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Restructuring Through FDI in Romanian Manufacturing

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Abstract

Romania has experienced a drawn-out transformation process and received relatively low amounts of foreign direct investment (FDI). But it has become competitive in labour-intensive manufacturing industries through the integration into European company networks by processing trade. The country has also achieved economic growth supported by a massive export expansion for the third year running in 2002, after long and deep setbacks. The FDI inflows of the last five years have decisively contributed to the resumption of economic growth and the recovery of exports. But flowing at the current speed and in the current structure, FDI will not be able to restructure the Romanian economy in a way for it to stay on a rapid economic growth path.

Despite the low amount of FDI in Romania as compared with the more advanced transition countries, foreign penetration in the manufacturing industry is high. With a database relying on company balance sheets, the performance of foreign affiliates in manufacturing industries was analysed. An important finding is that significant foreign presence in an industry coincides with increasing export performance. Foreign affiliates have so far had a conserving rather than restructuring effect on Romania's foreign trade structure. FDI reinforced Romania's traditional specialization in clothing, footwear and metals. They are also the driving force behind the emergence of exports in the electrical machinery and electronics sector. We can foresee a similar development in the car industry in the future. More success in new export industries was hindered by unfavourable conditions for green-field investments.

Keywords: foreign direct investment, restructuring, foreign investment enterprises, foreign trade, privatization, Romania

JEL classification: F14, F21, F23, O14, P21, P27

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Restructuring Through FDI in Romanian Manufacturing*

1 The role of FDI in transition countries

The transition countries joined the club of FDI targets in the early 1990s with opening up their economies to international capital flows. Some of them advanced to functioning market economies quite rapidly and have become increasingly popular locations for FDI. The inflow of foreign capital, in turn, accelerated the transformation process through participation in privatization and introducing modern marketing and management methods. In countries where the transformation policy was hesitant and privatization proceeded with delay, the FDI inflow remained meagre which further delayed market-based development. The import of technology and know-how could only partly be replaced with learning-by-doing and those countries were left back in terms of restructuring and modernization.

The size of FDI in the Central and East European countries (CEECs) has mainly been determined by the speed of market opening and privatization (Hunya and Kalotay, 2000). In the initial period, the access to domestic markets was the primary motivation of investors. Lately this motive has been confined to the financial and other services sectors, while in manufacturing production cost advantages gave rise to export-oriented investments.

Among the more advanced CEECs, Hungary started privatization by sales to foreigners ahead of other countries and sold most of the assets slated for privatization by the late 1990s. It also pursued an investor-friendly economic policy (Éltetö, 2001) and thus became the first major target in the region for green-field investments. Less and less new investments chose the country for labour cost reasons lately but assembly-type industries dominate among foreign firms. The share of high-tech products in exports is the highest among the CEECs and most of these exports come from foreign affiliates. But high-tech products are not necessarily demanding high-skill labour. Only in recent times do some research and development subsidiaries settle next to modern production centres. The Czech Republic and Poland have become major FDI targets since the late 1990s. Stepped-up large-scale privatization and new investment incentives for green-field investors exerted stimulating effects. In these countries assembly-type subsidiaries were set up in medium- and high-tech industries. Green-field investments boosted manufacturing exports especially in the Czech Republic, while in Poland, larger in size, FDI has been more domestic-market oriented (Hunya, 2001).

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In both the Czech Republic and Hungary FDI helped to a decisive degree to overcome transformation-related recessions in the mid-1990s. The sale of state-owned assets to foreign investors helped to correct high current account deficits, and speeded up industrial and banking sector restructuring. Both countries are now on a sustainable economic growth path. These positive effects are present also in other CEECs to various degrees.

A high degree of foreign control raised debates concerning the sustainability of FDI inflows, the related income outflows and the pace of technological change. Although is seems that no successful transformation can be carried through without a massive presence of foreign affiliates, future developments will also depend on the acquiring of new and more sophisticated competencies, such as research and headquarters.

We generally know less about the characteristics and impact of FDI in the less developed CEECs. Data are more scarce and domestic research less developed. Privatization and FDI started later in these countries and has attracted less FDI per capita and in relation to GDP than in the more advanced countries. Romania (as elaborated below) has featured a drawn-out transformation process and relatively low amounts of FDI inflow. But it has become competitive in labour-intensive manufacturing industries through the integration into European company networks by processing trade. The country has also achieved economic growth supported by a massive expansion of exports for the third year in a row in 2002 after long and deep setbacks.

The recent developments in Romania raise the following questions:

– To what extent is the recovery based on the impact of FDI?
– Is growth sustainable, and what can be the role of foreign affiliates in it?
– What is the specialization pattern of production and exports emerging due to foreign penetration?

Before answering these questions, chapter 2 provides an overview of the relevant economic policy framework, the external balances and the privatization policy. These topics are presented both for the period 1998-2000 as a background to the analysis of the characteristics of the foreign sector provided in chapters 5-8, and for the last two years to demonstrate current trends. It is argued that these main problem areas would get a relief with increasing FDI. The overview of foreign trade structures in chapter 3 presents the major shift in trade volumes. Chapter 4 discusses the main trends of FDI in Romania. The performance of the foreign affiliates in manufacturing is the subject of chapters 5-8, followed by conclusions.

2 Some features of slow transformation in Romania

With twelve years having elapsed since the beginning of the transformation to a market economy, Romania is still far from having completed this process. While inherited structures could be blamed for the slow progress in the early years, now it is mainly policy inconsistency that causes delays. Nevertheless, even if in a stop-go manner, Romania's transformation has progressed especially in the last five years and investors can expect much better institutional conditions than before. In the following we deal with just two features that hindered economic growth and transformation: external financial constraints and privatization policies. These two features are directly linked with the insufficient amount of foreign direct investment. We shall also stress the remarkable progress that Romania has made since 2000 in terms of gaining financial stability and progressing privatization.

In many respects Romania progresses along the standard track of economic transformation and is but a few years behind the more advanced CEECs. On the other hand it also develops marked features of crony, relation-based capitalism and captured state similar to those in Balkan and CIS countries (Hellman et al., 2000; Peev, 2002). In the third section of this chapter we summarize the relevance of various pressures on economic policy-making.

Powerful external constraints

Several times during the past decade the Romanian economy seemed to have entered a phase of rapid growth. But sooner rather than later these growth episodes turned into crises necessitating painful adjustments (see for details Hunya, 1999 as well as Rühl and Daianu, 2000). In 2001 we witnessed yet another boom in industrial output, wages and employment – and imports. The problem is that, as in the past, the vigour is connected with lax wage policy in the public sector (still very widespread), softening of tax discipline (rising arrears) and is accompanied by high inflation. (See Table 1 for statistical information.)

Already in the mid-1990s Romania had enjoyed an economic upswing that had been based on foreign borrowing but failed to create the production base required for earning the foreign revenues needed for repayment. Nor could the country establish itself as a reliable borrower due to weak public governance, the slow speed of restructuring and low foreign currency reserves. The unavoidable stabilization measures in 1997 resulted in a second transformation-related recession. The important steps taken in the field of liberalization were not followed by similarly decisive steps in the field of privatization.

