can Sezer, "Turkey's state banks suspend use of Russian Mir payment system -finance minister," Reuters (September 29, 2022): https://www.reuters.com/business/finance/turkeys-ziraat-bank-suspends-use-russian-mir-payment-system-ceo-2022-09-29/ (accessed March 10, 2023).

and Security Policy (CFSP), including compliance with all restrictive measures and sanctions. Thus, they are set to reap a reward. They are likely to evaluate an offer to take a further half step toward the EU positively in exchange for being "phased into" individual EU policies, the EU market, and EU programs – including increased investments and funding that are part of the negotiation frameworks – prior to accession.

Deepening cooperation under the EU's Common Security and Defense Policy (CSDP) comes at a price for candidate countries. Therefore, decisions to do so need to be properly supported, encouraged, and compensated. True, some in the EU still need to be convinced and would prefer to make only small alterations to the existing enlargement strategy. Yet is worth reminding them that the revisions made to the accession methodology in 2020[12] have had little or no impact so far, meaning that the current unhappy setup remains: a decades-long process of enlargement in which major reforms are demanded up front and big economic benefits only come at the end. The result is reform backsliding and the lack of strong economic convergence in the region, both of which dissuade many private sector investors from entering its markets.

HOW AN INTERIM ECONOMIC STATUS MIGHT LOOK

Germany and the EU can make a major impact in moving the countries of the Western Balkans, Moldova, and Ukraine closer to the Visegrád model of integration into the EU market ahead of accession. Providing them with more economic carrots during the accession process will make it more likely that real reforms can be achieved, simultaneously incentivizing alignment with EU foreign policy. As part of a gradual phasing in, there are **four key measures that the EU should take**:

First, aim for full single market participation in the near term.[13] While the SAAs have increased exports to the EU by around 20 percent, there is still untapped potential. After all, the impact of full EU membership is 100 percent, pointing to significant further upsides.[14] With the exception of Ukraine, we are talking about very small economies, and none are especially open measured by external trade/GDP. The value of Western Balkan exports to the EU is about EUR 27 billion. For Slovakia, which has an economy roughly the same size as the Western Balkans combined, the figure is around EUR 70 billion.

Second, the Eight could be more fully included in the EU budget. Since joining in 2004, many parts of EU-CEE have received the equivalent of 50 percent or more of their GDP in budget transfers. This, in turn, has financed major infrastructure upgrades and has been one of the key drivers of their impressive convergence performance in the past two decades.[15] Nothing comparable has been offered to the Western Balkan states, never mind Moldova or Ukraine. While Ukraine's size and reconstruction needs make it a special case that will certainly require a different funding instrument, the Western Balkans and Moldova could be included in the EU budget at a negligible cost to the EU itself.

Third, the EU should increase its overall investment in the Eight in cooperation with the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), closely tying these investments to the twin digital and green transitions. EBRD data consistently shows huge infrastructure investment needs of 10 percent of GDP or more in this region (in contrast to most of EU-CEE) – including in transport, which poses major connectivity challenges. Particularly since 2008, this gap has been partly filled by China, which is often neither in the interest of the EU nor of the countries themselves (especially in the case of Montenegro).

Fourth, the EU – and Germany in particular – should do all they can to incentive European multinationals that are considering nearshoring to invest in the Western Balkans, Ukraine, and Moldova. Alongside the increased investment in infrastructure outlined above, this could include the provision of more information via Chambers of Commerce and other relevant bodies, risk analysis, investment incentives, and a greater push for improvements in governance and other reforms relevant to foreign investors. Despite the challenges, many

