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## Covid-19: A new era of closer cooperation between the EU and its neighbours?

Geopolitical developments over the last few years and now the Covid-19 pandemic are reshaping international business models and global supply chains. Could the European Union's eastern and southern neighbours benefit from this? In this Policy Brief we argue that the European neighbours would need to improve their business environment – and in particular their governance structures – for new investment and business.<sup>1</sup>

### A new role for the EU's "ring of friends"?

Geopolitical developments over the last few years and now the Covid-19 pandemic are reshaping business models and how corporates operate across borders and regions.<sup>2</sup>

Some commentators have argued that the countries in the European Union's (EU's) neighbourhood might benefit from these developments as it might give them the opportunity to play a greater role in European supply chains (Pandey 2020, and Savills 2020).

The eastern and southern neighbours – specifically Georgia, Jordan, Moldova, Morocco, Tunisia and

Ukraine – have played an important role for the EU for many years, with the latter considering stability and security in its neighbourhood as key to its own stability and security (Prodi 2002). The EU is thus keen to develop the region as a "ring of friends".

So is a closer economic relationship with the EU a realistic proposition for the eastern and southern neighbours, given their current economic development and political circumstances? What would have to be done to increase their chances of success?

This is a particularly pertinent issue for the EU's neighbours as closer integration into European supply chains and economies could support their economic transformation and modernisation. As a result, the most qualified citizens would benefit from increased

<sup>1</sup> Authors: Frank Eich, Christian Hanelt and Miriam Kosmehl.

<sup>2</sup> See for example Petersen and Bluth (2020).

labour-market opportunities at home. This could potentially slow the so-called brain drain, which has often been cited as one factor holding back the economic development of emerging and middle-income countries (European Committee of the Regions 2018). Closer economic integration could also be expected to lead to increased prosperity, which would improve the general well-being of the population, and strengthen the tax base. Last but not least, in the sense of an expanded concept of security, a greater degree of economic integration should also help to improve the overall security situation in the regions and hence in the EU's neighbourhood.

The paper is structured as follows. The next section presents the changing global backdrop, developments in the EU's neighbourhood and the impact of the Covid-19 crisis. The following two sections provide insights into the EU's economic relationship with the neighbourhood countries, and assess the attractiveness of the EU's neighbourhood countries as potential business locations. They also discuss some of the key policy challenges. The final section concludes with the uncomfortable yet realistic supposition that a relocation of global value chains closer to Europe is not a self-runner for neighbouring countries.

## Background: A changing global environment

### The end of globalisation?

Over the last few years, we have experienced major geopolitical shifts, with the increasing tensions between the United States and China dominating world events. Since 2017 we have seen an escalation specifically in trade tensions, mainly involving the United States and China but increasingly affecting other countries and regions too, either indirectly (e.g. trade diversion) or directly (e.g. the United States imposing tariffs on certain exports from the European Union). The erection of trade barriers is, however, not limited to the United States and China: there has been

a trend towards higher trade barriers in many countries in the recent past.<sup>3</sup>

These developments have led to what many consider to be a reversal of globalisation. Global trade growth has slowed markedly (UNCTAD 2020), foreign direct investment has weakened and international organisations such as the World Trade Organisation or more recently the World Health Organisation are losing influence and thus credibility.

Over the same period, we have seen an acceleration in “reshoring”, in other words, the relocation of production from emerging economies back to advanced economies. This is – at least partly – the result of technological progress, for example the increased use of robots and 3D-printing in manufacturing, which has not only reduced production costs in high-wage countries but also added flexibility in production.<sup>4</sup>

