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Global Value Chains in the Post-pandemic World:

How can the Western Balkans Foster the Potential of Nearshoring?

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How can the Western Balkans Foster the Potential of Nearshoring?

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Abstract

The organisation of business activities into global value chains was a defining component of the significant advancements in globalisation witnessed in the three decades leading up to the Great Recession. In the years that followed the speed of global trade integration slowed down, and the COVID-19 pandemic exacerbated the uncertainty surrounding internationally fragmented production processes. More importantly, it made nation states keener to build up greater autonomy in the production of strategic goods, which resulted in notable increases in the scale of restrictive trade policies adopted by countries in the wake of the pandemic. Hence, the 'new normal' is likely to see a greater regionalisation of FDI flows and may lead to some restructuring of existing value chains. This presents an opportunity for transition economies in the Western Balkans, as it implies that firms from major FDI sources in Western Europe will be less inclined to look beyond the continent, giving geographically closer locations a competitive edge over traditional offshoring superpowers like China or India. While it is too early to tell whether the current relatively strong rebound in FDI inflows in the Western Balkans can indeed be attributed to the restructuring of value chains, it paints a relatively optimistic picture regarding the prospects of these economies to establish a firmer FDI presence, particularly in the areas of business services and logistics, which have gained momentum following the pandemic. To reap the full benefits of these opportunities, however, the countries of the Western Balkans must first and foremost step up their investment promotion activities, above all by focusing on improving their infrastructure and education systems and by enhancing their institutional capacities.

Keywords: FDI, global value chains, value chain restructuring, near-shoring, Western Balkans, COVID-19

JEL classification: F21, F6, O24

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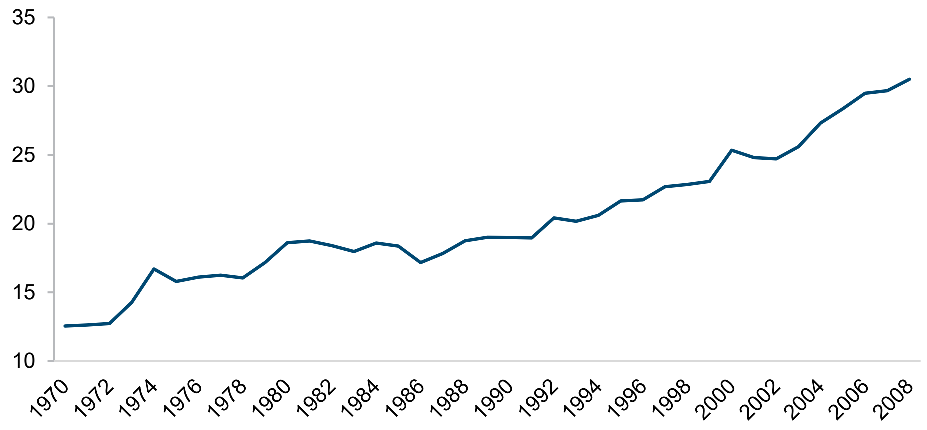
1. INTRODUCTION: FDI-LED GROWTH AND THE AGE OF 'SLOWBALISATION'

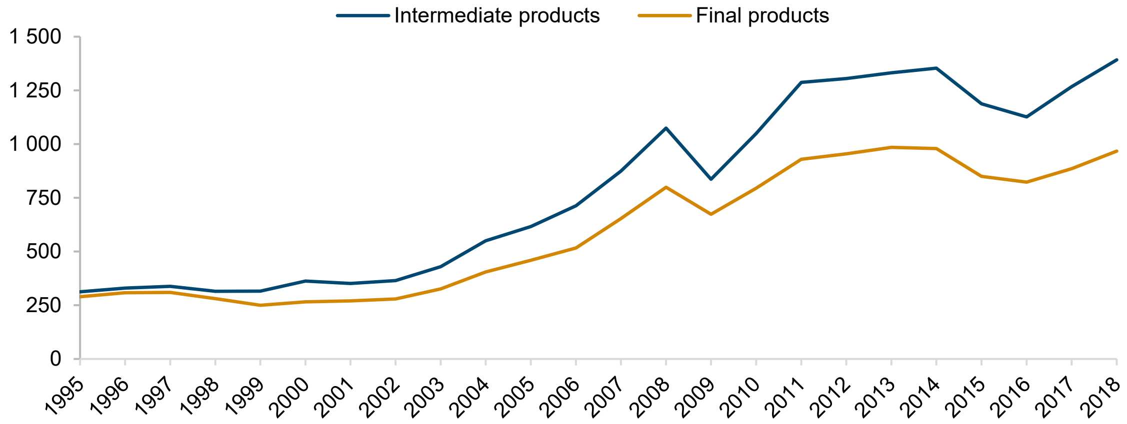
The period between the 1980s and the Great Recession was characterised by unprecedented levels of trade liberalisation and the integration of economies into the world trade system. This included the fall of the Iron Curtain, the associated transition towards capitalist economic systems, the foundation of the World Trade Organisation (WTO), China's opening up and subsequent WTO accession, the IT revolution, and the significant decline in transport costs (Cosar & Demir, 2017). All of these milestones contributed to the strong and consistently advancing trend of globalisation between the 1970s and the 2008 global financial crisis, as shown in Figure 1. Multinational enterprises (MNEs) began to reap the benefits of an internationally fragmented production process via offshoring – the practice of relocating some business processes to another country to take advantage of the major labour cost differentials that prevail between advanced and developing economies.

Figure 1 / Development of world trade as a share of GDP before the Great Recession (in %)



Note: As the data show the sum of world imports and exports, the values are halved to arrive at the world trade figures, as done by Antràs (2020).
Source: World Bank World Development Indicators.

Figure 2 / Gross world exports in intermediate and final products originating from OECD member countries (in USD bn)



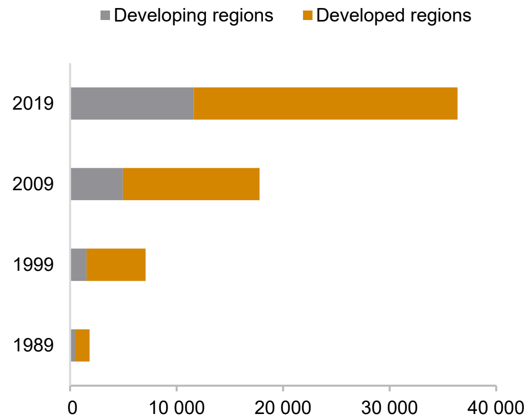
Source: OECD TiVA database.

The outcome of this fragmentation was the creation of a complex web of production flows spanning countries and borders, commonly referred to as global value chains (GVCs). Today the bulk of international trade represents flows associated with GVCs, characterised by the shifting of intermediate goods, services and technology (OECD, 2021). As Figure 2 illustrates, over the past three decades world exports have been on a general upward trend. However, since the early 2000s there has been a divergence in world export patterns, with exports becoming more orientated towards intermediate goods, suggesting a growing importance of GVCs. Similarly, the geographical distribution of foreign direct investment (FDI) has shifted slightly from being completely dominated by capital flows between developed countries to encompass a greater share of developed to developing-country FDI, often driven by offshoring activities of MNEs (Figure 3). While a 10-percentage point shift in the share of FDI stocks to developing nations over a 20-year period (as depicted in Figure 4) may seem rather small, considering the much higher initial levels of developed countries' FDI stocks, it is a non-trivial increase.

In many respects, this hyperglobalist 'first decade of the 21st century was extraordinarily good for developing countries' (McMillan, et al., 2017, p. 2). The advancement of global integration was coupled with impressive advancements in poverty alleviation and the expansion of the middle class across developing and transition economies. Indeed, according to the World Bank's World Development Indicators, the progress made over the past decades – coinciding with the rapid expansion of globalisation – is astonishing on many counts: the share of the population living below the poverty threshold[1] dropped by roughly 34 percentage points from 62.6% to 28.9% between 1997 and 2017 in low- and middle-income countries, and life expectancy at birth went up from 64.6 to 70.8 years.

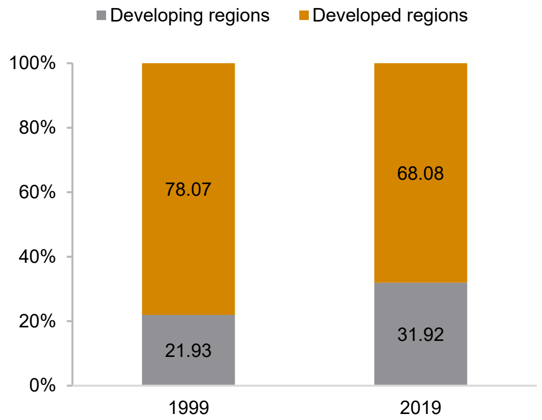
[1] Defined as USD 3.20 in 2011 purchasing power parity.

Figure 3 / Total inward FDI stocks based on the level of economic development (in USD bn)



Note: Values in current prices.
Source: UNCTADStat.