Table 1

Romania: selected economic indicators

	1995	1996	1997	1998	1999	2000	2001 [1]	2002 forecast
Population, th pers., mid-year	22681.0	22607.6	22545.9	22502.8	22458.0	22435.2	22409.0	21698.2 [2]
Gross domestic product, ROL bn, nom.	72136	108920	252926	371194	545730	800308	1154126	1485000
annual change in % (real)	7.1	3.9	-6.1	-4.8	-1.2	1.8	5.3	3
GDP/capita (USD at exchange rate)	1564	1563	1565	1872	1585	1644	1772	.
GDP/capita (USD at PPP - WIIW)	6210	6630	5640	5450	5510	5740	6180	.
Gross industrial production								
annual change in % (real)	9.4	6.3	-7.2	-13.8	-2.4	7.1	8.2	4
Gross agricultural production								
annual change in % (real)	4.5	1.3	3.4	-7.5	5.2	-14.2	21.7	.
Gross fixed capital formation, ROL bn, nom.	15424.9	24998.5	53540.1	68111.6	96630.4	151486.2	219289.3	.
annual change in % (real)	7.0	5.7	1.7	-5.7	-4.8	4.6	6.6	4
Construction output total								
annual change in % (real)	13.2	3.7	-24.4	-0.5	-0.2	2.8	4.1	.
Employment total, th pers., end of period	9493.0	9379.0	9022.7	8812.6	8420.0	8629.0	.	.
annual change in %	-5.2	-1.2	-3.8	-2.3	-4.5	2.5	.	.
Employees in industry, th pers., average	2614.7	2586.0	2443.0	2272.0	1991.0	1873.0	1817.0	.
annual change in %	-8.4	-1.1	-5.5	-7.0	-12.4	-5.9	-3.0	.
Unemployed reg., th, end of period	998.4	657.6	881.4	1025.1	1130.3	1007.1	826.9	.
Unemployment rate in %, end of period	9.5	6.6	8.9	10.4	11.8	10.5	8.6	12
Average gross monthly wages, ROL	281287	426610	846450	1357132	1957731	2876645	4282622	.
annual change in % (real, net)	12.0	9.3	-22.6	3.4	-3.8	4.6	6.1	.
Retail trade turnover, ROL bn [3]	22242	35316	83035	125513	160137	213569	.	.
annual change in % (real) [3]	29.0	15.3	-12.1	20.6	-6.4	-7.0	0.4	.
Consumer prices, % p.a.	32.3	38.8	154.8	59.1	45.8	45.7	34.5	25
Producer prices in industry, % p.a.	35.1	49.9	152.7	33.2	44.5	53.4	41.0	.
Central government budget, ROL bn								
Revenues	12888	18373	43835	67216	93240	120342	148203	.
Expenditures	15858	23732	52897	77617	106887	149168	184012	.
Deficit (-) / surplus (+)	-2970	-5359	-9062	-10401	-13647	-28826	-35809	.
Deficit (-) / surplus (+), % GDP	-4.1	-4.9	-3.6	-2.8	-2.5	-3.6	-3.1	.
Money supply, ROL bn, end of period								
M1, Money	7083	11173	18731	22110	29669	46331	64309	.
M2, money + quasi money	18278	30335	62150	92530	134123	185060	270512	.
Discount rate, % p.a., end of period	34.1	35.0	40.0	35.0	35.0	35.0	35.0	.
Current account, USD mn	-1774	-2571	-2137	-2968	-1469	-1363	-2349	-2000
Current account in % of GDP	-5.0	-7.3	-6.1	-7.1	-4.1	-3.7	-5.9	-4.4
FDI inflow, net, USD mn	417	263	1224	2040	1025	1051	1154	
Gross reserves of NB excl. gold, USD mn	334.1	550.7	2193.5	1374.8	1526.3	2469.7	3922.5	.
Gross external debt, USD mn [4]	5482.1	7208.9	8584.3	9322.6	8770.7	10240.5	11685.5	.
Exports total, fob, USD mn	7910.0	8084.5	8431.1	8302.0	8487.0	10366.5	11385.0	12500
annual growth rate in %	28.6	2.2	4.3	-1.5	2.2	22.1	9.8	10
Imports total, cif, USD mn	10277.9	11435.3	11279.7	11837.8	10557.0	13054.5	15551.6	16800
annual growth rate in %	44.6	11.3	-1.4	4.9	-10.8	23.7	19.1	8
Average exchange rate ROL/USD	2033.3	3082.6	7167.9	8875.6	15332.9	21692.7	29060.9	33000
Average exchange rate ROL/EUR (ECU)	2629.5	3862.9	8090.9	9989.3	16295.6	19955.8	26026.9	32000

1) Preliminary. - 2) According to census March 2002. - 3) From 1998 new methodology. - 4) Medium- and long-term.

Source: WIIW Database incorporating national statistics; WIIW forecasts.

In 1999, the worst-case economic scenario – i.e. the country defaulting on foreign debts – could only be avoided by domestic borrowing and abandoning the inflation target previously set. GDP dropped by 1.2% (after -4.8% in 1998) and average annual inflation rose to 46%, almost double the official target of 25%. Devaluation played an important role in diminishing consumer goods imports. It also fuelled inflation and stimulated exports.

The external constraints on economic growth eased in 2000 and further on in the two subsequent years. There was also a fiscal reform which lowered corporate income tax to 25%. But income generated by exports became subject to only 5% tax which may have contributed to the export boom.

The resumption of economic growth in 2000 was fuelled by external demand, in 2001 by domestic demand. The current account deficit for 2001 expanded to almost 6% of GDP. The main source was the expansion of the deficit in commodity trade as imports grew nearly twice as fast as exports. Shrinking demand in western Europe had a delayed but all the more obvious effect in November and December when exports declined below the previous year's level. While the export boom of the last two years faded away, imports stayed at a record high level. Financing the current account deficit presented no problem due to the inflow of foreign capital exceeding all expectations. The country's presence on the Eurobond market was firmly established, although the interest rates of around 10% on Romanian government securities entailed an onerous risk premium. Furthermore, the government guaranteed the issuance of company bonds for state-owned companies with questionable balance sheets, thus contributing to an increase in portfolio investments. FDI was about one half of the capital inflows. Official reserves (without gold) increased from two to over three months of imports of goods and non-factor services. The debt to GDP ratio increased from 27% to a relatively modest level of 30% of GDP, and the debt service ratio stood at about 17%. These indicators suggest a remarkable degree of external financial stability, also borne out by the improvement in the country's international risk ratings. In 2002 ratings further improved and capital inflows continued so that reserves increased to five months of imports. Exports were up by 6.9% year-on-year in USD terms in the first four months of the year while imports increased by 1.6% only. The current account deficit decreased by 29% compared with the same period a year earlier due to both improvements in the commodity trade balance and increasing current transfers. Transfers of Romanians living abroad covered more than half of the trade and services deficit. Improved investment ratings and good return prospects have increasingly attracted foreign portfolio investors to Romania. As pointed out below, FDI inflows reached USD 1.1 billion annually in the last three years. They came mainly neither as new green-field investment projects, nether were there significant privatization revenues. FDI came mainly during the post-privatization restructuring in the form of foreign take-over or capital increase of privatized companies.

The current external stability is also based on short-term money which flew into Romanian government securities offering high yields. The possible reversal of this trend comprises one of the major risks. Another risk is the sustainability of exports. As pointed out later, export structures have hardly changed and revenues are dependent on the West European consumer demand. The risk attached to high current account deficits eased by mid-2002 mainly due to the development of the USD/EUR exchange rate. As Romanian imports are to a large extent in dollars while exports in euros, the foreign trade gap has shrunk.

Hesitant privatization and slow restructuring

The overcoming of problems related to economic growth and inflation required budgetary tightening and the privatization of the remaining state-owned enterprises (SOEs). Adjustment of the public sector proved to be a drawn-out process. Aggregate balance sheet data for both 1999 and 2000 indicate that private companies made profits while state-owned and mixed companies produced losses.

Privatization picked up a bit after 1997 due to changes in the privatization law and the introduction of new and more transparent privatization mechanisms supported by the World Bank. With utilities included, only about 15% of all large enterprises' assets were privatized by 2000. Continued losses, the pressure of tighter fiscal policies and the elimination of subsidies led to an accumulation of inter-enterprise arrears in the economy, estimated at 38% of GDP in that year.

The banking sector reform started late but was more effective than industrial restructuring. The bank privatization law was passed in 1997 and rehabilitation plans for the main lossmakers were worked out. As of December 2000, there were 33 fully licensed banks in Romania of which four were state-owned and two of which were privatized the following years. There were also 21 foreign-owned banks among them. The share of the public sector declined from 85% of the banking assets in 1998 to 47% in 2000 and further to the current 35%. During the process of bank restructuring since 1998 bad debts have been either written off or shifted to a state agency. As a result, the size of overdue and doubtful loans in per cent of the own capital of banks decreased from over 250% in 1998 to 31% in 1999 and below 5% in 2000. The same debts as a per cent of all banking assets decreased from 16% to 0.5%. The capital adequacy ratio increased from 6% in 1998 to 10% in 2000. This means that the Romanian banking system is now cleaned from the old portfolios and the remaining state banks can more easily go private.

Banks with quite healthy portfolios have almost stopped lending to the enterprise sector: the ratio of bank credit to GDP was 12.4% at the end of 2001. Yields on virtually risk-free T-bills became higher than lending rates and crowded out the private sector. As the government wants to meet about 70% of its funding requirements externally, the convenient financing of banks by T-bills is coming to an end. It is hoped that domestic banks may start lending to firms. Lower minimum reserve requirements and a more liquid secondary market for government debt would also free capital for corporate lending.

Soft financing since 2000 shifted from the banking sector to the general budget in the form of either tax arrears to the government and specialized budgets, or payment arrears to the state-owned utility companies. Arrears in 2002 are at about 42% of GDP, decreasing only if public debt is forgiven. In order to solve the liquidity problems facing state-owned companies, the government resorted to a mix of sectoral policies ranging from partial bailouts and temporary direct subsidies to major indebted companies faced with the threat of closure to outright privatization. These measures were often applied on an ad-hoc basis and modified in the event of worker resistance becoming too fierce.