### Developments in the European neighbourhood

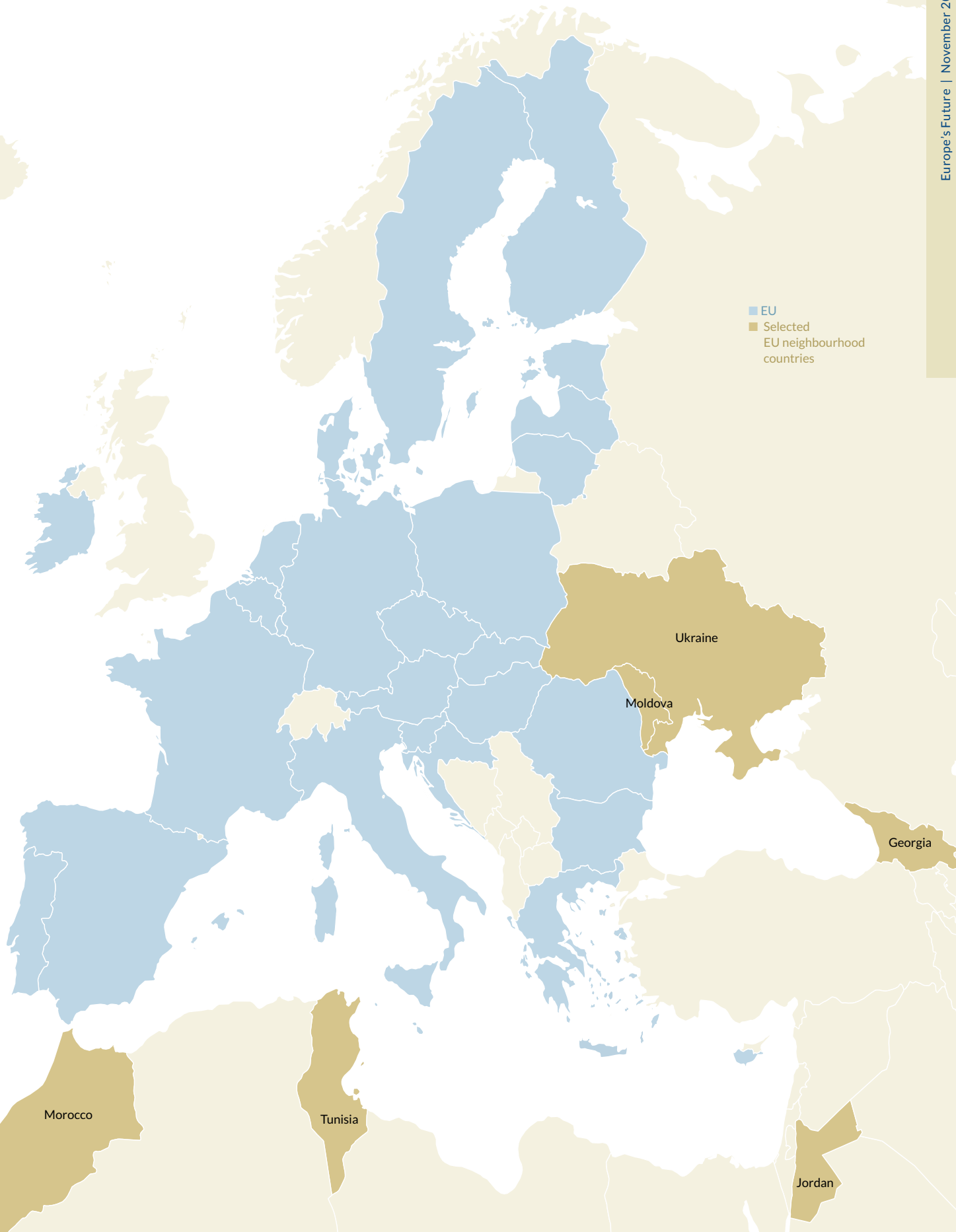
Russia's increased projection of power as well as tensions in the Middle East have also shaped the political landscape globally and in the European neighbourhood more specifically.

Two developments have had a particular impact on economic cooperation and trade in the eastern neighbourhood: first, the EU's economic sanctions targeting Russia in response to the latter's annexation of the Crimean peninsula in 2014 (European Council / Council of the European Union 2020) and, second, Russia's repeated embargos against countries in the Eastern Partnership such as Georgia, the Republic of Moldova or Ukraine, or eastern EU member states such as Poland.

Over the same period tensions and conflicts in the Middle East, the Sahel region or in Libya have also affected the EU's southern neighbours Morocco, Tunisia and Jordan. For example, hundreds of thousands

<sup>3</sup> See, for example, International Monetary Fund (2019), Scenario Box 1.2.