Figure 4 / Share of inward FDI stocks based to the level of economic development, 1995 and 2019 (as % of total world stocks



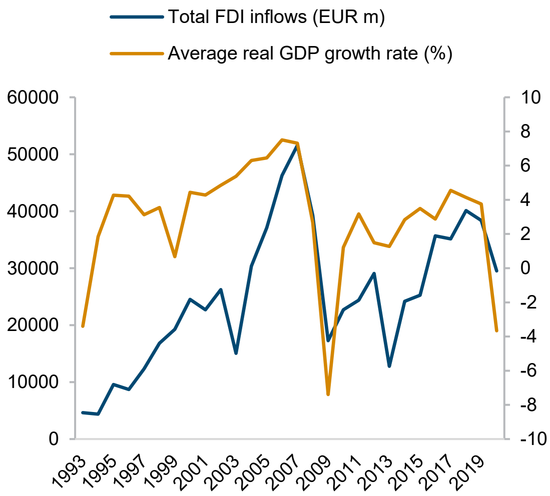
Source: UNCTADStat.

Those developing economies that managed to attract foreign investment were able to make significant leaps in upgrading their industrial base and expanding their export activities. Following its transition from central planning, much of Central and Eastern Europe (CEE) became a major beneficiary of FDI inflows. The accession process into Euro-Atlantic institutions gave investors greater confidence in what would become the EU-CEE countries, because the pre-accession years brought about important structural reforms and gradually integrated them into the EU single market. Consequently, we observe a notable rise in FDI inflows in the 1990s into these countries as the prospects of EU accession came within reach. This went hand in hand with a period of high real GDP growth rates (see Figure 5).

The Western Balkan economies, on the other hand, were limited by the absence of the same enabling preconditions and generally faced greater difficulties in attracting FDI in the years leading up to the global financial crisis (see Figure 6). Although the Western Balkans were also on a broad course towards Euro-Atlantic integration over this period, this process was much slower than for the countries that were joining the EU, not least because of the wars of the 1990s. Likewise, although they benefited from a fair degree of single-market integration through Stabilisation and Association Agreements, their geographical distance from the EU15 was mostly greater, which made them less attractive than the EU-CEE economies. As a result, both from an economic and from a security standpoint, the Western Balkan countries were a less appealing prospect for MNEs than the CEE countries that joined the EU.

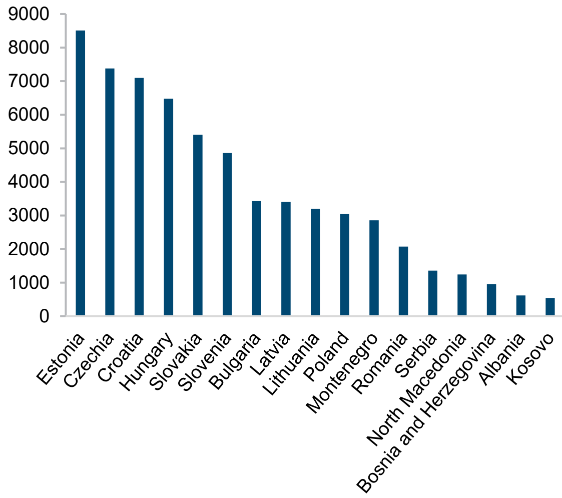
Notably, as we can also see from Figure 5, the years following the global financial crisis tell a somewhat different story. While the years following the Great Recession saw some recovery in growth as well as in FDI, both metrics never reached their pre-crisis levels. This is in line with the globalisation slowdown seen more broadly – the period between 1986 and 2008 accounts for around 80% of the growth in the ratio of world trade to GDP over the past five decades (Antràs, 2020). As Figure 7 shows, it seems that we have now exited a period of hyperglobalisation and entered a period of slowdown in the extent of global integration (ibid.). Consequently, some authors have coined the term 'slowbalisation' to describe the trends characterising today's global economy (see e.g. *The Economist*, 2019).

Figure 5 / Total FDI inflows (in EUR m) and average annual real GDP growth (secondary axis; in %) in EU-CEE



Note: The 10 countries which joined the EU in 2004 and 2007 are considered. The average growth rate is a simple average.
Source: wiiw FDI database and wiiw annual database.

Figure 6 / Inward FDI stocks per capita in EU-CEE and the Western Balkans (in EUR, 2007)



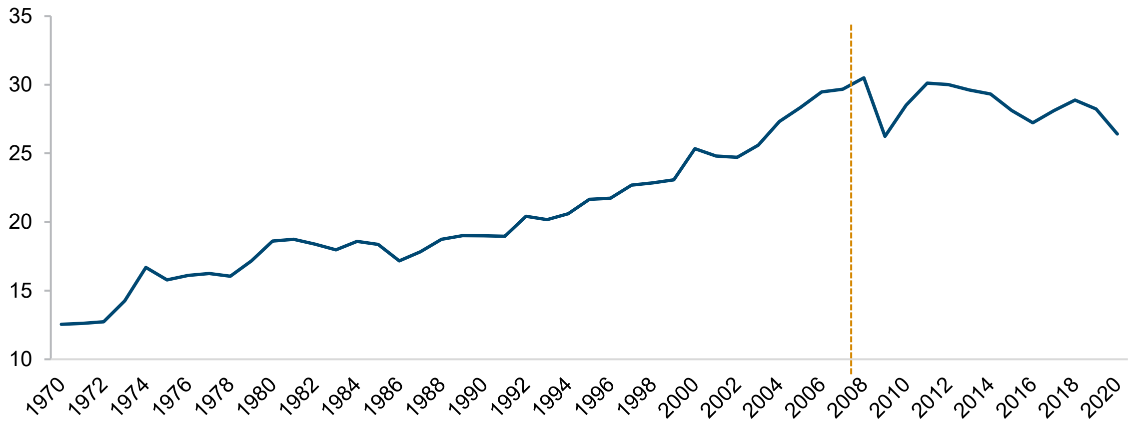
Note: The year 2007 is selected as it is the earliest point when data are available for all countries.

Source: wiiw FDI database.

As Antràs (2020) notes, one possible reason for this slowdown may simply be the unsustainability of the rapid acceleration of globalisation in the previous period. Another possible contributing factor may be the austerity measures implemented following the Great Recession and the resultant credit supply constraints, which put a damper on trade and investment activity (Bernanke, 2018). In addition, the return on investment achieved from FDI may have weakened somewhat, as labour costs in emerging markets began gradually to converge towards those in advanced economies and the significant decline in transport costs came to a halt. In other words, the reduced return on FDI played a role in the slowdown as well (UNCTAD, 2020). In this context, further technological progress in the area of Industry 4.0 is also argued to have diminished the labour cost advantages stemming from global sourcing, as one can conceptually imagine global sourcing and robots to be partial substitutes (Kilic & Marin, 2020). Hence, as the COVID-19 pandemic speeds up the digital transformation, one can expect the relative attractiveness of offshore production to weaken.

Undoubtedly, another key factor contributing to the 'slowbalisation' trend of the past decade is the deteriorating sentiment towards trade openness witnessed over the past couple of years. Advocates of free trade are now confronted by evidence of the negative distributional implications that complete market liberalisation and openness bring about. The Great Recession, rooted in the financialisation of the global economy, further impaired the reputation of globalisation, as it deepened the divide between the winners and the losers of the hyperglobalist age (Rodrik, 2019). Consequently, seeing much of their lower value-added manufacturing employment being relocated to other countries, developed economies became warier of the social consequences of offshoring. Yet, given the lack of successful compensation mechanisms for the adversely impacted (through various assistance and retraining programmes, for instance), it often gave rise to populist forces instead (Rodrik, 2018). As a result, the rhetoric in trade policy has seen a substantial shift, which is not limited to the trade war between China and the US.

Figure 7 / World trade as a share of GDP (in %)



Note: As the data show the sum of world imports and exports, the values are halved to arrive at the world trade figures, as done by Antràs (2020).
Source: World Bank World Development Indicators.

Combined with the exogenous shock brought on by the COVID-19 crisis, the prevailing conditions are argued to have now paved the way for a perfect storm, which is bound to force GVCs to modify their structure in the years to come (Javorcik, 2020). But if this is the end of (hyper)globalisation, it raises important questions regarding the continued ability of developing countries to pursue FDI-led growth paths. If offshoring is to lose its momentum and GVCs are predicted to retreat following the pandemic, this may have major implications for emerging economies – including those in the Western Balkans, for which attracting FDI remains a key component of their development strategies (Jovanović, et al., 2021). Therefore, the next section considers the question of value chain restructuring in greater detail and assesses potential reshoring opportunities that may be found in a 'slowbalised' world.

2. WILL THE COVID-19 CRISIS KILL THE APPEAL OF OFFSHORING?

With the pandemic still very much ongoing, it is as yet difficult to quantify the effects the pandemic will have on the shape and size of future GVCs. Moreover, as the characteristics of GVCs are heterogeneous across industries, a full understanding of these changes will require a deeper scrutiny of individual sectors and products (Vandenbussche, 2021). Nonetheless, there is no doubt that the significant bottlenecks, sudden surges in demand for certain essential products and the supply shortages characterising the pandemic years have played a role in bringing the themes of increased resilience and restructuring of supply chains to the forefront of the GVC debate.