In 2001 the government revitalized some idle capacities and displayed greater tolerance towards tax arrears in the economy as a whole than it had previously. The arrears accumulated by the 200 principal debtors vis-à-vis the general government increased by 10% in real terms in the first half of 2001. Quite possibly, the increase may not have stretched into the second half of the year: arrears drop when debts are forgiven. But forgiving debts is just another form of subsidization. In the third quarter the authorities reduced the debts of a number of major enterprises and only a small amount of that was connected to privatization.

Political and economic stability improved compared to the second half of the 1990s. The major economic achievement in 2001 was robust GDP growth of 5.3% with an output boom registered in all main economic sectors. Even if this is to a large extent the result of growing inventories, the country is clearly on a growth path after several years of severe setbacks. Economic growth demonstrates that a healthy part of the economy is able to export and to meet the necessities of the local market. This happens despite the mess in the public sector and the poor performance of public governance.

Most of the small and medium-size manufacturing companies have become private. Privatization in manufacturing has finally reached the stage when mostly large companies have been offered to investors. These companies are either sound and therefore the government keeps waiting for a high-price offer, or heavily indebted and in arrears with taxes, requiring financial restructuring prior to or during the privatization process. In mid-April 2002, 595 state-owned companies were in the process of reorganization and liquidation. With the corporatization of state-owned enterprises ('regies autonomes') in the utilities sector and splitting some of them into potentially competing units, the prerequisites of future privatization have been established. But setting cost-covering utility prices can hardly be achieved due to the low efficiency in the sector and the low purchasing power of the population. The long delayed privatization of agricultural and tourism companies has been put under way in 2002.

In March 2002, the government submitted to parliament a new legislative initiative for the acceleration of privatization. Instead of cancelling the previous privatization legislation and replacing it with a new text, Law No. 137/2002 completes the earlier text with new provisions. There is a provision for selling off companies for a symbolic value ('1 euro'). This is implicitly aimed to be applied to companies in financial distress. The government assumes that these companies are worth preserving: the new owner is expected to offer new capital investment and maintain the workforce. It is to be seen whether potential investors will be prepared to make such efforts for unattractive companies. As an alternative, liquidating the company and selling off physical assets could be a more rapid way of divestiture.

The new law attaches great importance to the issue of working out the debts incurred by state-owned companies prior to their privatization and brings another novelty in the legal framework of privatization by introducing 'special administration' for companies undergoing privatization until the ownership of the shares is transferred to the buyer. While privatization may become easier by the new rules it also generates moral hazard problems. Companies slated for privatization may lose the incentive for honouring their obligations towards the various public budgets based on the expectation that they will be bailed out anyway. The claims of the utility suppliers on companies slated for privatization can also be cancelled, reduced, re-scheduled or converted into equity. The law empowers the ministry of public finances to grant alleviation of utility suppliers' own obligations towards the state budget, which equals the debt alleviation they grant to companies undergoing privatization.

Although some of the main obstacles to privatization have been eliminated, we do not expect that the privatization and restructuring process will speed up because of the new legislation. There is ample offer for sale to foreign investors for another two to three years. Economic growth will most probably stay at 3-4% in the 2002-2005 period. There will be a continuing slow decrease of inflation and slow real appreciation. Financing the current account deficit at some 5% of GDP seems to be no problem, unless the deficit starts growing again.

The current economic policy framework

For the transformation period as a whole, the performance of Romania in terms of economic growth and inflation is one of the worst among the EU accession countries. The progress of restructuring and privatization has been the slowest. The efforts to save capacities and cushion the employment impact of structural change had high priority but did not yield the expected results.

After allegedly continuous efforts to privatize the economy, almost half of the industrial value added is still produced by state-owned enterprises. Asset stripping and profit privatization has been widespread. What is left for privatization beyond utilities are mainly companies with run-down assets and weak financial standing with accumulated debts and arrears to the budget and to suppliers. The lack of effective insolvency mechanisms for indebted state-owned companies discourages restructuring and liquidation. The failure to impose financial discipline on state-owned enterprises does not have objective grounds after twelve years of transition, it rather demonstrates the weakness of the political and legal systems.

The cause of the uneven performance is that the government is obliged to manoeuvre between at least three obstacles:

- burdensome reforms, appearing as pressure from international organizations, call for austerity and restructuring *cum* privatization;
- the population, represented by trade unions and voters, calls for higher living standards and less painful restructuring, which may overstrain the budget;
- strong pressure groups demand benefits in exchange for their financial support.

Giving each of these parties something, but withdrawing the benefits from time to time is the typical government policy. The long-term expressed interest of the government lies with progressing with EU accession, market reforms and economic growth. This is clearly demonstrated in various government programmes (Government of Romania, 2002). The European Union, the International Monetary Fund and the World Bank support the government in staying on this track. But domestic pressure groups push the government to violate conditionalities of the IMF agreement in terms of wage policy and public sector restructuring. The World Bank is ready to finance adjustment programmes primarily under PSAL II, which would support the reorganization and privatization of major state-owned companies. But trade unions in some of these companies successfully organize against painful restructuring and privatization programmes, as has happened in the case of the Brasov-based truck producer 'Roman' and the agriculture machinery producer 'Tractorul' (SAR, 2002). These companies could have been successfully privatized at an earlier stage of transformation, but their chance of finding a foreign investor has diminished with time.

Can the quality of public governance be quantified? The 1999 Business Environment and Enterprise Performance Survey (BEEPS) was carried out for 20 CEE and FSU countries (Hellman et al., 2000, also EBRD, 1999). It looks at various features of government capture, administrative corruption, government transparency and public interference in the economy by asking a sample of company executives about their experience. In terms of government capture (private influence on the formation of laws and regulations) Romania performed much worse than Central European countries (the Czech Republic, Hungary, Poland) but better than CIS countries. The frequency of bribing public officials to avoid taxes or other regulation showed similar differences. In terms of the frequency, amount and effectiveness of bribery in more general terms, Romania performed much worse than many other South East European countries. Not only the high amount of bribes is a problem in Romania, but also the relatively low rate of delivery of the 'paid' service. Investors may consider this messy situation especially risky. A more recent assessment acknowledges the current government's efforts in fighting corruption but results have yet to come (OECD, 2002).

Weak governments and corrupt institutions may not totally deter FDI. As another survey found out, local-market oriented projects may come in lower-technology sectors and in the form of joint ventures (Smarzynska and Wie, 2000). Corruption reduces inward foreign investment and shifts the ownership structure towards joint ventures. As corruption makes the local bureaucracy less transparent, the value of using a local partner to cut through the bureaucratic maze increases. What is hindered most by corruption is the export-oriented, green-field, 100% foreign FDI in technologically advanced industries which has the strongest positive economic effects on host countries in terms of growth, employment and external balance.

In countries liable for government capture, investors rely on tailored legislation in single cases of privatization or FDI. While this can be a necessary stimulus for those who benefit, it is detrimental to the legal system and to competition. Examples of tailor-made incentives appear in Romania in the Renault–Dacia takeover while others withdrew from projects when agreed benefits were abolished (Akmaya–Petromidia). More recently the legislation outlined in the previous chapter offers blanket solutions for such cases.

The private sector cannot stay outside the economic-political maze. There is a class of new domestic owners that benefited from crony privatization, became rich through half-legal business and has acquired a great impact on politics. Corruption has its especially dangerous form of state capture: there is evidence of ordinances, legal modifications and exemptions that favour just one or the other interest group. No wonder that foreign investors complain about legal instability and weak public governance (FIC, 2002). Cleansing the legal system, making it more transparent and less equivocal would improve conditions to invest.

Keeping up the commitment to reforms may be easier now that part of the economy is doing well, inflation is falling and capital inflows finance even a relatively high current account deficit. The speed of structural reform, in turn, depends on the interest of investors in state-owned enterprises and their activity of investing in acquired or newly established firms.

3 Changing Romania's export structure

Romanian exports were very low at the beginning of transformation, falling from the enforced high level of the late 1980s. They amounted to just USD 4.3 billion in 1991 but doubled until 1997. While exports to transition countries and developing countries declined, the EU became the main export partner. The most important commodities driving the upswing of the mid-1990s were textiles and clothing, leather products and metals. The share of machinery and vehicles declined rapidly due to the lack of marketing and technical innovation. Simple processing agreements with foreign firms provided the only viable way for Romanian companies to appear on the European market. Foreign firms usually did not appear as investors in this period.

