

## The Contribution of Foreign Direct Investments to the Specialisation in Romania: *Case Study in South-West Oltenia Region*

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### **Abstract**

*Globalization and the integration of Romania in the European Union lead to deeper specialization and a more regional concentration of the economic activities following the traditional industrial development patterns. In this paper we analyze the evolution of specialization between 2003 and 2010 describing the investment climate in Romania. The emphasis is on the role of foreign direct investments location choice in this process. In the second part, we focus on a short case study on the South-West Oltenia region, where we identify several specialization directions based on the development opportunities.*

**Keywords:** foreign direct investments, specialization, investments opportunities

### **1. Introduction**

The transition to the market economy in Romania began after the fall of communism in 1989 and ended in 2006. In this period of time, the influx of foreign direct investments increased as market advanced to liberalization and as Romania was more and more integrated in the global and regional economy. Most of these investments were made on the basis of privatizing the old ineffective state companies, fact that theoretically should have slowed down the change in specialization. The polarization of the economic activity did occur, because new companies identified the opportunity of supplying to the new companies. The accession to the European Union in 2007 brought considerably more foreign direct investment (FDI) to Romania and the specialization advanced because Romania lost competitiveness in some areas, while the import products were becoming cheaper than the domestic ones, and it gained comparative advantages in others.

The economic activities tend to concentrate in regions which bring many location advantages, such as: small operating costs, good market access, qualified personnel, etc., determining a certain regional or national specialization and an inter-industry trade between agglomerations (Helpman and Krugman, 1985). This dynamics can lead to redefined comparative advantages of each region or country (Ricardo, 1963; Balassa, 1963). The more a country has a more successful and longer experience on the international market, the more it will become deeper specialized and similar development levels of entities determine a specialization in the same type of products (Krugman and Venables, 1996). After many years of transition, Romania is still trying to find its main comparative advantages and to follow a clear specialization strategy. At this stage, FDI is still an important vehicle of the specialization process.

The macroeconomic stabilization was a main condition of the attractiveness of FDI in Romania, as well as the adjustments that were made in the legal and institutional framework (Corduneanu and Iovu, 2007; Henriot, 2003). The efforts made by the government to bring FDI in Romania consisted in tax exemptions given on various periods of time, according to the field of activity. The profit repatriation was also possible, but the differences between the monetary policy and the structural adjustment persisted, determining a very small capacity of absorbing high technologies and modern management. As the economy advanced and became more mature, a specialization should take place in those fields in which the country is traditionally competitive, reaching an equilibrium created by the free market (Henriot, 2003).

This paper emphasizes the specialization patterns of the foreign direct investment companies which activate in Romania. They have an important role in identifying the most stable and profitable economic activities due to their international experience and in developing certain industries due to the financial capital and technology that they invest. Moreover they create spillovers on the local market determining the development of other domestic companies from the same branch: suppliers, competitors or clients (Drifford and Taylor, 2000). High FDI in certain sectors is, therefore, a good indicator of a good potential for development.

The final purpose of the paper is to establish which sectors are still attractive for investments and have development opportunities in the current context of the economic crisis which still affects Romania. In the second part, we focus on a case-study of the South-West Oltenia region, which hosts the smallest amount of FDI among the eight Romanian development regions, in spite the fact that it offers very interesting investment opportunities. Finally, we sketch a few recommendations about a set of economic activities which have a good potential for development, taking into consideration the need of the region.

## ***2. The specialization of inward FDI in Romania***

In Romania, between 2001 and 2008 (until the outbreak of the crisis) FDI inflows increased by about 6 times, while exports increased by about 3 times. The fall of communism changed the map of trade for countries in Central and Eastern Europe. Thus international trade has been reoriented from east to west, from Member States CMEA to European Union (EU) Member States. (Guerrieri, 1998). Changing trade did not occur only geographically but also in composition goods there are significant changes for each individual state.

After the fall of communism trade collapsed in Romania, and in 2002 it managed to hold a 0.2% share of total world exports, a percentage that is below the one achieved in the years 80. . In the second decade of transition, the share of Romanian exports increase to 0.25% of total world exports and during the crisis it arrived to percentages over 0.3%. The reduction was due to the decrease of exports in industrial products, textile and footwear sectors increased during transition, while oil products and technology-intensive products declined. The evolution of FDI in Central and Eastern Europe reflects the evolution of international trade for the region. The EU is both the leading investor and trading partner, suggesting intra-firm trade flows, the region being an export base for the EU. (UNCTAD, 1996)

During transition, former communist countries, including Romania, not only had the advantage of cheap labor, but they also were close to EU with serious prospects for accession (in particular the least developed) and several preferentially agreements were signed, thus achieving excellent locations for export platform investments. It seems that the concept of FDI as a platform for re-export is found mainly in the states of Central and Eastern Europe (Geishecker et al, 2004).

One important element contributing to the trade activity is represented by the sector in which investment takes place, is extremely important the differentiation between sectors "tradable" and "non-tradable". Although the second category, which consists mainly of services, provides high added value in the economy, the "non-tradable," is what makes international trade. Romania received at the beginning FDI in the tradable sector, especially in the manufacturing, but recent years have led to a sectorial changes, Romania becoming one of the main host countries of shared service centers.