The crucial question at the core of these discussions is whether we can expect the decoupling of GVCs in the years to come, with firms embarking on more regionalised structures. One hypothesis is that while firms will become more nervous about extended supply chains in light of the COVID-19 crisis, there remains a major incentive to outsource labour-intensive production from developed to developing countries given continued high wage differentials. As a result, countries characterised by low labour costs located closer to MNEs' home markets would become more attractive than they have been in the past. Eppinger et al. (2021) simulate the effects of the COVID-19 supply shock under a GVC-decoupling scenario and find that while welfare losses associated with shutting down GVCs are significant, closing down all GVC activity except for intra-EU value chains leads to considerably smaller losses. These results echo the importance of regional integration on welfare and might serve as a basis for increasing the appeal of regional value chains to ensure greater resilience to shocks.

Regional value chains could be good news for transition economies in the Western Balkans, as they could mean that European FDI would be less inclined to look beyond the continent, giving geographically closer locations a potential competitive edge over traditional offshoring superpowers like China or India. This could result, for example, in an Austrian firm outsourcing relatively more to Serbia in the future and less to China. As can be seen from Table 1, the majority of inward FDI stocks in the Western Balkan countries already originates from the EU and other geographically close locations, meaning that Western Balkan economies face no significant downside risk related to nearshoring (the process of bringing production closer to the home country). Rather, they would stand to benefit from being on the receiving end of this phenomenon, as European businesses reconsider their production plants in distant locations.

Table 1 / Inward FDI stocks in Western Balkan economies- top 10 investor countries (as % of total by countries, 2019)

Albania		**Bosnia and Herzegovina**		**Kosovo**	
Switzerland	18.7%	Austria	18.2%	Germany	12.8%
Netherlands	15.2%	Croatia	15.7%	Switzerland	12.1%
Canada	14.0%	Serbia	13.9%	Turkey	11.0%
Italy	9.4%	Slovenia	7.5%	Austria	5.9%
Turkey	7.5%	Netherlands	5.5%	Slovenia	5.3%
Austria	6.9%	Russia	5.4%	United States	5.1%
Bulgaria	6.0%	Germany	5.3%	United Kingdom	4.6%
Greece	5.9%	Italy	4.5%	Albania	4.5%
France	3.9%	United Kingdom	4.0%	Sweden	1.8%
Cyprus	2.5%	Switzerland	3.1%	Italy	1.3%

Montenegro		**North Macedonia**		**Serbia**	
Russia	11.4%	Austria	13.5%	Netherlands	14.5%
Serbia	6.1%	United Kingdom	11.6%	Austria	13.2%
Italy	6.0%	Greece	9.1%	Germany	7.7%
Cyprus	5.5%	Netherlands	7.0%	Luxembourg	6.3%
United Arab Emirates	5.3%	Slovenia	7.0%	Russia	6.1%
Croatia	5.0%	Germany	6.4%	Italy	5.2%
Switzerland	3.9%	Turkey	6.0%	Switzerland	5.1%
Slovenia	3.7%	Hungary	3.6%	Norway	4.1%
Austria	3.2%	Bulgaria	3.4%	France	4.0%
Luxembourg	2.8%	Switzerland	3.2%	Hungary	3.9%

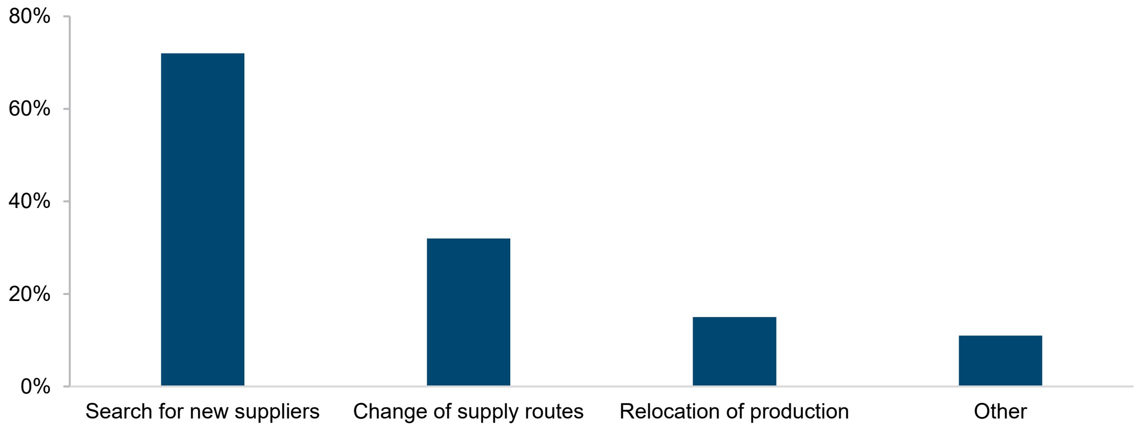
Source: wiiw FDI database.

Indeed, some firms have already begun actively to consider reshoring and nearshoring as possible alternatives to global sourcing for their business in order to strengthen their value chain resilience (Jovanović et al. 2021; Van Hoek & Dobrzykowski, 2021). Cases of firms reconsidering production in remote destinations are increasingly making the headlines. Examples include the German car maker Volkswagen, which decided to expand its capacities in its existing Slovak plant rather than committing to a greenfield investment in Turkey (Domček, 2020); the Italian apparel brand Benetton, which turned away from Asia to invest in Serbia, Croatia, Turkey and other locations in greater geographical proximity to shorten lead times (Anzolin & Aloisi, 2021); or the furniture giant IKEA, which sought to minimise supply chain disruptions and save on shipping costs by moving production to Turkey (Caglayan & Ceyda, 2021).

Moving beyond the level of anecdotal evidence, however, there is no consensus as to how important the phenomenon of nearshoring will actually be, or whether a value chain closer to home would indeed serve to reduce the risks stemming from major demand or supply shocks. Undoubtedly, there are firm-level benefits to bringing production closer to home, including reductions in lead times, cost savings in the areas of freight and logistics, or the greater responsiveness to customer demand and preferences, as well as a lower risk of disruptions to production (van Hoek & Dobrzykowski, 2021). It is because of these advantages that the World Economic Forum called upon firms in the wake of the pandemic to 'aggressively evaluate near-shore options to shorten supply chains and increase proximity to customers' (Betti & Kristian Hong, 2020).

The shortages and delays along the value chain experienced over the past months have gone beyond semiconductors and affected a variety of production inputs, such as metals, rubber, plastics or paper (Fisher & Seckute, 2021). As a result, according to the Economic Survey conducted by the Association of European Chambers of Commerce and Industry (EUROCHAMBRES), the most significant obstacle perceived by European businesses going into the next year are supply chain disruptions (EUROCHAMBRES, 2021). Likewise, the survey by the Network of German Chambers of Commerce (AHK) of German companies operating abroad shows that over half of the companies surveyed (54%) experienced problems with their supply chains and logistical issues in the autumn of 2021. This represents an increase from the previous period and marks an all-time high. Consequently, the majority of firms experiencing disruptions are in the process of considering alternative suppliers (see Figure 8).

Figure 8 / Adjustments considered by German firms operating abroad experiencing supply chain disruptions (% of respondents facing disruptions, autumn 2021)



Source: Deutsche Auslandshandelskammern (2021).

In this regard, climate change may also play a role by making disruptions stemming from exogenous shocks to the global economy more frequent and severe, increasing the number and intensity of extreme weather events (Javorcik, 2020). Furthermore, given the multitude of 'slowbalisation' factors at play in the background – including the ongoing US-China trade conflict, the proliferation of regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP) or the increase in production and transport costs – it is difficult to determine just how much of what we observe is directly attributable to the COVID-19 pandemic. Hence, even if the pandemic-induced disruptions do prove to be transitory, it may still be the case that we have entered a more volatile and uncertain period due to other underlying factors, making global coordination riskier and thus costlier in the years ahead.

However, there are also non-negligible costs arising from a regionalised value chain setup that remain in place. It is important to realise that the GVC structures we witness today are equilibrium outcomes of agglomeration and dispersion factors influencing the offshoring decision of MNEs (Baldwin & Freeman, 2021). Had the above-mentioned benefits of geographically close production not come without significant trade-offs, supply chains would have been shorter and less fragmented even in a hyperglobalised world economy. In other words, the extent of regionalisation we can expect to see depends on whether the perceived increase in trade costs with distant partners will outweigh the relative weakness of nearby destinations – including the costs, quality and availability of labour (Navaretti, 2021). Likewise, market size is a major consideration for the relocation of production, as European multinationals operating in Asia may find little incentive to exchange their large, high-growth markets for smaller markets such as the Western Balkans.