Table 2

Romanian exports (FOB), USD million

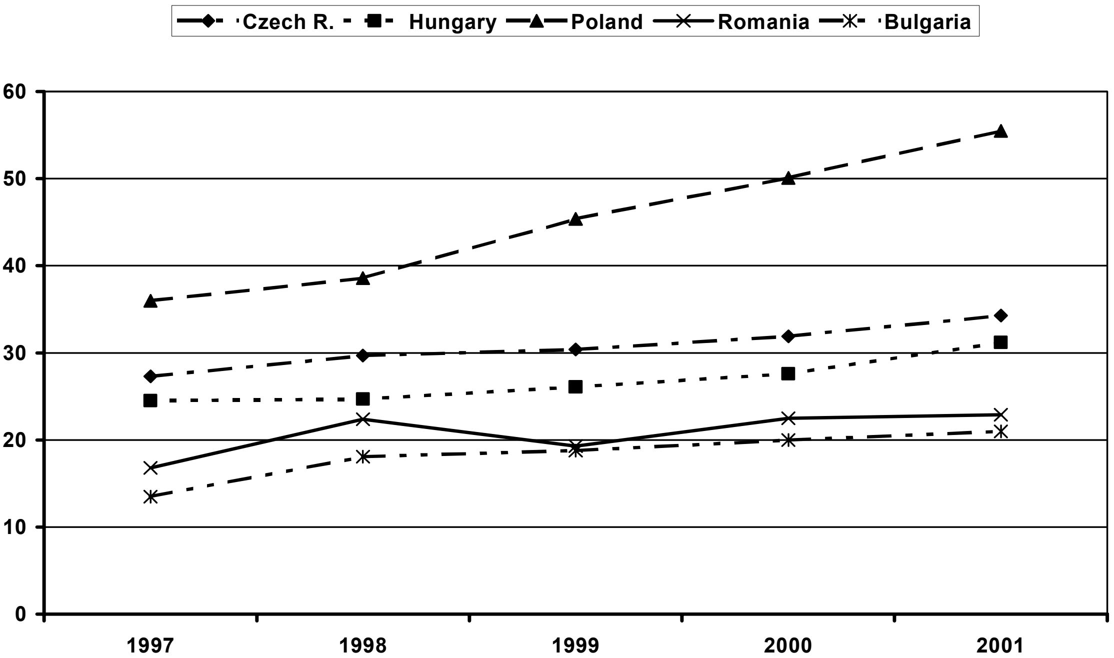
	1990	1991	1992	1993	1994	1995
Total	5775	4266	4363	4892	6151	7910
annual change (%)		-26.1	2.3	12.1	25.7	28.6
share of manufacturing (%)	98	94	94	96	96	95
Manufacturing exports total	5676	4015.8	4111.7	4679.8	5876.7	7510.3
annual change (%)		-29.3	2.4	13.8	25.6	27.8
	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Total	8084.5	8428.9	8299.6	8504.7	10366.5	11385
annual change (%)	2.21	4.26	-1.53	2.47	21.89	9.82
share of manufacturing (%)	93	95	95	95	97	97
Manufacturing exports total	7540.5	8044.8	7899.3	8091.6	10054.8	10986.6
annual change (%)	0.4	6.7	-1.8	2.4	24.3	9.3

Source: WIIW Database incorporating national statistics.

After the initial recovery and structural shift, exports stagnated at USD 8.4 billion in 1997-1999. This coincided with the decline of GDP. The following years brought a jump of exports to USD 10.4 billion in 2000 and again to USD 11.4 billion in 2001 (Table 2). The last two years can thus be considered as a period of relative export boom and regained competitiveness. Policy may have played a positive role in achieving export growth as the corporate tax on export-related profits was reduced to 5% in 2000. Further components of the economic environment such as the exchange rate and unit labour costs have been by and large neutral (Figure 1). Substantial real depreciation in 1999 was followed by slight real appreciation, and unit labour costs in 2001 reached the level of three years before. It is interesting to see what composition of commodities contributed to this new phenomenon and what were the main markets benefiting.

Figure 1

Unit labour costs, PPP-adjusted, Austria = 100



Source: WIIW database

The main export industry in 2000 was the same as in the previous few years, textiles and textile products (Figure 2). Although the volume of these exports increased, its share in the total dropped below 24%. Basic metals were the second largest category with 16.5% with both volume and share expanding. The major novelty constituted the industry electrical and optical equipment, which almost doubled its exports reaching a share over 8%. Traditionally important export industries such as leather goods and furniture could not keep pace.

The export boom of the year 2000 was based on three main items:

– electrical equipment, mainly TV sets;

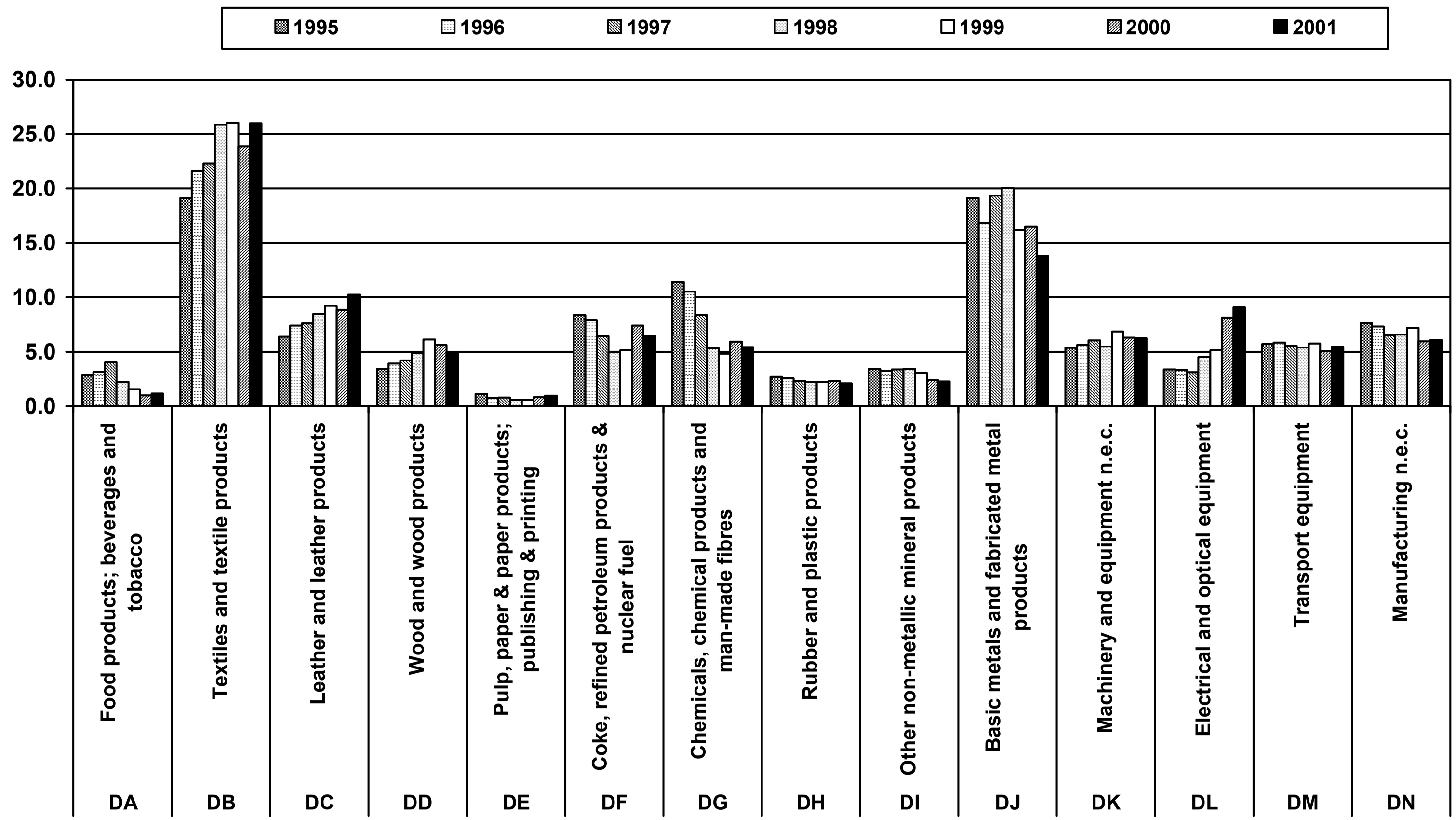
– light industry: textiles and clothing;

– semi-finished goods: basic metals and oil-products.

There was a slight shift from textiles and leather to electrical machinery. Metals, oil products and chemicals benefited from increasing international prices, thus increasing their weights in exports.

Figure 2

Share of industries in Romanian exports, 1995-2001, per cent



Source: National Institute of Statistics, Bucharest.

The export development in 2001 was characterized by:

- decline of fuel and metal products;
- increase of light industry products, textiles, clothing and leather products;
- increase of general machinery and electric machinery.

Specialization in 2001 shifted back to the benefit of light industry, mainly to the detriment of fuels and metals which suffered under lower international prices. The main novelty was that also the exports of some machinery products were expanding, in particular industrial consumer goods and their components.