<sup>4</sup> International Monetary Fund (2019), Scenario Box 1.1.



of Tunisians used to work in oil-rich Libya, supporting the local labour market and supporting the Tunisian economy with remittances – these opportunities do not currently exist.

### The Covid-19 pandemic

On top of that we now have had the Covid-19 crisis, the worst pandemic in living memory, resulting in a collapse in economic activity and international trade. The pandemic has also exposed the fragilities of our economic model, based on “just in time delivery”, often across borders and even continents. The paradigm seems to be shifting from “just in time” to “just in case”.

Moreover, the crisis has exposed a number of deep-rooted problems in the EU's neighbouring countries. For example, their economies generally continue to suffer from a high degree of informality, resulting in inadequate social safety nets, access to health-care provision and tax bases. In some countries, the crisis has also exposed the lack of investment in IT and transport infrastructure and human capital.

For the EU's eastern and southern neighbours the impact of Covid-19 has not only been direct (for example in terms of numbers of people infected and pressure on their national health care systems), but also indirect via their relationship with the European Union.<sup>5</sup> The sharp decline in EU GDP in the first half of 2020 has had a marked effect on export orders, while travel restrictions brought about a collapse in tourism revenue – an important source of export earnings for many countries. Similarly, labour-market opportunities in Europe for migrant workers have declined sharply, leading to a steep fall in remittances, another major source of national income in the countries under consideration (OECD 2020).

## The EU's economic relationship with its eastern and southern neighbours

### DCFTA

The EU's economic relationship with a number of its eastern neighbours has intensified over time, most recently as a result of the Deep and Comprehensive Free Trade Areas (DCFTA) established between the European Union, and Georgia, the Republic of Moldova and Ukraine. DCFTAs go beyond “standard” FTAs by offering some of the benefits of integration into the EU's Single Market to non-EEA member states.

The EU's economic relationship with its southern neighbours has not yet reached the same depth. Morocco and Tunisia have signed Association Agreements with the EU but DCFTA negotiations are on hold (European Commission 2020). Jordan similarly has an EU-Association Agreement but unlike the other two southern neighbours has not yet officially launched negotiations on a future DCFTA (ibid.).

It is too early to tell what long-term effect the DCFTAs will have as the full benefits of deeper economic integration and more comprehensive trade relationships generally take many years to materialise. However, early evidence suggests that in the case of Georgia, Moldova and Ukraine the DCFTAs have had a positive effect on exports but less so on foreign direct investment (Berlin Economics 2019).<sup>6</sup>

### Trade flows

Table 1 shows bilateral goods trade between the EU and its eastern and southern neighbours as a share of the EU's goods trade with the rest of the world. Between 2009 and 2019 the countries managed to increase their share from 5.1 percent to 5.5 percent, to the benefit of Morocco and Ukraine and the loss of Tunisia. Trade volumes between the EU and Ukraine have been rather volatile over the whole period, with sharp falls offset by subsequent rapid increases.

<sup>5</sup> See for example Bertelsmann Stiftung (2020a) and Bertelsmann Stiftung (2020b).

<sup>6</sup> For further information on how DCFTAs might succeed, see Adarov and Havlik (2017), and Rudloff (2020).

TABLE 1: **Bilateral trade in goods between the EU and its neighbours** (sum of exports and imports, % of EU's extra-EU trade)

	2009	2016	2019
Georgia	0,1	0,1	0,1
Jordan	0,2	0,2	0,2
Moldova	0,1	0,2	0,2
Morocco	1,5	1,9	1,9
Tunisia	1,4	1,2	1,0
Ukraine	1,8	1,7	2,1

Source: European Union Trade in Goods (DG Trade).

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In all cases trade in goods was substantially larger than in services, which comes as expected given the current Association Agreements and is in line with global trade patterns more generally.

Clearly, from the EU's perspective, the neighbourhood countries only play a minor role in terms of trade relations and any changes are too small to make a marked difference to European trade patterns. From the perspective of a neighbourhood country the picture might well be different though: what might appear to be minor changes in terms of trade patterns could in

fact be considerable steps forward for a particular country in terms of its economic development and future growth potential.