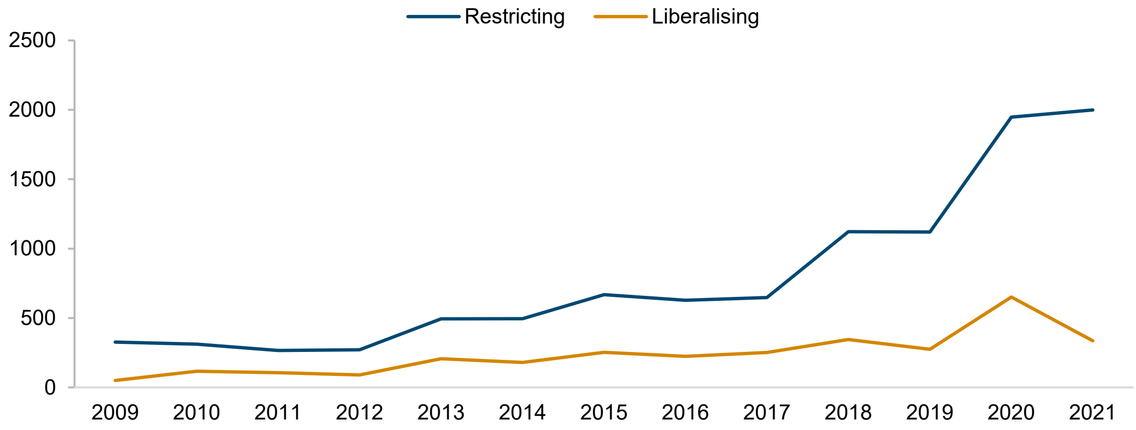
In this regard, although the search for new suppliers highlighted by the AHK survey of German companies operating abroad may imply some degree of nearshoring, the option to change supply routes or to relocate production does not yet figure explicitly as the preferred response strategy. Furthermore, according to De Backer et al. (2016, p. 25), 're-shoring is still rather "a trickle than a flood"'. This is because there are other means of increasing supply chain resilience that do not necessarily require the relocation of value chains. Mitigating the increased risk stemming from global sourcing can also be achieved via investment in superior risk management systems, better monitoring and information sharing, building up inventory buffers or adding a degree of redundancy in the supplier network, rather than changing the established architecture (van Hoek & Dobrzykowski, 2021). Although GVCs have added significantly to the complexity of world trade rather than simplifying the network, investment in systems that manage this complexity and better account for disruptions are more likely to dominate.

Moreover, the soundness of re-engineering the existing operational setup into a more regional one depends first and foremost on how much of the root causes contributing to the present disruptions are seen by firms to be lasting in their nature, permanently skewing the costs and benefits of geographical proximity. The anticipated preference for other risk mitigation strategies over relocating production plants is primarily due to the sunk costs involved in FDI, which does not allow for agile responses to shocks (Antràs, 2020). As emphasised by Baldwin & Freeman (2021, p.22), 'buyer-supplier networks are notoriously sticky due to the way in which niche expertise for very specific value chains is located around the globe'. Therefore, dismantling, relocating and setting up new operations closer to home is extremely costly in terms of time, resources and social capital (e.g. establishing new supplier relationships, many of which requires customised inputs or coordinating with existing suppliers to jointly relocate), making it an option only after lengthy appraisal procedures. Given that 41% of the German firms surveyed by the AHK also report that they anticipate an improvement in the business climate in the coming 12 months (Deutsche Auslandshandelskammern, 2021), the substantial level of resource commitment required for reshoring may be hindered by the prevailing view regarding the temporariness of the experienced disruptions. Therefore, while it cannot be ruled out that there will be some value chain decoupling, its capacity to become a major trend in the 2020s is far from obvious.

3. POLICY AS THE MAIN DRIVER OF THE RESHORING NARRATIVE, NOT THE MARKET

Given the above factors, the possibility that the increased risk aversion brought on by the pandemic could stimulate a considerable reversal of the established global production processes seems relatively unlikely. However, what proves much less sticky than the sunk resources committed via FDI – and has therefore more power to skew the topography of GVCs – is the policy adopted by individual countries (Raza, et al., 2021). While prevailing market conditions and the associated changes in the risk composition may not suffice to create the 'perfect storm' that would permanently alter GVCs, protectionist policies increasingly adopted by nation states might provide the necessary impulse (UNCTAD, 2021a). The interdependencies revealed by the pandemic have elevated the globalisation backlash that followed the hyperglobalisation period, reviving the appeal of greater national autonomy. Hence, the intensified geopolitical tensions in the wake of the pandemic, combined with the renewed interest in industrial policy, are likely to be more pervasive than the supply-side disruptions in global procurement. Indeed, we observe a gradual rise in the amount of restrictive trade interventions since the late 2010s, with a notable spike at the onset of the COVID-19 crisis (Figure 9). The Indian prime minister. Narendra Modi. has even gone so far as calling it a 'new era of economic self-reliance' (The Economist, 2020).

Figure 9 / Number of newly implemented trade interventions globally



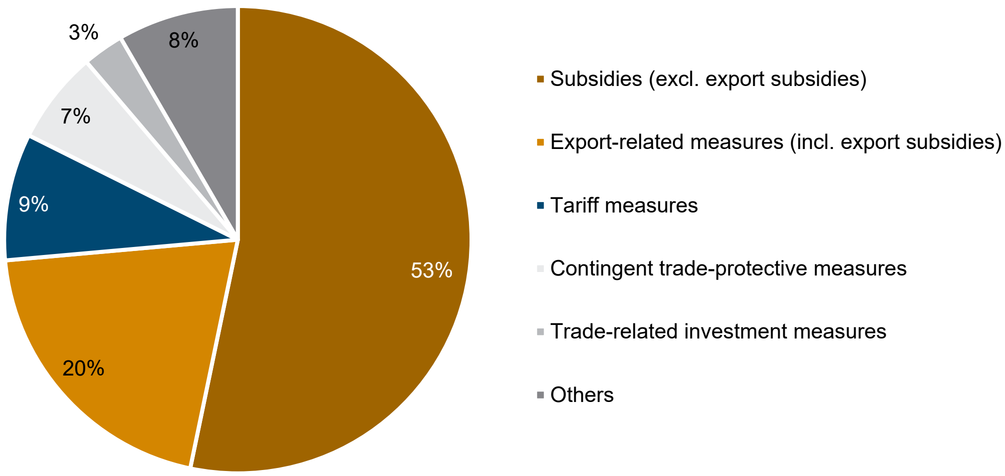
Note: Reporting-lag adjusted statistics.
Source: Global Trade Alert.

'Push' policies, which would make offshore destinations less attractive (through tariffs, for instance) are likely to play a lesser role in stimulating more regional value chain structures. The increased US-China tensions, as well as the uncertain position in which the EU finds itself as a result, may lead some producers to distance themselves from China. However, this does not automatically imply that European firms would be motivated to move away from the region. This FDI may flow instead to other South-East Asian emerging economies which offer similar advantages without the geopolitical strains. For instance, Japanese firms operating in China are increasingly looking towards neighbouring Vietnam as a result of the US-China conflict (Japanese Bank for International Cooperation, 2021). On the other hand, there is so far no empirical support for nearshoring gains in Mexico, even as US manufacturers were expected to move away from China (Navaretti, 2021).

Hence, rather than the adverse conditions brought on by various 'push' policies, 'pull' policies – which make the home country more attractive, e.g. in the form of subsidies and other incentives – are more likely to play a key role in reconfiguring GVCs. One of the main channels through which the global trade and investment environment is predicted to change in the years ahead is through the realignment of economic governance to avoid dependence in strategic areas (Zhan, 2021). The preference for these 'pull' policies can also be observed in Figure 10, where subsidies appear to be the most frequently adopted measures of the newly implemented trade restrictions in the post-2008 period.

In the EU context, this manifests itself in multiple documents, policy guidelines and public statements by senior officials. For instance, in the 2021 State of the Union Address the EU president, Ursula von der Leyen, called on EU leaders to 'coordinate EU and national investment along the value chain' to reclaim strategic autonomy (von der Leyen, 2021). In a similar vein the French minister of economy and finance, Bruno Le Maire, called for 'increased European production capacity, to build up our autonomy in strategic areas' (Le Maire, 2020). The same narrative is also present in Austria, with the federal minister for digital and economic affairs, Margarete Schramböck, claiming that the EU 'can't rely on the functioning of the global supply chain' in semiconductor manufacturing because, in her view, it is 'too important to depend on foreign suppliers' (Noyan, 2021). Among these newly fashionable industrial policies, reshoring figures as one of the strategies to be pursued in the 'Renaissance of Industry for a Sustainable Europe Strategy' of the European Parliament, which predates the pandemic (De Backer, et al., 2016). The interest in bringing the production stage back to the continent is also evident in the European Reshoring Monitor published by the European Foundation for the Improvement of Living and Working Conditions (Eurofound), which tracked concrete cases of reshoring and nearshoring between 2014 and 2018 and found some 253 cases over the observed period (Eurofound, 2019).

Figure 10 / Restrictive trade policies adopted by type (% of all restrictive measures, 2009-2021)



Note: Reporting lag-adjusted statistics.
Source: Global Trade Alert.