If we compare the Romanian export structure of 2001 with that of 1999, after an export increase of 34% we can see a constant share of textile products and an increasing share of the electrical equipment sector. Higher shares can be observed for leather goods and refined oil. The main declining sectors are basic metals and wood. All in all, the direction of structural change towards higher-technology goods is not very obvious. The textile and leather industries continue to be the main export sectors, and most of these exports are in the framework of processing agreements. At an earlier stage simple processing agreements with foreign partners were usually enough in these industries to ensure quality standards. But with the need to expand capacities, direct investments of the co-operating partners have become necessary.

Light industry is heavily dependent on imported components but also shows positive revealed comparative advantage. RCA ratios have been more or less constant over the last three years meaning that exports and imports increased simultaneously in the main commodity categories. Major changes of RCA can be observed in the electrical equipment sector (RCA is becoming less and less negative) and in the vehicle industry (RCA has turned from positive to negative). The Gruber-Lloyd index showing the level of intra-industry trade is constant at about 0.6 if calculated for total trade but increased from 0.57 in 1998 to 0.67 in 2001 for trade with the European Union only (Unguru, 1999 – updated). Increasing intra-industry specialization with the EU and expanding processing not only in the clothing industry but also in electrical equipment production are important novelties of the last couple of years.

The development of the direction of exports shows very clear preferences: the share of the EU countries has been on the increase. It rose from 55% in 1995 to 68% in 2001. Commodity and regional concentration went hand in hand. The exports of processed goods concentrate on Italy, Germany and France. International production networks with Italy can be identified in the industries of clothing and leather goods. For machinery products German companies are the main co-operation partners.

Table 3

Gaining and losing industries in Romanian exports to the EU(15), 1995-2000

	NACE rev.1	Exports 2000 ECU mn	Average annual change in %	Competitive gain, 1995-2000 ECU mn	Market share in EU(15) 2000, in %
10 biggest winners					
Other wearing apparel and accessories	182	2222.4	20.6	1026.4	5.45
Footwear	193	863.7	22.9	421.4	9.32
TV, & radio transmitters, apparatus for line telephony	322	190.8	225.0	189.9	0.78
Knitted and crocheted articles	177	335.4	26.0	176.8	4.60
TV, radio and recording apparatus	323	153.1	115.6	148.1	0.67
Electrical equipment n. e. c.	316	211.1	30.4	121.2	1.57
Ships and boats	351	113.1	54.6	92.1	1.99
Basic precious and non-ferrous metals	274	386.1	10.0	71.9	1.00
Office machinery and computers	300	70.0	128.5	68.3	0.10
Sawmilling, planing and impregnation of wood	201	96.3	31.8	64.1	1.66
10 biggest losers					
Bodies for motor vehicles, trailers	342	10.5	-3.7	-8.7	1.20
Beverages	159	15.1	-0.3	-9.2	0.48
Motor vehicles	341	4.2	-13.7	-9.6	0.01
Basic chemicals	241	214.5	4.2	-14.7	0.62
Glass and glass products	261	56.4	1.9	-17.8	1.58
Coke oven products	231	0.0	-79.5	-20.4	0.00
Cement, lime and plaster	265	14.3	-17.4	-31.6	2.30
Refined petroleum and nuclear fuel	232	31.2	-5.6	-34.7	0.15
Furniture	361	413.5	7.1	-52.6	3.98
Basic iron and steel, ferro-alloys (ECSC)	271	288.4	-1.2	-123.4	2.84
	Total	**7395.2**	**17.8**	**2814.8**	**0.93**

Source: Own calculation based on Eurostat COMEXT database.

The increasing concentration on a specific group of commodities shows up in the development of Romania's share in EU imports. The overall market share is quite small, only 0.88% in 1998, rising to 0.93% in 2000.[1] The highest market shares with significant increases in the 1998-2000 period were booked in the NACE industries 'leather and leather goods' (DC) and 'textiles and textile products' (DB). The wood industry has smaller but increasing shares, while the relatively high market shares of furniture, non-metallic minerals and basic metals declined. The following industries have low but increasing market shares: 'electrical and optical equipment', 'transport means', 'rubber and plastic', 'pulp and paper'. Table 3 shows the gaining and losing industries at the NACE 3-digit level

[1] Countries such as Poland or Hungary have three times higher shares of EU imports.

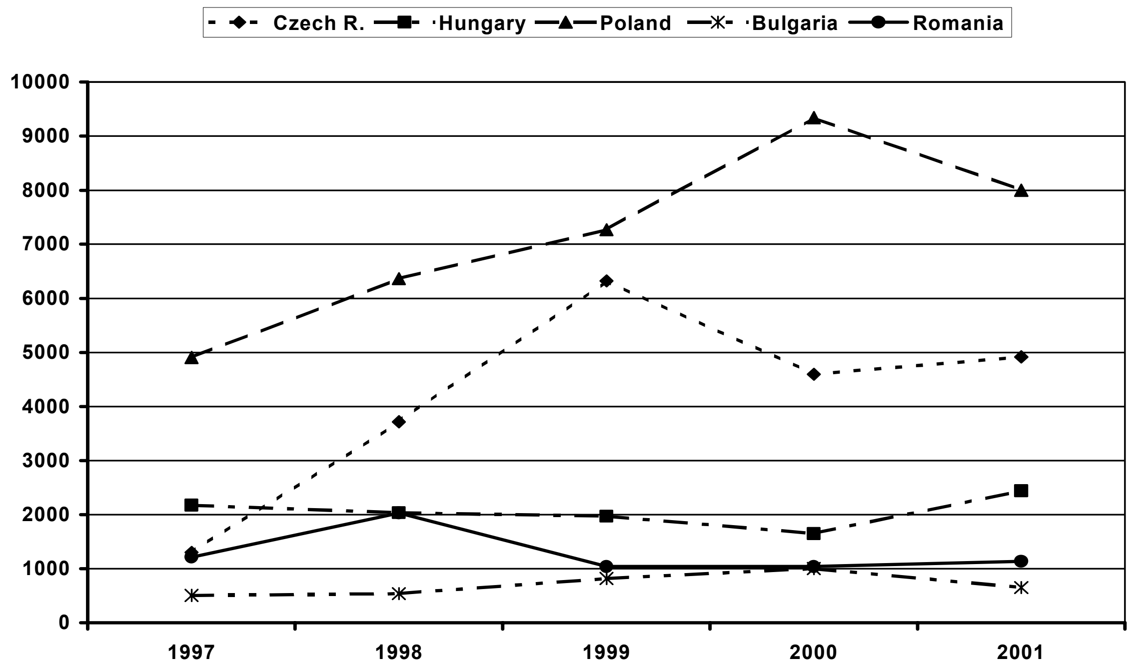
confirming the above trend. In a next step, we try to establish a relationship between the role of FDI in Romania and the changes in export specialization.

4 FDI in Romania – size and distribution

FDI inflow to Romania has been low in comparison to the size of the country. Higher inflows have been registered since 1997 following the last liberalization and stabilization shock. FDI is mainly linked to the start of privatization-related selling of state-owned companies to foreigners. The limited institutional capacity and weak political will to privatize produce rather flat annual revenue inflows. FDI was at a level of USD 1 billion a year in 1997, 1999 and 2000, double that amount only in 1998 (telecom and bank privatization). In 2001 a slight increase compared to the previous year was registered, to USD 1.1 billion (Figure 3).

Figure 3

FDI inflow, USD million



Source: WIIW-WIFO database on FDI.

The above data are based on the balance of payments. A consolidation of balance of payments figures with other data on FDI has not been successful. On the one hand, there is the Trade Registry which informs about the increase of the statutory capital of companies. On the other hand, various government organizations report revenues from privatization in foreign currency. Trade Registry data show an upward trend of FDI in new companies and by capital increase with a different pattern of fluctuation than balance of payments data (in USD billion): 0.7 in 1998, 0.9 in 1999, 0.8 in 2000 and 1.4 in 2001. Last year the number of new foreign affiliates was smaller than before but the invested capital higher than in any previous year. The advantage of the Trade Registry data is that it includes re-invested profits which are not covered by the balance of payments statistics.

In the year 2000, 45% of the USD 4.6 billion FDI stock (Trade Registry database, excluding privatization) was located in the manufacturing industry, the rest mainly in trade and financial services. As only the manufacturing industry produces export commodities, we look at this category in more detail later.

FDI promotion policy has been most unstable, from time to time the country even lacked a related specialized institution. Tax and other concessions were often changed even before taking effect. The general conclusion of the literature (Bonciu, 2000; FIAS, 1999a; FIC, 2002; Mazilu, 1999) is that direct policy instruments had no or an adverse effect on the development of FDI. The investment promotion agency stopped its activity in 2000 and has been re-activated only in mid-2002.