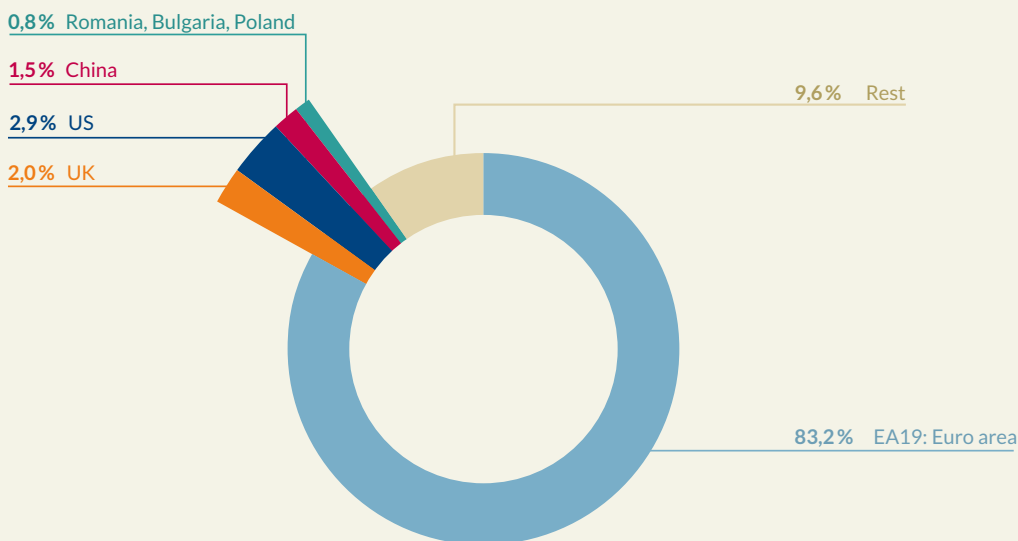
### Trade in value added – value chains

Bilateral trade flows do not necessarily reflect the economic interactions arising from supply chains though. These are better captured by trade in value added (TiVA) data, as for example published by the Organisation for Economic Cooperation and Development (OECD).

Chart 1 shows the origin of the value added embedded in euro-area exports to the rest of the world. For example, a German car assembled in Germany and sold outside the euro area will have had many components manufactured somewhere else. Similarly, the value of the car will reflect services provided outside the euro area, e.g. design, marketing, financial or legal services.

The chart shows that in 2015 (the latest year for which these data are available) the overwhelming majority of value added embedded in euro area exports to the rest of the world came from the euro area itself – 83 percent. Only 5 percent (together) came from the US and the UK, 1.5 percent from China, and 0.8 percent from Bulgaria, Poland and Romania (which are EU member states but not in the euro area) combined. The rest of the world made up less than 10 percent, with Russia and Japan