In addition, the green transition, along with the increased government pressure on corporate accountability, may also contribute to the transformation of GVCs into more regional structures (Zhan, 2021). Domestically produced goods and shorter supply chains are often encouraged as a means of reducing emissions through a multitude of 'buy local' initiatives, particularly in food production. Moreover, as various human rights issues emerge related to suppliers in less developed countries with weaker labour protection standards, Environmental, Social and Corporate Governance (ESG) criteria are becoming increasingly important. The EU is currently pushing for legislative measures to effectively trace the ethical aspect of production, proposing a ban on all imports produced with the use of forced or child labour (European Parliament, 2021). Similarly, earlier this year Germany approved a draft of its Supply Chain Due Diligence Act, which aims to impose on German firms the legal obligation to respect human rights across their global supply chains (Federal Ministry of Labour and Social Affairs, 2021). In addition, some firms may also willingly consider bringing production to economies that are characterised by higher levels of environmental and labour protection, as changing consumer preferences increasingly allow for green premiums based on the value attributed to certain 'Made in' labels (Ancarani & Di Mauro, 2018).

Nonetheless, the scope of the above 'pull' factors will probably only reach selected sectors of the economy. Given the costs involved in incentivising the relocation of production, governments – already facing high levels of debt following the disbursement of extensive pandemic relief measures and accounting for the significant investments associated with supporting the twin transition – will need to be highly selective when it comes to the type of production processes they really want to see returning to Europe. Thus the focus will mostly be limited to critical goods such as health supplies on the one hand, and strategic inputs such as semiconductors, where the current level of dependence is high, on the other hand (Baldwin & Freeman, 2021; Raza, et al., 2021). In these sectors there is certainly room for lower-wage economies in Europe, including the Western Balkans, to capture some investment presently located in far-off destinations. Given the size of the Western Balkan countries, even a handful of such incoming investments can have a substantial impact on the host economy.

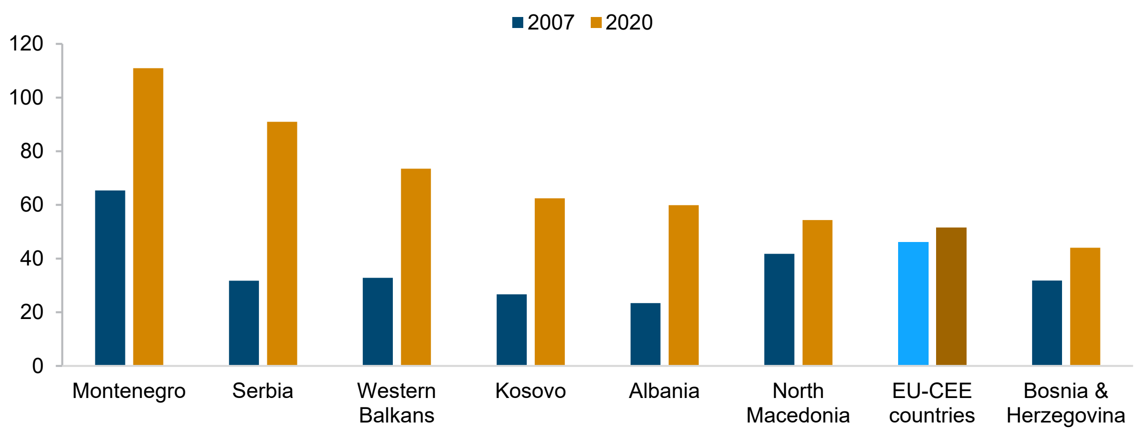
Moreover, in addition to production plants that are already set up abroad, future FDI flows – subject to the same underlying forces – have a greater potential of being more regionally skewed, as the investment appraisal processes will be made in the absence of large-scale sunk fixed costs. In this regard, it can be concluded that 'resilience is not expected to lead to a rush to reshore, but to a gradual process of diversification and regionalisation, as it becomes part of MNE location decisions for new investments' (UNCTAD, 2021a, p. xiii). Yet even so, it is important to keep in mind that much of the host-country parameters relevant for attracting FDI will remain unchanged (Navaretti, 2021). Therefore, not only will the Western Balkan countries continue to face stiff competition in the race for inward FDI from other countries in the region, but their present position may put them at a disadvantage on multiple important fronts, as will be examined in more detail in the next section.

4. NEW INVESTMENTS, SAME SHORTCOMINGS: QUALITY OF INCOMING FDI AND HOST-COUNTRY DETERMINANTS

As outlined above, the most likely driver of a more permanent regionalisation of GVCs will be policy pressure to move the production of strategic and sensitive sectors within geographical reach. From the perspective of Western Balkan economies seeking to attract foreign investors into their countries to advance their levels of economic development, this reality has numerous important implications.

First, the developmental impact of near-shored plants focused on producing essential supplies using low-skilled labour is rather limited, i.e. the potential for industrial upgrading and sustainable growth associated with making unsophisticated products such as face masks and respirators is relatively low, even if the supply of these goods is critically important for the wellbeing of the population. Likewise, as FDI inflows in such low value-added sectors are particularly driven by low wages, there is reluctance on the part of the host economy to allow any significant increases in the wage levels to maintain their competitiveness. Indeed, this would intensify an old problem in the region: while Western Balkan economies have been relatively successful in attracting high shares of FDI in relation to their GDPs in recent years – even overtaking EU-CEE countries (Figure 11)[2] – the sectoral breakdown shows that particularly in some economies the capital has not always gone to productivity-enhancing sectors. For instance, we observe that a large chunk of FDI inflows was concentrated in real estate (NACE rev. 2 L) in Kosovo, or extractive industries (NACE rev. 2 B) in Albania (see Table 2). Furthermore, the same problem also largely applies to manufacturing FDI, where the FDI inflows in countries such as North Macedonia or Bosnia and Herzegovina are characterised by labour-intensive, low-productivity and low value-added activities.

Figure 11 / Inward FDI stocks in the Western Balkan countries (as % of GDP, 2007 vs 2020)



Source: wiiw FDI database.

[2] Naturally, this is also due to the lower levels of GDP in the Western Balkan countries compared with the EU-CEE. Hence, an investment inflow of the same absolute amount claims a much larger share of the GDP of a Western Balkan economy.

Table 2 / FDI inflows in the Western Balkan countries by NACE Rev. 2 activities (as % of total FDI inflows, average for 2015-2020)

	Albania	Bosnia and Herzegovina	Kosovo	North Macedonia	Serbia
A Agriculture, forestry and fishing	0.08	0.31	0.31	3.20	2.52
B Mining and quarrying	22.10	3.70	-2.99	-10.23	4.28
C Manufacturing	4.54	29.96	1.41	35.07	29.66
D Electricity, gas, steam, air conditioning supply	37.18	7.41	3.46	7.12	1.17
E Water supply, sewerage, waste manag., remediation		0.15	0.27	0.01	1.38
F Construction	2.80	1.79	5.70	10.65	14.97
G Wholesale, retail trade, repair of motor vehicles etc.	2.63	19.39	3.00	23.29	8.54
H Transportation and storage	2.66	0.42	-1.15	0.01	9.46
I Accommodation and food service activities	-0.28	-0.14	0.37	0.14	0.34
J Information and communication	0.33	-1.61	-0.81	2.28	3.35
K Financial and insurance activities	10.60	23.83	14.48	21.18	14.92
L Real estate activities	6.78	4.90	66.26	4.38	5.19
M Professional, scientific and technical activities	4.78	3.36	1.82	-0.33	2.50
N Administrative and support service activities	1.82	1.42	5.01	1.21	0.90
O Public administration, defence, compuls. soc. security			0.56		
P Education	0.08	0.16	0.31	0.38	0.03
Q Human health and social work activities	-0.05	0.03	0.20	0.72	0.01
R Arts, entertainment and recreation	0.81	0.77	0.06	1.38	0.20
S Other service activities	0.00	0.04	1.17	-0.17	0.02

Note: Montenegro is missing in the dataset.
Source: Calculations based on the wiiw FDI database.

Looking at greenfield investment, which expands the host country's capital stock and is therefore the more growth-inducing type of FDI (Harms & Méon, 2011), it can be seen that the Western Balkan countries have generally attracted a significantly smaller number of investment projects compared with the EU-CEE countries. Serbia is a notable exception, which is to a large extent attributable to the growing position of China. In the case of Montenegro, the great number of jobs created despite the small number of announced projects can be explained by one large-scale construction project – again pointing to the region's relative weakness in securing productivity-enhancing FDI. Hence, going forward, more emphasis is needed on FDI demanding more sophisticated levels of human capital and technology.