5 Foreign penetration in Romanian manufacturing

The database on foreign affiliates in Romania comprises all manufacturing enterprises which filed an income statement in each of the years 1998, 1999 and 2000.[2] Companies with at least 10% foreign share in their nominal capital have been classified as foreign investment enterprises (FIEs). This definition makes the Romania database comparable with other countries in the WIIW database on FIEs (Hunya, 2001). It also corresponds to the international definition of foreign direct investment capital.[3]

Table 4 contains the most important aggregate indicators of foreign penetration in the manufacturing industry. Compared with earlier published incomplete data (Boscaiu, 2000[4]), they reveal an important and rapidly increasing role of the foreign sector in the Romanian economy. It turns out that with only USD 2 billion foreign capital invested, foreign affiliates produce 38.6% of manufacturing turnover, employ a quarter of the manufacturing labour force and account for 44% of the direct manufacturing exports. All these indicators underwent significant increases in the 1998-2000 period. The share of FIEs increased due to three factors:

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2 Data have been provided by the Chamber of Commerce and Industry of Romania in Bucharest. The author is grateful to this organization.

3 A problem with the database can be that minority FIEs may not be under foreign control. Although direct investors usually strive for control over the acquired company and this can often be achieved without majority ownership, exceptions are possible. Companies partially listed on the stock exchange may not be foreign-controlled if a foreign investor acquires 30-40% of the stocks while the majority shareholder of non-listed stocks maintains control (as in the case of the huge aluminium company ALRO Slatina).

4 Boscaiu et al. reviewed only larger firms and classified over 50% foreign ownership as foreign investment enterprise. They showed penetration rates as low as almost only one half of ours.

– newly established foreign firms,

– the expansion of foreign affiliates,

– shift from the domestic to the foreign sector through foreign acquisition, most notably privatization.

Table 4

Share of foreign investment enterprises (FIEs) in main indicators of manufacturing companies in selected countries in 1998, 1999 and 2000, in per cent

	Equity capital			Employment			Investments			Sales			Export sales		
	1998	**1999**	**2000**	**1998**	**1999**	**2000**	**1998**	**1999**	**2000**	**1998**	**1999**	**2000**	**1998**	**1999**	**2000**
Czech R.	27.9	41.8	.	19.6	26.9	.	41.6	52.7	.	31.5	42.4	.	47.0	60.5	.
Hungary	72.7[1]	72.9[1]	73.1	44.9	46.5	47.1	78.7	82.2	72.7	70.0	73.0	73.7	85.9	88.8	.
Poland	43.2	50.5	.	26.0	29.4		51.0	63.1	.	40.6	49.0	.	52.4	59.8	.
Slovenia	21.6	21.8	22.6	13.1	13.0	15.1	24.3	22.3	20.7	24.4	23.3	26.3	32.9	30.3	34.2
Romania	19.7[1]	27.3[1]	36.5[1]	13.7	21.0	25.2	.	.	.	24.3	33.9	38.6	22.4	33.4	43.9

Notes: 1) For Hungary: nominal capital in cash; for Romania: nominal capital in cash and in kind.

Size coverage: Hungary, Romania, Slovenia: all firms; Czech Republic: more than 100 employees; Poland: more than 5 employees.

FIE – Foreign Investment Enterprise: companies with at least 10% foreign equity ownership.

Source: WIIW Database on foreign investment enterprises; for Romania: Chamber of Commerce and Industry of Romania.

The ownership shift distorts the development indicators of the foreign affiliates but truly shows the size of the foreign sector in a particular year. One cannot tell whether the foreign sector increases its production and export performance via the same set of FIEs, or whether foreign investors take over the best domestic companies and improve the indicators of the foreign sector in this way. Whatever the way foreign penetration increases, the general result is better access to technology, know-how and markets. As of 2000, Romanian penetration indicators are similar to those in the Czech Republic and Poland one or two years earlier.

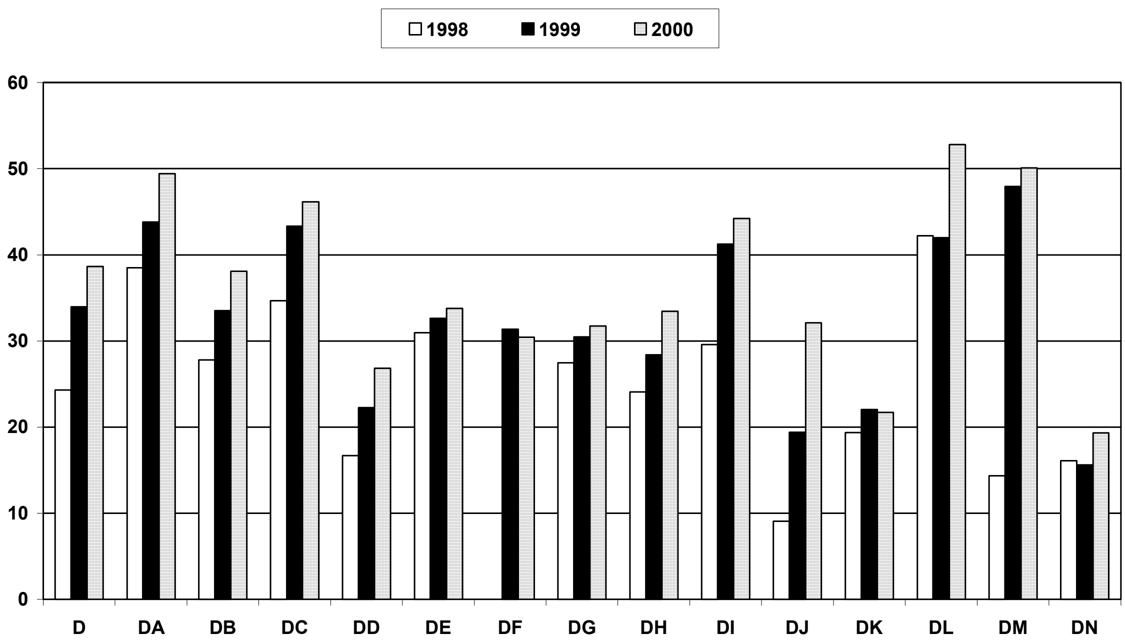
As in other CEECs, the foreign sector in Romania features higher labour productivity and higher export propensity than the domestic sector. But productivity gaps are smaller in the case of Romania than in the other countries. This is mainly due to the dominance of low-tech, less capital-intensive industries in the Romanian foreign sector. The export propensity difference between foreign and domestic firms is similar to Poland, the other 'large' country where foreign affiliates are more domestic-market oriented than in smaller countries.

6 Industry specialization of foreign affiliates

The foreign penetration measured by sales in NACE 2-digit industries falls between 21.7% (DK, machinery and equipment n.e.c.) and 52% (DL, electrical and optical equipment) in the year 2000 (Figure 4). (The country average is 38.6%.) Compared with other CEECs, this is a relatively flat distribution of foreign penetration among branches. Foreign capital was attracted both into domestic-market oriented industries such as food, beverages and tobacco, and export-oriented industries such as textiles. Unlike in other countries, there are no industries with close to 100% foreign penetration.

Figure 4

Share of foreign affiliates in manufacturing industry sales in Romania in 1998-2000, per cent

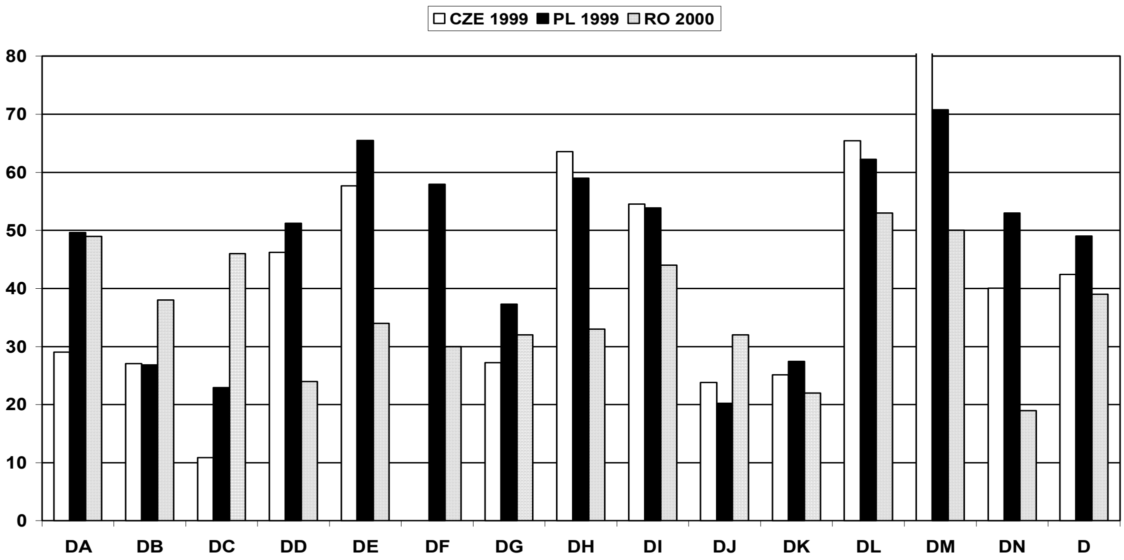


Source: Chamber of Commerce and Industry of Romania. See Fig 2 for NACE codes.