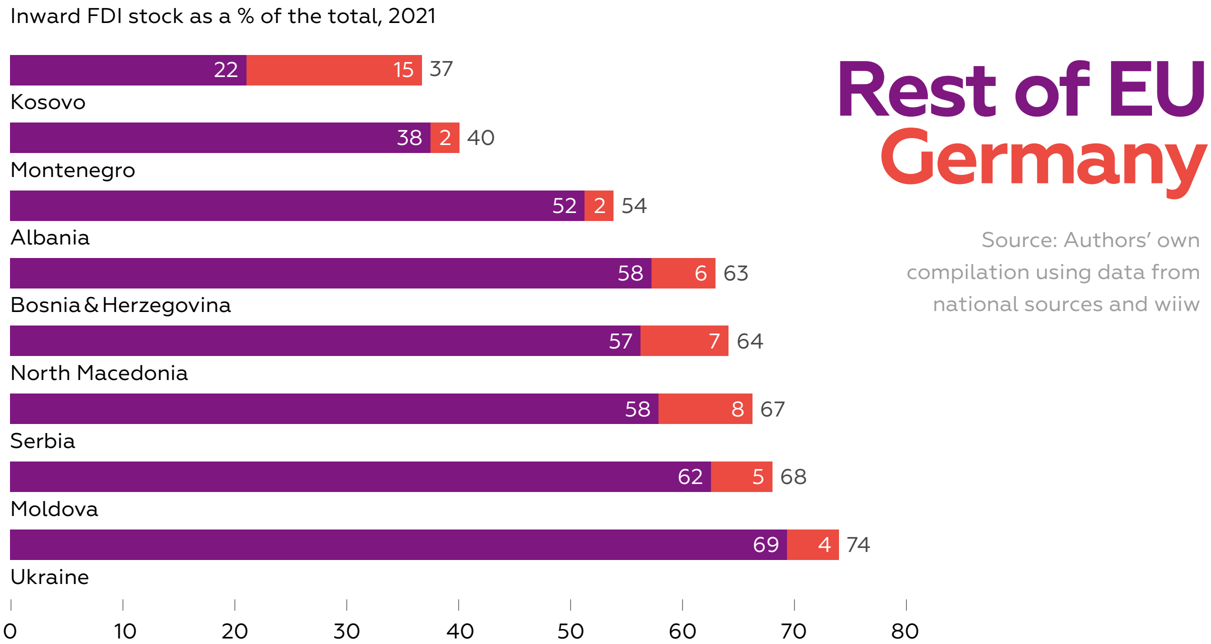
12 European Commission, "A more credible, dynamic, predictable and political EU accession process - Commission lays out its proposals," Press Release (February 5, 2020): https://ec.europa.eu/commission/presscorner/detail/en/IP_20_181 (accessed March 10, 2023).

13 Gerald Knaus, "Action Plan for the Western Balkans and EU Neighborhood," DGAP Report, German Council on Foreign Relations (September 20, 2021): https://dgap.org/en/research/publications/action-plan-western-balkans-and-eu-neighborhood (accessed March 10, 2023).

14 Oliver Reiter and Robert Stehrer, "Value Chain Integration of the Western Balkan Countries and Policy Options for the Post-COVID-19 Period," wiiw Policy Note/Policy Report No. 48, Vienna Institute for International Economic Studies (March 2021): https://wiiw.ac.at/value-chain-integration-of-the-western-balkan-countries-and-policy-options-for-the-post-covid-19-period-p-5696.html (accessed March 10, 2023).

15 Mahdi Ghodsi et al., "The long way round: Lessons from EU-CEE for improving integration and development in the Western Balkans," Joint Study No. 2022-06, Vienna Institute for International Economic Studies and Bertelsmann Stiftung (June 2022): https://wiiw.ac.at/the-long-way-round-lessons-from-eu-cee-for-improving-integration-and-development-in-the-western-balkans-p-6194.html (accessed March 10, 2023).

4 – Germany has the potential to invest more in the countries of "the Eight"



firms are interested in the region, but they want to see more significant governance improvements. This is certainly the case in the Western Balkans, and it arguably applies to Moldova and Ukraine as well.[16]

A KEY ROLE FOR GERMANY

The EU's – and Germany's – excessive dependence on the Chinese market, in addition to a substantial increase of corrosive Chinese capital facilitating hostile takeovers of European firms by those supported by the Chinese state, have spurred the EU and its member states to introduce anti-coercion policies and to adopt investment screening mechanisms to safeguard strategic sectors crucial to public law and order. They increasingly expect the EU's neighbors to follow their lead, turning down FDI from third countries. This is just one more way in which the EU is posing new demands upon its neighbors while offering them few means to defray the economic or political costs.

In a context of growing geoeconomic competition, the EU has made heavy recent investments in its own industry. It has deepened its own internal regulation on everything from digitalization to climate change. And it has leveraged access to EU consumer markets to spread its standards using such mechanisms as the Carbon Border Adjustment Mechanism. While this may make sense for a grudge match with China over the future of global standards, it has rendered the EU's near neighbors – who depend on access to the bloc – more vulnerable to geoeconomic competition. By deepening their integration into the EU market in return for regulatory alignment, the EU would in fact boost their ability to handle and absorb non-European FDI in a resilient manner and diversify their own markets and sources of wealth.

Given that Germany is the EU's leading investor and trade partner across much of Southeast Europe, German businesses will play a central role. When Germany makes investments, it also exports its high standards for compliance with labor standards, business integrity, and other norms. German companies are not only key players in corporate philanthropy but also major investors in local media outlets with the potential to play a key role in supporting independent media in markets suffering from media capture. In many parts of the Western Balkans and Eastern Neighborhood, the local business community is one of the key pro-EU constituencies, making German and other EU business contacts with these groups a key driver of the EU integration process.

16 Balša Ćulafić et al., "Getting Stronger After COVID-19" (see note 5).

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DGAP receives funding from the German Federal Foreign Office based on a resolution of the German Bundestag.

Publisher
Deutsche Gesellschaft für
Auswärtige Politik e.V.

ISSN 2198-5936

Editing Helga Beck

Layout Luise Rombach, Lara Bührer

Design Concept WeDo

Author picture(s) © DGAP (Nechev, Parkes); wiiw (Grieveson)

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