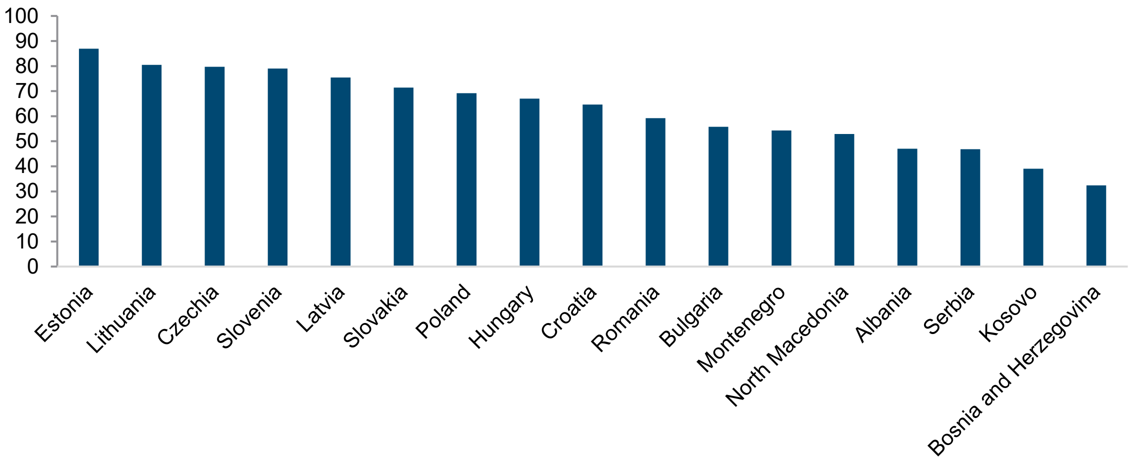
On the one hand, with respect to the EU looking to near-shore strategic sectors like the production of semiconductors, the Western Balkan region is constrained by numerous parameters that are crucial for attracting this type of FDI. Using a gravity model, Jovanović et al. (2021) analyse which variables play a significant role in explaining FDI stocks and flows in the Western Balkans, CEE and Asia. They find that the cross-country differences in FDI stocks are driven by differences in governance, education, transport infrastructure, taxes and fiscal stability. On the other hand, their results suggest that labour market variables (defined as wages and labour productivity) do not appear to be significant, which is most likely due to the fact that the wage and productivity levels are generally lower across the board compared with the countries from which the FDI originates, making it a less important parameter for the location decision within the region. Furthermore, looking at FDI flows, they conclude that education tends to play a more important role over the long term.

Table 3 / Greenfield FDI projects announced in EU-CEE and the Western Balkan countries (total between January 2018 and September 2021)

Destination country	Number of announced projects	Jobs created per 100k population
Poland	1274	908.32
Romania	461	979.07
Hungary	367	630.90
Czechia	291	507.03
Serbia	240	985.36
Lithuania	240	880.97
Bulgaria	168	502.93
Slovakia	123	640.35
Croatia	79	144.94
Latvia	77	873.04
Estonia	76	684.39
Bosnia and Herzegovina	42	119.13
Slovenia	41	339.90
North Macedonia	30	395.98
Montenegro	18	1075.09
Albania	15	181.11
Kosovo	6	15.70

Note: Preliminary data for 2021. The data include estimations by fDi Markets.
Source: calculations based on fDi Markets and Eurostat.

Figure 12 / Average percentile rank of EU-CEE and Western Balkan countries in the World Governance Indicators (2020)



Note: The chart displays the given country's percentile rank among all countries covered by the World Governance Indicators, with 0 representing poorest governance and 100 the best. Average percentile rank for the six dimensions of governance: Voice and Accountability; Political Stability and Absence of Violence/Terrorism; Government Effectiveness; Regulatory Quality; Rule of Law; and Control of Corruption.
Source: World Bank World Governance Indicators.

As Jovanović et al. (2021) further show, the Western Balkan countries display relative weaknesses in these imporant dimensions, which may deter investors away from the region. According to the World

Bank's World Governance Indicators, the Western Balkans fall significantly below EU-CEE countries in their quality of governance (Figure 12). As Table 4 illustrates, the greatest gap between the best regional performer and the worst one is found in the area of Government Effectiveness, which captures the quality and credibility of public services and policymaking and assesses the independence from political pressures. Here, Estonia almost reaches the top decile, while Bosnia and Herzegovina finds itself in the second-lowest decile. Likewise, the role of Political Stability is particularly crucial, as it is arguably one of the most important considerations for foreign investors (ibid.). The countries of the Western Balkans have a relatively bad reputation in this respect given the wars and conflicts of the past three decades, and continue to face issues even today. The recent tensions in Bosnia and Herzegovina, Kosovo and Montenegro undermine the attractiveness of these economies as hosts of FDI further. Another particularly problematic issue for the Western Balkan economies lies in their inability to control corruption. Given the greater support for the 'sand the wheels' view of corruption found in literature (Méon & Sekkat, 2005), this reality can be harmful for FDI attraction.

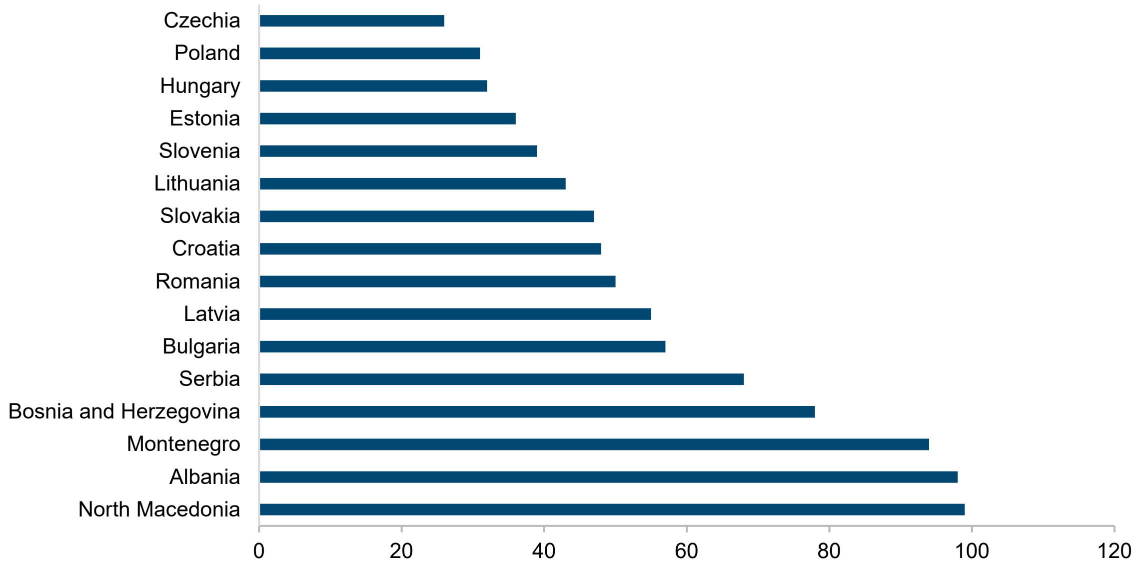
Table 4 / Percentile rank of EU-CEE and Western Balkan countries by dimensions of the World Governance Indicators (2020)

	Control of corruption	Government effectiveness	Political stability and absence of violence/terrorism	Regulatory quality	Rule of law	Voice and accountability
Estonia	92.3	88.5	70.3	92.8	89.4	88.4
Lithuania	79.8	82.7	75.5	83.2	81.7	80.2
Czechia	71.2	78.8	79.2	86.5	83.2	79.2
Slovenia	79.3	85.6	69.8	77.4	83.7	78.3
Latvia	75.5	76.9	60.4	85.1	81.3	73.4
Slovakia	66.3	71.6	67.5	74.5	73.6	74.9
Poland	73.1	66.3	63.2	76.4	69.2	66.7
Hungary	60.6	72.1	75.0	67.8	67.8	58.9
Croatia	61.5	68.8	65.6	65.9	62.0	64.3
Romania	54.8	42.8	63.7	64.4	64.4	65.2
Bulgaria	46.2	50.5	60.8	69.7	51.4	56.0
Montenegro	56.3	53.4	47.2	64.9	55.3	48.8
North Macedonia	38.0	57.7	50.5	68.8	52.4	50.2
Albania	31.7	48.1	49.5	60.6	40.9	51.2
Serbia	37.5	54.3	43.9	57.2	47.6	40.6
Kosovo	36.5	40.9	36.8	41.3	38.9	39.6
Bosnia and Herzegovina	28.8	15.4	27.8	42.3	43.3	36.7

Note: The table displays the given country's percentile rank among all countries covered by the World Governance Indicators, with 0 representing poorest governance and 100 the best.
Source: World Bank World Governance Indicators.

The quality of logistics services and infrastructure presents another formidable challenge for inward FDI in the Western Balkans. Looking at the World Bank's Logistics Performance Index, which scores countries based on survey data of logistics professionals operating in the given country, the attractiveness of the Visegrád countries is apparent. On the other hand, transporting goods in the Western Balkan countries faces numerous challenges, ranging from deficiencies in the transport infrastructure to the efficiency of customs clearing and the quality of logistics services provided in the country. Likewise, border crossing often presents a problem, as trucks are frequently held up at border checks. The Open Balkan initiative may help to streamline this aspect, as it aims to remove the borders between the countries. However, so far only Serbia, Albania and North Macedonia are taking part in the initiative. As much of the FDI in the region is predominantly export-oriented, such logistical shortcomings in the Western Balkans serve to give the more advanced economies in the region a significant competitive edge.