A comparison of Romanian data for 2000 with Czech and Polish data for 1999 is at hand to demonstrate the differences concerning the foreign penetration by industry (Figure 5). A Romanian specificity is the relatively high foreign penetration in the textile and leather industries. This is true both for the share of foreign affiliates in sales and in exports. These two main export industries have attracted foreign capital which then helped to increase exports further as shown by rising market shares in the EU. These industries, which are usually not integrated into international corporate networks by capital participation, did attract foreign investors in Romania. The increasing quantity and quality of exports demanded new investments and better organization that could not be transferred by more simple networking than direct investment.

Figure 5

Share of foreign affiliates in manufacturing industry sales in the Czech Republic, Poland and Romania, per cent



Source: Chamber of Commerce and Industry of Romania. See Fig 2 for NACE codes.

In all other industries, foreign penetration in Romania is smaller than in the Czech Republic and Poland. It is particularly low in DN, which contains the large and export-oriented furniture industry. It seems that this industry is not attributed much future by foreign investors. Problems are also indicated by the declining EU market share.

The chemical and metals industries have relatively low foreign penetration in Romania. In the metals industry, a low foreign share in sales is combined with relatively high export shares of these affiliates. However, the picture will change radically in the course of the year 2002 with the main steel and aluminium plants becoming foreign affiliates. In the industries of higher technological sophistication, electrical machinery (DL) and transport equipment (DM), foreign penetration is much lower than in the more advanced countries. In these industries Romania still has a number of inefficient state-owned companies which have high shares in output and especially labour. Also in these branches in Romania, foreign affiliates show a relatively high export orientation. Increasing investment activity was recorded in the last few years by which exports of foreign affiliates could have increased further. Still, the exports of these industries remain relatively low compared to the more advanced countries.

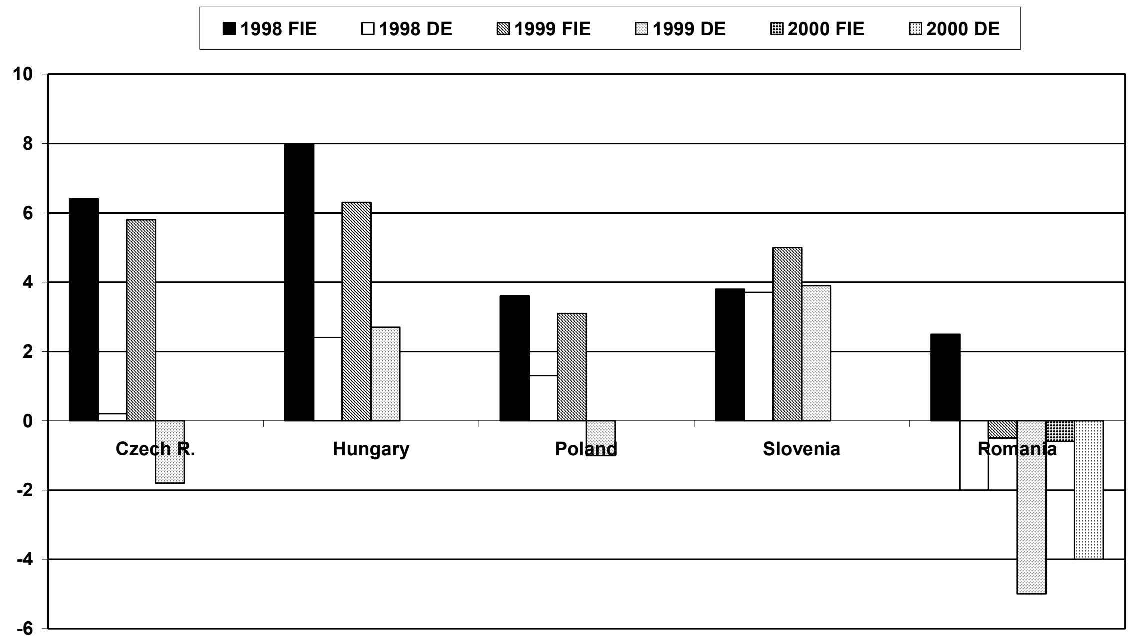
Value added has a very similar distribution among industries as have sales. Value added per sales shows to what extent certain industries rely on outside inputs, e.g. raw materials of components. The foreign affiliates are only slightly more dependent on outside inputs than the average of the Romanian economy: value added is about 30% of sales in the year 2000. The higher-than-average value added ratio in the export-oriented industries textiles and leather shows the labour-intensive character of those industries. FIEs generally use more alien inputs than domestic firms most probably because they rely more on imported components. This is especially the case in the machine building sector. In the electrical and optical equipment sector, on the other hand, FIEs have higher value added/sales than domestic companies meaning that they are more vertically integrated and less engaged in assembly.

7 Foreign affiliates with no profits?

FIEs are generally more profitable than domestic-owned companies (Figure 6). This is not the case in Romania where FIEs had on average 0.6% pre-tax loss per sales in 2000. This contrasts with a 21% loss rate of state-owned enterprises and a 2.7% profit rate of domestic private enterprises. It is not surprising that the public sector concentrates the large loss-makers, but the general loss-making of foreign affiliates needs more explanation.

Figure 6

Foreign owned and domestic enterprises
Profits per sales, per cent



FIE: Foreign Investment Enterprise. - DE: Domestic Enterprise
Source: Chamber of Commerce and Industry of Romania. See Fig 2 for NACE codes.

One of the explanations is that FDI in Romania is relatively new and operates under less transparent rules than in more advanced countries. Low or negative profit rates of foreign affiliates were also widespread in other CEECs at an early stage of transformation, in the first few years of operation of foreign affiliates. Efficiency and profits improved later and may appear also in Romania. On the other hand, transnational corporations and their affiliates may be less profitable than individual country firms due to their larger opportunity to apply transfer pricing and shift profits between countries with different financial years, tax rates and accounting systems.

8 Foreign penetration and export performance

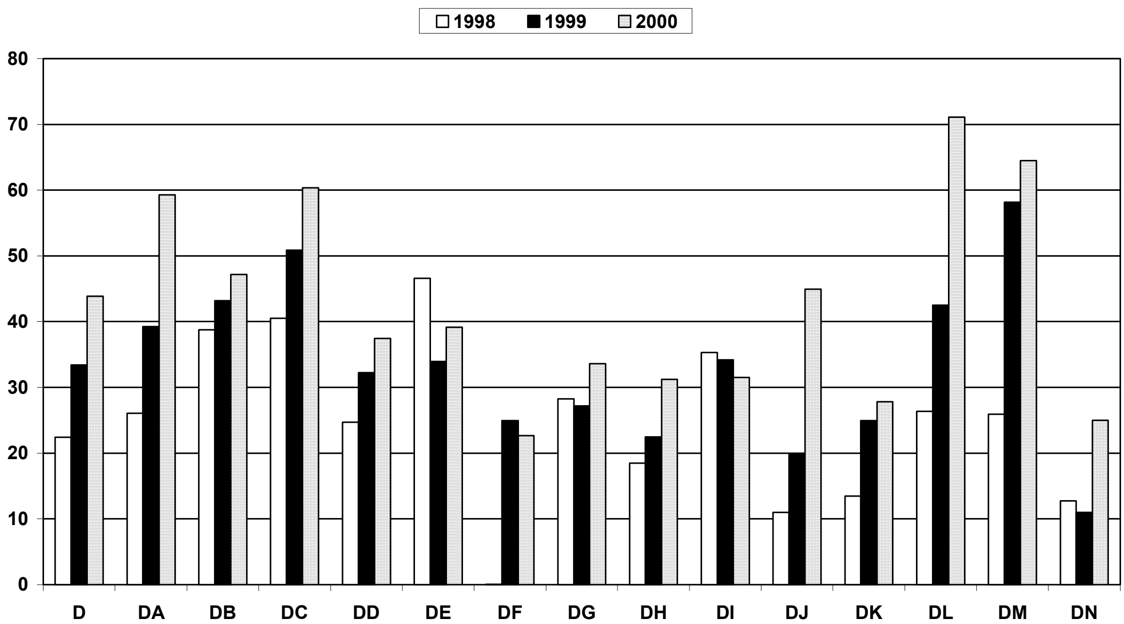
Romanian manufacturing companies exported 23% of their production in 1998, 27% in 1999 and 30% in 2000. These export ratios are relatively low even for countries of similar size, but the increasing trend is a proof of diminishing autarchy. Companies under different ownership show different patterns of export propensity. State- and foreign-owned firms have similar rates but with different trends. It is first of all the foreign affiliates that are able to increase exports. State-owned enterprises decreased their export ratios while FIEs increased theirs between 1998 and 2000. This can be both due to the increasing export propensity after foreign acquisition and to the successful privatization of the export-oriented companies. Domestic privately owned companies are the least export-oriented and also the smallest in size. It seems that the new private sector finds it difficult to become direct exporters. Export increase can be achieved more directly by promoting FDI than by promoting small companies.