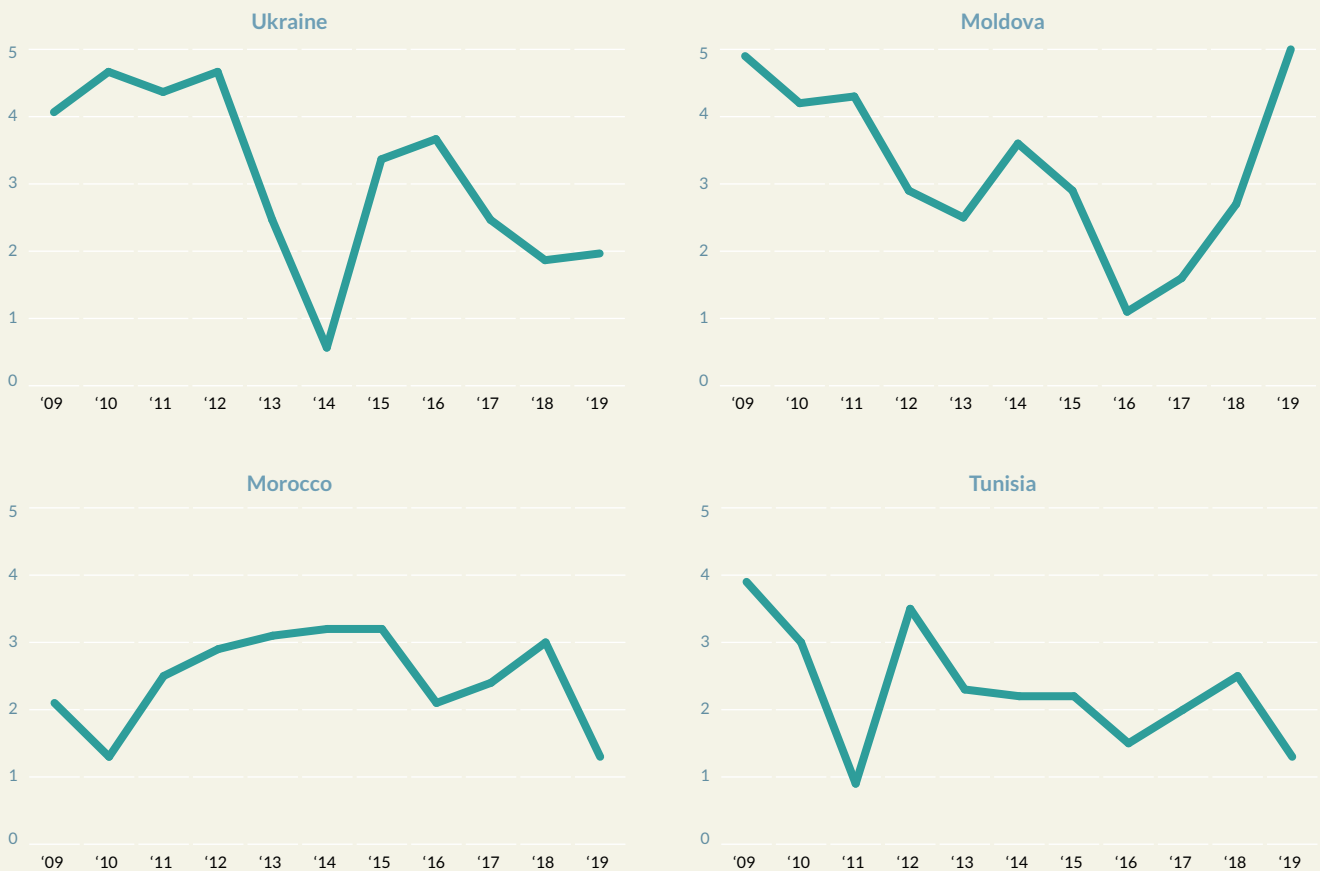
CHART 1: **Origin of value added in euro area exports (2015)**



Source: OECD TiVA.

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CHART 2: FDI Ukraine, Tunisia, Morocco, Moldova (share of GDP)



Source: World Bank Development Indicators.

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leading this group. Not shown in this chart is the concentration within the euro area itself: nearly two thirds of value added originating from within the euro area come from three countries only: Germany, France and Italy.

That said, the above numbers do not fully reveal the increase in integration that has taken place since the mid 2000s when Bulgaria, Poland and Romania joined the EU. While low in absolute terms, the 0.8 percent share is significantly higher than a decade earlier. Similarly, over the same period, Bulgaria, Poland and Romania became more important sources of value added embedded in EU28 final demand: their share increased from 2.8 percent to 3.8 percent even though the EU28 overall became a marginally less important source of value added embedded in EU28 final demand. This represents a significant increase for the countries in question.<sup>7</sup>

<sup>7</sup> The OECD previously announced to publish the next (2018) TiVA statistics in September. The data will now be published at a later stage.

## Foreign direct investment

Charts 2a to 2d show the annual net inflows of foreign direct investment (FDI) as a share of GDP into Ukraine, Moldova, Morocco and Tunisia. These net inflows originated from the rest of the world, not the EU or euro area only.