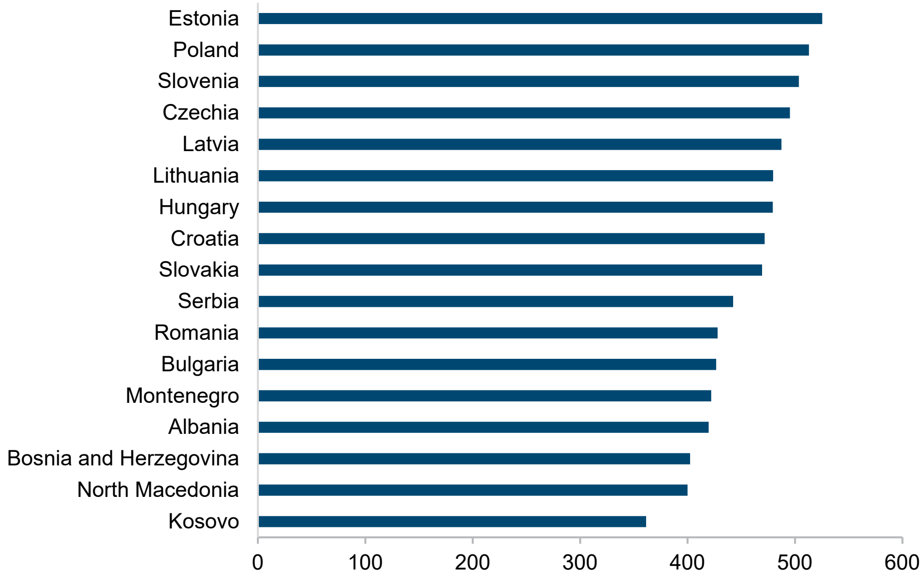
Figure 13 / Ranking in the Logistics Performance Index (weighted aggregate for 2012-2018)



Note: Comparison of 161 countries. The aggregated LPI is weighted in a way that the most recent data is attributed the highest weight. Kosovo missing in the dataset.
Source: World Bank's Logistics Performance Index.

Finally, the sizable outward migration and brain drain in the Western Balkans make skilled labour scarce. Because the FDI in strategic sectors is anticipated to be predominantly capital-intensive and technologically progressive, the type of jobs to be created by such firms opting for production in Europe is likely to be increasingly concentrated on high-skilled labour. This is also because much of the lower value-added activities can now be robotised, which dilutes the labour cost advantage of the region as a whole. Hence, the quality of human capital – already identified as a key aspect of FDI attraction – is likely to become ever more important. In this regard, the results of the PISA tests given to 15-year-olds depicted on Figure 14 highlight the deficiencies of the education systems of the Western Balkan countries, limiting the future development potential of the region. On the other hand, some signs of brain gain recently observed in Serbia, Montenegro and North Macedonia suggest that highly educated students are returning to their home countries, which may offset at least some of these shortcomings (Leitner, 2021).

Figure 14 / Average PISA test scores (aggregated mean scores for Reading, Math and Science; 2018)



Source: OECD PISA database.

In sum, even in the light of anticipated changes in GVCs in the years ahead, the challenges faced by the Western Balkans in attracting FDI remain largely unchanged. As we have seen, the underlying economic conditions which determine the scale of inward FDI continue to lag behind the EU-CEE. Moreover, the intra-regional labour cost differentials, which are already relatively insignificant, are likely to become even less relevant given the increased adoption of robots. Hence, the areas discussed in this section not only outline the general weaknesses of the Western Balkan economies from the perspective of FDI, but they also suggest key areas for future improvement.

5. LOOKING FOR EARLY SIGNS OF CHANGE IN FDI PATTERNS

Because much of the underlying forces identified above as having the potential of skewing the established GVC structure are deemed to take a relatively long time before materialising, any immediate deviations from past trends must be interpreted with a degree of caution. Nonetheless, it is worthwhile to turn to the available FDI data since the start of the pandemic and assess whether we can already observe some notable changes in the patterns of foreign investment flows.

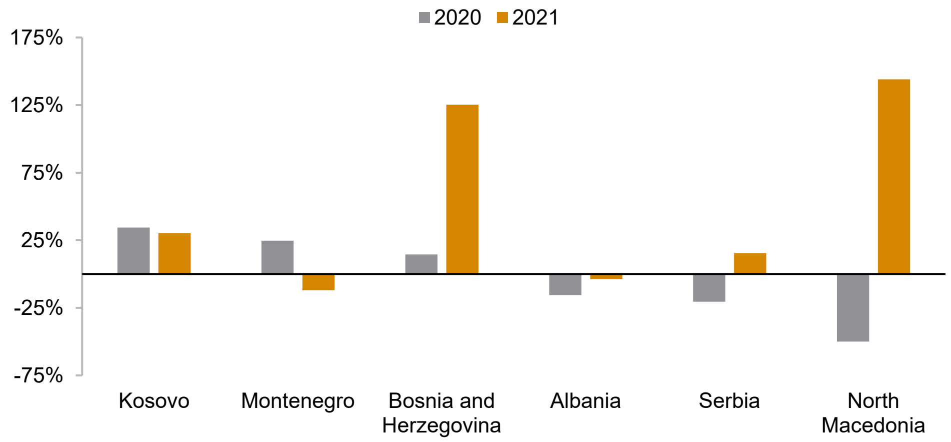
In response to the COVID-19 shock global FDI flows fell by 35% year on year in 2020, a much more dramatic downturn than the falls recorded for trade and GDP (UNCTAD, 2021a). The Western Balkan countries proved relatively more resilient to the pandemic in terms of FDI, recording a 14.8% decline in the total inward FDI inflows into the six countries in 2020 compared with the previous year. This was also above the level of the EU-CEE economies, where 2020 brought about a yearly decline in FDI inflows of 18%.[3] The regional aggregate masks significant cross-country differences, however, as Figure

[3] Calculations based on data from the wiiw FDI database.

15 shows. Given the nature of FDI in the Western Balkans as discussed in the previous section, much of the fluctuations we observe are not so much related to GVCs as driven by medium-term investment prospects, particularly in Kosovo or Albania, where real estate plays a key role in FDI (Hunya, 2021). Likewise, the increase in Montenegro in 2020 was largely driven by growth in debt instruments. On the other hand, Serbia and North Macedonia, which are more integrated into manufacturing GVCs, have seen downturns with the onset of COVID-19 that are more consistent with global trends.

The data for the first six months of 2021 show general signs of a recovery in FDI activity in the Western Balkans, albeit with varying degrees of magnitude across individual countries (Figure 15). Overall, FDI inflows into the region were up by 20% compared with 2020, with Bosnia and Herzegovina, Kosovo and Montenegro even surpassing the pre-pandemic average quarterly FDI inflows in the first half of 2021 (Jovanović, 2021). While it is too early to tell whether some of this rebound can indeed be attributed to nearshoring, it still paints a relatively optimistic picture regarding the prospects of the Western Balkan economies to swiftly recover from the pandemic and establish a firmer FDI presence for themselves than before the onset of the COVID-19 crisis.

Figure 15 / Changes in average quarterly FDI inflows in the Western Balkan countries (in %, change compared with previous year's average)

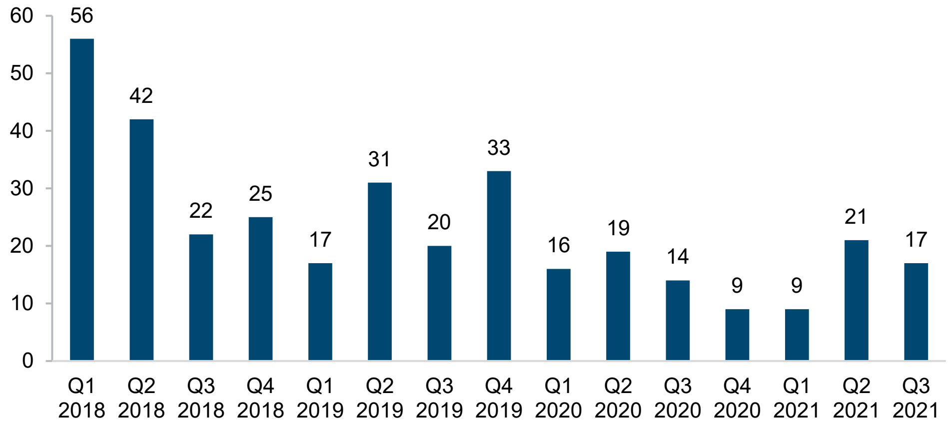


Note: 2021 figures encompass the first half of the year only.
Source: Based on Jovanović (2021) using the wiiw FDI database.

However, the preliminary FDI statistics also point to the remarkable resilience of traditional offshoring destinations in Asia. Not only was China the only major world economy which did not experience a contraction in FDI inflows in 2020, but FDI inflows into East and South-East Asian countries also rose by 25% in the first half of 2021[4] (UNCTAD, 2021a; UNCTAD 2021b). Therefore it cannot be established that the recovery in FDI flows to the Western Balkans is a direct result of divestitures by Western Europen firms' of their offshored subsidiaries.