A central part of our analysis is to show how much of the exports and especially of the export recovery in 2000 was due to FIEs. Unfortunately data do not allow a precise answer, because figures by ownership relate to company sales destined for exports and not to the exports at customs statistics. The amount of manufacturing exports by customs statistics was USD 7.9 million in 1998 and USD 10.1 million in 2000. For the same years the export sales of manufacturing companies amounted to USD 5.0 billion and USD 8.1 billion respectively. The coverage of the export statistics by the export sales statistics increased in fact from 63% to 80%. We must assume that the relative importance of FIEs shown by the export sales statistics corresponds to that indicated by the customs statistics.

The share of foreign affiliates in export sales doubled between 1998 and 2000, reaching 44% (Figure 7). Both by the entry and expansion of new exporters and the privatization of traditional ones, the foreign sector was an important primary carrier of the export expansion in the year 2000. Out of the nominal export sales increase in dollar terms between 1998 and 2000, 78% was due to FIEs and only 22% to domestic companies. If this relationship is true for the manufacturing exports measured by customs statistics, we have a strong proof for the overwhelming importance of foreign affiliates in

Figure 7

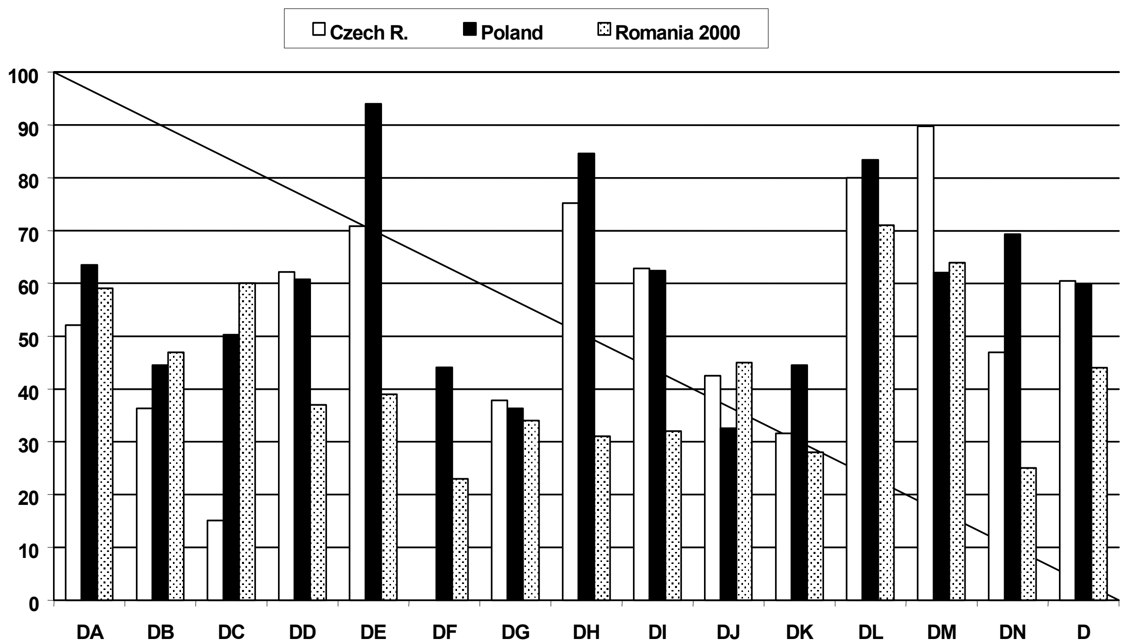
Share of foreign affiliates in Romanian exports, per cent



Source: Chamber of Commerce and Industry of Romania. See Fig 2 for NACE codes.

Figure 8

Share of foreign affiliates in exports, in the Czech Republic, Poland and Romania, per cent



Source: Chamber of Commerce and Industry of Romania. See Fig 2 for NACE codes.

the recent recovery. Still it is worth noting that the contribution of FIEs to exports in Romania is still much lower than in the Czech Republic or Poland where FIEs provided 60% of exports already in 1999 (Figure 8).

The export shares of foreign affiliates show marked differences by industry. The highest share can be found in the electrical machinery industry, (DL) which featured a strong increase of both exports and foreign penetration in 1998-2000. This is in accordance with international trends; in fact, the Czech Republic and Poland show even higher FIE dependence in their electrical machinery exports. The role of foreign affiliates in exports increased also in the manufacturing of transport equipment (DM) but without expanding export volumes yet. We can see the result of privatization but of no follow-up investments yet. In the basic metals sector (DJ) the good international market position of some state-owned firms attracted investors. They hope to be able to restructure steel and aluminium plants in a way to remain competitive even after quasi-fiscal subsidies have expired. The decreasing export shares of these industries may stop if foreign takeovers prove to be a success.

The industries textiles and clothing, (DB) as well as leather products, (DC) displayed already in 1998 a relatively high importance of foreign affiliates in exports which further increased in 2000. The higher-than-average role of FIEs in these sectors' exports is a Romanian specificity and does not apply for the Czech Republic or Poland. In the furniture and other industries (DN), on the other hand, the role of foreign affiliates is relatively, low which contrasts with Poland.

Significant foreign presence in an industry coincides with increasing export performance. Foreign investors support Romania's traditional specialization in clothing, footwear and metals. They are the driving force behind the emergence of exports in the electrical machinery and electronics sector. We can foresee a similar development in the car industry in the future. In sum, foreign affiliates have up to now a more conserving than restructuring effect on Romania's foreign trade structure. No massive emergence of new export industries occurred, most probably due to the unfavourable conditions for green-field investments in the analysed period.

9 Conclusions

Although the amount of FDI in Romania has been much lower than in the more advanced transition countries, foreign penetration in the manufacturing industry is yet advanced. This can happen because firms and assets in Romania are relatively cheap. Less investment than in other CEECs is necessary to acquire the same production capacity. As another feature, minority foreign ownership is more widespread than in the advanced CEECs, thus the control of the foreign owner is provided with less capital invested. Among the minority owners, investment funds in the wake of partial privatization have had an active role in restructuring and finding new markets.

The FDI inflows of the past five years have decisively contributed to the resumption of economic growth and the recovery of exports. But flowing at the current speed and in the current structure, FDI will not be able to restructure the Romanian economy in a way that it can stay on a rapid economic growth path.

The inclusion of Romania into a comparison of CEECs' export and FDI patterns confirms the existence of technology-based specialization according the 'flying geese theorem' (Ozawa, 2000). The role of the technological leader and source of FDI (the leading goose) is played by the European Union. Both in terms of technological specialization and FDI penetration, Hungary is ahead of the Czech Republic and Poland while Romania specializes in the low-tech and labour-intensive sectors.

Romania's export specialization shows some striking similarities with the penetration of FDI in the various manufacturing industries. Foreign affiliates concentrate primarily in the labour-intensive, low-tech but export-oriented textiles and leather sectors. In these industries the country takes over market shares in the EU from more advanced CEECs, first of all from Poland where labour costs are much higher.

Foreign investment in Romania appeared recently also in the electrical equipment and the car production sectors, which thus gained momentum in restructuring, and at least the electrical industry expanded its exports as well. It will take another few years for these industries to achieve more significant foreign market shares. The Romanian export industries can remain successful due to continuing foreign penetration bringing in technology and providing market access.

Economic growth in Romania cannot be solely attributed to the impact of foreign affiliates. In 2000 both the foreign and the domestic (private) companies improved their performance. Through relying increasingly on FDI, economic growth can be maintained, even if only at a moderate 3-4% level in 2002 and 2003. The main structural problem lies with the large state sector with the major loss-makers and non-competitive producers. Their exit or privatization-related restructuring are key factors for stepped-up economic growth. It is expected that foreign investors will play a decisive role in this process.

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