Chart 2a shows that net FDI flows into Ukraine collapsed in 2014 and have remained at a lower level than pre-crisis. By contrast, FDI flows into Moldova bottomed out in 2016 and were on an upward trajectory over the last three years. In Morocco net FDI flows have fluctuated around 2 percent of GDP over the last decade, with no discernible trend apparent. Meanwhile FDI into Tunisia has averaged between 2 and 3 percent of GDP since 2013 and as such lower than what was recorded prior to the “Arab Spring” in 2011.

## Business environment and policy challenges

### The forces shaping global supply chains

It has been suggested that global trade tensions and Covid-19 could lead to a reconfiguration of global supply chains, with proximity – from “globalisation to regionalisation” – becoming increasingly important (Cordon 2020).

Businesses will only contemplate these fundamental changes to their business models if the expected benefits outweigh the substantial costs in the long term (Chatham House 2020, and Bank of America 2020).

For this to happen many businesses will have to conclude that the current geopolitical tensions are here to stay and that Covid-19 will have lasting impact. Reducing transport costs and emissions might be an additional impetus for businesses to move production closer to markets.

### Could the EU's neighbours benefit?

Suppose European businesses conclude that the expected benefits of bringing supply chains closer to home outweigh the significant costs of doing so.

Under what circumstances could the EU's eastern and southern neighbours benefit from such a development?

Businesses would base their investment decisions on a range of factors, with labour costs (more precisely per unit labour costs, which adjusts for productivity differences) constituting only one criterion. The overall attractiveness of a location will depend on its overall business environment, which covers inter alia the rule of law, governance, labour skills, access to financing, trade relationships and administrative burden.

From the perspective of a potential European investor, the EU's eastern and southern neighbours would most likely be in competition with the newer EU member states such as Poland, Bulgaria, Romania, which have joined since 2004, as well as Turkey.

Especially the former will represent tough competition due to the fact that they are also members of the EU's Single Market.

The World Bank's Doing Business rankings, the European Bank for Reconstruction and Development's Transition scores for six qualities of a sustainable market economy and the Bertelsmann Stiftung's BTI Transformation Index provide insights into countries' relative attractiveness.

Table 2 shows – in alphabetical order – the ranking of key EU neighbours and a number of relevant EU member states in the current World Bank's Doing Business survey (World Bank 2020). For comparison, Turkey is also added.

Most countries are ranked in the 40s to 60s; Georgia, at 7th, stands out with Jordan and Tunisia trailing somewhat. Importantly though, countries such as Ukraine, Moldova or Morocco have similar rankings to Bulgaria or Romania.

The Annex provides the rankings for the sub-categories starting a business, dealing with construction permits, getting electricity, registering property, taking up credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts and resolving insolvency.

All these aspects are crucial for businesses to operate and will influence investment decisions.

The EBRD's scores for six qualities of a sustainable market economy provide further insights. They are:

- Competitive
- Well governed
- Green
- Inclusive
- Resilient
- Integrated

TABLE 2: World Bank Doing Business

	Global rank
Bulgaria	61
Georgia	7
Jordan	75
Moldova	48
Morocco	53
Poland	40
Romania	55
Tunisia	78
Turkey	33
Ukraine	64

Source: World Bank (2020).

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TABLE 3: EBRD Transition indicators

	Competitive	Well governed
Bulgaria	5,71	5,79
Georgia	4,98	6,4
Jordan	4,18	6,23
Moldova	4,36	4,81
Morocco	4,49	5,34
Poland	6,76	6,82
Romania	6,01	6,04
Tunisia	3,93	4,88
Turkey	5,42	6,18
Ukraine	4,77	4,78

Source: EBRD Transition Report 2019–2020.

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TABLE 4: Transformation indices

	Political	Economic	Governance
Bulgaria	7,95	7,57	6,18
Georgia	6,60	6,18	5,86
Jordan	4,32	5,96	4,86
Moldova	5,80	5,75	4,89
Morocco	3,68	5,71	4,40
Poland	7,95	8,36	6,15
Romania	7,65	7,64	4,85
Tunisia	6,55	6,21	5,43
Turkey	4,92	6,11	4,05
Ukraine	6,90	6,71	5,52

Source: Bertelsmann Stiftung, 2020.