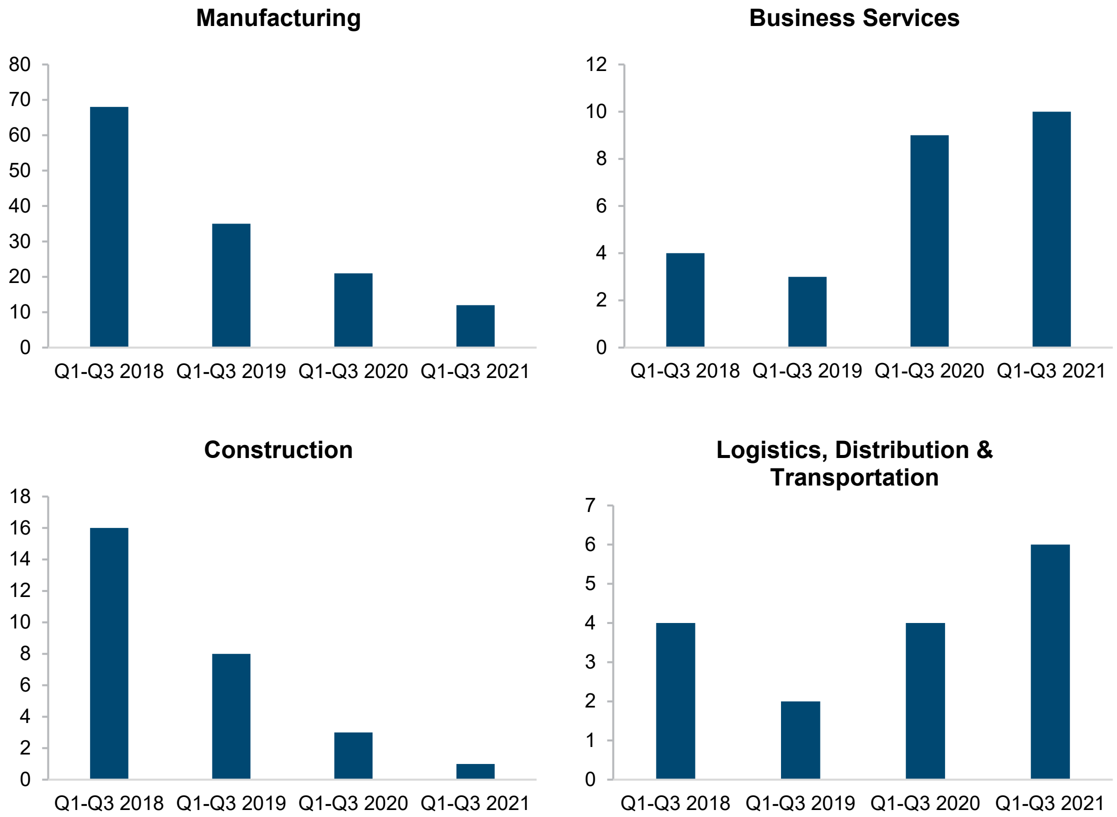
[4] Partial-year growth rate. See UNCTAD (2021b) for more details.

Figure 16 / Total number of greenfield FDI project announcements in the Western Balkan countries (quarterly data)



Note: Preliminary data for 2021.
Source: fDi Markets.

Figure 17 / Number of greenfield FDI project announcements in the Western Balkan countries by activity (quarterly data)



Note: Preliminary data for 2021.
Source: Calculations based on fDi Markets.

Turning to greenfield FDI, which can potentially provide a more informative picture of the more productivity-enhancing foreign investment flows, we see that the Western Balkans have yet to reach pre-pandemic levels in the overall number of project commitments, despite some recovery in the second quarter of 2021 (Figure 16). However, the breakdown by activities reveals some interesting structural differences in this regard. As can be seen in Figure 17, the number of FDI projects related to manufacturing and construction has seen a notable decline in the Western Balkan countries following the pandemic, as the appetite of MNEs to commit resources in new investments declined due to the uncertainty presently characterising industry and GVCs (UNCTAD, 2021b). On the other hand, business services and logistics-related FDI activities have gained noticeably in popularity since the beginning of the COVID-19 crisis. The dynamism we observe in these activities reflects the changes in the way of doing business brought on by the pandemic, with significant advancements in digitalisation and e-commerce requiring strengthened investment in such areas to adapt to the new normal. Hence, it is particularly in these activities that the Western Balkan countries may find opportunities for successful value chain integration in the post-pandemic period.

6. TAPPING INTO THE POTENTIAL OF REGIONALISED GVCS: POLICY RECOMMENDATIONS FOR ECONOMIES STUCK IN THE EU'S WAITING ROOM

FDI can certainly play a crucial role in the industrial upgrading and economic development of the Western Balkan countries, and the potential changes in the configuration of GVCs represent attractive growth opportunities for the region in the period ahead. However, the ability to attract the type of FDI that will indeed serve this purpose does not come automatically and requires the host economies' strategic efforts. In order to reap the benefits stemming from the anticipated regionalisation of value chains, the Western Balkans must first and foremost step up their investment promotion activities. This, however, should not imply a race to the bottom in financial incentives and tax breaks, as is unfortunately the case in much of the Central, East and Southeastern Europe (CESEE) region. Instead of focusing on giving MNEs special incentives, successful investment promotion policies should above all focus on improving the underlying FDI determinants discussed above, which will ensure large-scale, sustainable inflows of high-quality FDI: investing in infrastructure, nurturing high-quality human capital, eliminating corruption at all levels and building up institutional capacities. Furthermore, as Javorcik (2020) notes, an FDI-friendly host economy is characterised by stability and transparency.

The Western Balkan economies therefore ought to strengthen and expand the implementation of their own 'pull' policies to drive possible nearshoring into the region. This is particularly relevant for attracting FDI in higher value-added sectors of the economy and may include reinforcing initiatives such as the establishment of technology parks or research centres as well as other schemes that would better stimulate cooperation between the private sector and academia. Furthermore, this should be coupled with greater investment in R&D and technologies, the protection of intellectual property rights and higher education institutions, which would improve the absorptive capacity of imported innovation brought to the Western Balkans through the presence of MNEs (Gabrisch, et al., 2016). The Western Balkans Investment Framework, which offers financial support and technical assistance for investments in critical areas, can be particularly useful in this regard. However, none of these policies can be expected to be successfully implemented without enabling institutions. Therefore, improvements in governance represent the most important first steps towards the goal of increased FDI attraction.

Moreover, facilitating spillover effects across the economy through FDI is a difficult task, as demonstrated by the experience of EU-CEE economies currently struggling to get out of the middle-income trap (The Vienna Institute for International Economic Studies, 2021). Hence, given the stagnation in convergence that we observe across much of the EU-CEE region today, the importance of fully leveraging the presence of foreign entities in the country will prove crucial. In other words, successful investment promotion policies should not stop at the point where the investor chooses a given country over others to set up operations. Rather, host-country institutions should also target the creation of linkages between domestic and multinational entities once the investor is established in the host economy, so that local companies can partake in GVCs.

Undoubtedly, greater access to EU funds would be a key enabler to successfully implementing the above investments and policies, transforming the underlying economic conditions that drive FDI (wiiw and Bertelsmann Stiftung, 2020). The prospect of Western Balkan countries becoming part of the EU by the 2025 target now appears unreachable, and the EU-Western Balkan Summit in Slovenia earlier this year did not instil renewed confidence in the possibility of accelerated accession. Instead, as the president of the European Council, Charles Michel, admitted after the summit, the views regarding the ability of the EU to integrate new members differ considerably across the 27 member states (European Council, 2021). In the light of fading accession prospects in the near future, the Western Balkan economies may struggle to find a sufficiently strong incentive to undertake the necessary structural reforms that would make them attractive for nearshoring, or FDI in general.

Therefore, as these countries seem to be stuck in the EU's waiting room with no firm end to this wait in sight, the EU and the Western Balkans ought to participate in a dialogue regarding the expansion of the financial support given to the pre-accession countries. This would help the region to meet its substantial infrastructure financing needs and support the cultivation of an innovation ecosystem. The increased presence of third countries may well serve as an incentive for the EU to finally step up its own financial presence in the region, particularly given the growing presence of China through various loans, of which the EU has become increasingly wary (Le Corre, 2019). In this way the Western Balkans ought to explore and take full advantage of 'phased accession' options available to them, moving beyond the traditional dichotomy of being either a member or a non-member (Kornblum, 2021).

Finally, as argued by wiiw and Bertelsmann Stiftung (2020), greater regional integration would also be fruitful for making the Western Balkans a more attractive destination for inward FDI. If the countries of the region can find a way to cooperate effectively as a single economic area, their likelihood of success in the race for FDI will surely be augmented. Rather than acting in isolation as five small economies and a medium-sized one, 'proper cooperation with countries in close macro-regions could become a turning point' (Barbieri et al., 2020, p. 134) in enhanced FDI attraction. Incentivising such collaboration may prove a challenge to begin with, given the greater appeal of deepening trade ties with more affluent markets in the EU. The general lack of cohesion and the underlying geopolitical issues in the region act as a further impediment, but raised living standards achieved via better integration and cooperation with the EU may in turn spill over into a strengthened trade and investment relationship, creating a stronger and more prosperous Western Balkan region. However, this will require the political will and engagement of the leaders of the EU and of the Western Balkan economies as well as their successful cooperation with other relevant actors.

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