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This development could open up opportunities for countries that have traditionally specialized in low value-added primary or secondary production. Depending on the skills of the workforce and the quality of its digital infrastructure, these countries might offer a “value proposition” to businesses.

Moving into these activities would not imply the challenges that come with becoming part of manufacturing value chains,

Table 3 shows the scores for the first two qualities, competitive and well governed, the Annex presents the scores for all six qualities.

The EU member states generally score more highly on these qualities than the EU’s neighbours, though Georgia and Jordan do at least well in terms of governance.

According to the BTI Transformation indices, the included EU member states generally do better than the rest. This is true in terms of political and economic transformation and – with the exception of Romania – also governance transformation. Countries in the eastern neighbourhood and Tunisia perform better though than say Turkey (a useful benchmark), while Jordan and Morocco trail behind (see Table 4).

### Does Covid-19 offer new opportunities?

Neither the World Bank’s, EBRD’s nor BTI’s latest rankings take into account the consequences of Covid-19 on global economic structures or on the EU’s eastern and southern neighbours.<sup>8</sup>

While Covid-19 will have created many new challenges, it might also offer new opportunities. For example, one potential outcome of Covid-19 could be that businesses will re-imagine the way they work and allocate activities across locations, with remote working and video-conferencing increasingly becoming established.

<sup>8</sup> For a discussion of what the BTI 2020 results mean in a Covid-19 context, see Hartmann (2020).

which generally incur high fixed (and often irreversible “sunk”) costs.

It is, however, too early to tell whether this is a real opportunity that could support sustainable economic development.

### Policy challenges and options

The rankings presented above suggest a range of policy priorities in the EU’s eastern and southern neighbourhood. Among these, improving governance must be one of the most important and will be key to making the regions more attractive to foreign investors.

In particular, the degree of informal decision-making, often a legacy of former authoritarian state structures, continues to stand in the way of development in the EU’s eastern neighbourhood. Foreign investors need to be sure that elected politicians do not succumb to the demands and political pressures of domestic economic players, and their oligarchic and monopolistic interests.<sup>9</sup> In the best-case, local politicians demonstrate a clear understanding of what responsible investor relations require, including a stable legislative and regulatory regime. This would in turn reduce business risks and ultimately lead to lower costs for both businesses and consumers.

<sup>9</sup> For an analysis on the interdependencies between the rule of law and corruption in Georgia (as well as Armenia and Azerbaijan) see Stöber (2020).



Establishing trusted relationships would inspire confidence and support further efforts to transform economies. It would also help establish dependable financial infrastructure with reliable (western) partners.

Governance is also an issue in the EU's southern neighbourhood but there are more basic challenges that need to be addressed. For example, basic electricity generation and broadband capacity is lacking in many parts of Morocco, Tunisia and Jordan. Investing in these would be a necessary first step towards exploring any new opportunities created by Covid-19.

The EU's neighbours should also proactively develop a "value proposition" and identify areas of collaboration with the EU. Could, for example, their green and digital transition contribute to the success of the European Commission's Green Deal agenda – for instance by exporting wind- and/or solar-generated electricity into the EU's electricity market?

With respect to the EU itself, it should insist that policy makers in its neighbourhood pursue an approach of clarity, consistency and transparency when establishing legislative and regulatory regimes, in all sectors. This is the only means to encourage economic transformation that would ultimately benefit consumers and society at large.

In addition to these deep-rooted structural challenges, the EU should consider how it could most effectively help its neighbours recover from the Covid-19 crisis. There are increasing demands for unconditional debt relief, higher and more predictable quotas for agricultural exports and ensuring easier access for seasonal workers to the European labour markets.<sup>10</sup>

## Conclusions

This paper showed that more than four-fifths of value added embedded in euro-area exports to the rest of the world was created within the euro area itself. And within this area, nearly two thirds of value added came from three countries alone. Meanwhile, Bulgaria, Poland and Romania combined contribute less than one percent of value added embedded in euro-area exports to the rest of the world.

Against this background it is likely that the EU's eastern and southern neighbours will find it challenging to attract significant parts of the value creation process, even if businesses actively consider reconfiguring their supply chains in the light of geopolitical developments. That said, even small reallocations of production from – say – China could make a significant difference to the countries given their generally low starting point. In some countries this might be easier than in others given existing structures: Morocco, for example, already plays an important role in European car and textile supply chains and ought to be able to build on this achievement relatively easily in the future (CBI 2018).

To increase their chances of success, the EU's neighbouring countries ought to improve their competitiveness; to most of them, the same applies to their quality of governance, with a view to standing their ground against the EU's eastern and south-eastern members. While governance in some of these countries may also still be an issue, the EU at least provides a legal framework that protects consumers and investors alike.

Within the EU neighbourhood, consumer and investor protection is the least developed in the non-associated neighbours. To help the countries in the entire European neighbourhood become more attractive for business, the best advice for the EU is to do more of the same: support governance reforms and foster the rule of law.

But much of the burden will rest with the countries themselves: they will need to establish the conditions under which foreign investors wish to operate and will need to make a stronger case for themselves on this basis. Businesses, especially those prepared to make substantial, irreversible investments, will go where the political and economic situation is stable and predictable. At least some of the EU's neighbours still have a lot of catching up to do to provide such a business environment.

<sup>10</sup> Based on informal discussions with stakeholders in Rabat, Tunis and Amman in 2019 and 2020.

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## Annex

TABLE 5: World Bank Doing Business in 2020

	Global Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Minority Investors	Paying Taxes	Trading across Borders	Enforcing Contracts	Resolving Insolvency
Bulgaria	61	113	43	151	66	67	25	97	21	42	61
Georgia	7	2	21	42	5	15	7	14	45	12	64
Jordan	75	120	138	69	78	4	105	62	75	110	112
Moldova	48	13	156	84	22	48	45	33	38	62	67
Morocco	53	43	16	34	81	119	37	24	58	60	73
Poland	40	128	39	60	92	37	51	77	1	55	25
Romania	55	91	147	157	46	25	61	32	1	19	56
Tunisia	78	19	32	63	94	104	61	108	90	88	69
Turkey	33	77	53	41	27	37	21	26	44	24	120
Ukraine	64	61	20	128	61	37	45	65	74	63	146

Source: World Bank (2020).

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TABLE 6: EBRD Transition indicators 2019-20

	Competitive	Well-governed	Green	Inclusive	Resilient	Integrated
Bulgaria	5,71	5,79	6,04	6,24	6,91	6,85
Georgia	4,98	6,40	5,32	5,14	6,19	6,35
Jordan	4,18	6,23	5,85	4,36	6,18	5,81
Moldova	4,36	4,81	4,68	5,58	5,82	4,94
Morocco	4,49	5,34	5,87	3,17	5,73	4,88
Poland	6,76	6,82	6,52	6,81	7,86	6,81
Romania	6,01	6,04	6,14	5,74	7,11	6,75
Tunisia	3,93	4,88	4,92	3,82	5,1	4,33
Turkey	5,42	6,18	5,28	5,01	7,02	5,7
Ukraine	4,77	4,78	5,87	6,21	5,67	4,75

Source: EBRD Transition Report 2019-2020.

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## About the project

Current crises and conflicts in the EU's neighbourhood have a destabilizing effect on the EU and its Member States. Under the Bertelsmann Stiftung's "Europe's Future" program, the project "Strategies for the EU Neighbourhood" aims to provide policymakers with the impetus to develop solutions for a European Neighbourhood Policy that effectively influences transformation processes in neighbouring countries, leading to more security, stability and prosperity for all sides.

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Bertelsmann Stiftung  
Carl-Bertelsmann-Str. 256  
33311 Gütersloh  
[www.bertelsmann-stiftung.de](http://www.bertelsmann-stiftung.de)

### Responsible for content:

Christian Hanelt

### Contact:

Frank Eich, External Advisor  
Christian Hanelt, Senior Expert  
Miriam Kosmehl, Senior Expert  
Program Europe's Future  
Phone: +49 30 275788-125  
E-Mail: [christian.hanelt@bertelsmann-stiftung.de](mailto:christian.hanelt@bertelsmann-stiftung.de)

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