Unlike FDI in tradable sector, the non-tradable sector made can lead to a substantial increase of imports, at least in the short term and there is the possibility to a negative effect on the current account due to a negative trade balance (IMF, 2010) To get a sustained economic growth in coming years, CEE countries should give ups to the growth model used in years previous to the crisis that led to a boom period and base on the tradable sector in achieving economic growth (IMF, 2010)

FDI have changed structure and in recent years have turned to non-tradable services and activities. But the tradable sector is contributing to the exports ans while non-tradable activities lead to increased imports (Yonoshita, 2011).

For developing countries, the most obvious indirect effects of foreign affiliates of services on trade is their contribution to growth in the exports of goods produced in the host country, by providing those services that the host country does not have or are not at high levels.

Services offered by the foreign subsidiaries are incorporated not only in goods exported by foreign subsidiaries but also of the local companies exported goods. FDI can contribute to the competitiveness of a country even by investing in assets with high added value in industry that has not been invested before or by changing labor-intensive activities in high technology-intensive activities. Until so far this is not the case of Romania or other Central European countries FDI can help developing countries to exploit the advantages comparative they already posses and also to provide support for these countries to build new advantages. FDI contribute to increasing exports of host countries in all industries by providing the missing elements, tangible and intangible, that they need to be competitive. Exports generate foreign currency to finance imports of goods and services to achieve economies of scale and scope.

The biggest benefit of FDI in trade for developing countries is to contribute to long term integration of the host country in the world economy as entering a foreign market requires not only the development of competitive products but also company's ability to achieve marketing and international distribution of the products, which involves high costs. Extremely important in analyzing the effect on trade and country's specialization is to analyze the structure of foreign direct investments by sectors. In the states of Central and Eastern Europe were relocated labor intensive activities, ie manufacturing. Recent trends show, however, a slight change in the investment services sector, especially as the banking sector was liberalized.

For Romania the manufacturing sector represented about 50% of total investments during '00, while with the outbreak of the crisis, in 2008, this percentage dropped to about 31%.

During the financial crisis, between 2008-2010, the changes recorded at sector level continued their way as follows:

- a) The largest share of FDI is held by financial intermediation services, insurance, trade and services due to high profits that can be obtained as a result of speculative activities in financial market (Zaman et al, 2011)
- b) Manufacturing maintains its share of about 31%, but most investments are turning increasingly to those sectors leading to modest value added : metallurgy, petroleum processing, chemicals, rubber or plastic (Zaman et al, 2011 )
- c) High technology industries receive investments of about 4.5% of all investments made and that due to the fact that research and development activities remain within the mother company or relocated to the branches in developed countries. (Zaman et al, 2011)

Analysing of FDI in economic sectors and the trend in recent years, highlights the preponderance of low technological investments to sectors (such as food, light, wood and wood products, pulp, paper, publishing, printing, furniture, waste recovery and waste recycling) with modest values added to the stage, and also to medium-low technology industries: food, light, wood and wood products, pulp, paper, publishing, printing, furniture, waste recovery and recycling of waste (Zaman et al, 2011) .

Due to the specialization in the manufacturing industry, which was developed in the communist era, the privatization offer brought most of the FDI between 2003-2010 in this field. Its growth was permanent and quite constant in during the decisive years of EU accession (2007) and the debut of the economic crisis (2008-2009). The situation is very different in other economic activities, which were boosted (finance, building and real estate) by the EU accession and slowed (information technology) or decreased (building and real estate) by the economic crisis. Apart from the manufacturing sector which still shows a growing interest of the investors in spite of the global economic problems, the energy sector has seen small but ascendant interest (3865 million Euros in 2010), being characterized by the investors as being steadier. A dramatic fall took place in the real estate and building investments due the prudent policy of the banking system and the lack of buyers. Instead, the investments in agricultural land and agricultural cultures and processing became an interesting alternative for foreign direct investments, which first appear in 2008 (707 million Euros) and reach 1068 million Euros in 2010.

Regarding the manufacturing system, there is a clear and a larger prevalence of foreign direct investment in low-tech industries. The disadvantage of this specialization is that it allows less value added, it does not bring sufficient technological spillovers. The interest for the high-tech industries is relatively constant, even beginning with the economic crisis, this being a more stable field.

The perspectives for the growth of FDI in the next period are not optimistic. The net incomes of the foreign direct investment companies in 2009 decreased from 2008 with 2244 million Euros, reaching only 694 million Euros and in 2010 - 491 million Euros. Therefore, the FDI in Romania has become less profitable since the incomes from FDI diminished and the stock of FDI increased. This could also mean that the investors are trustful that their investments will generate bigger profits in the next years. According to the statistics provided by the National Bank of Romania, the tangible and intangible assets of the foreign direct investment companies have reached a stock of 23272 million Euros in 2009, significantly larger than in 2008 (1226 million Euros). In 2010 the growth continued only at a smaller rate, the same indicator reaching 24309 million Euros due to the persistence of the economic crisis not only in Romania but also in the investors' home countries and on their main markets. The main activities with a large value of the investments in tangible and intangible assets were considered the most stable ones because this type of investments targets long term returns: industry (26.1%), from which the manufacturing industry holds 18.2%, than there is trade (6.5%) and constructions and real estate (4.5%).

Foreign direct investments are very important to the specialization of Romania, fact which is proved by the high share of the FDI in the country's trade: 72.4% in exports and 62.5% in imports in 2010. This share has grown over the years, along with the increase in inward FDI and it shows that the goods produced in Romania is destined more to the external market, this location offering the advantage of relatively small operating costs and a central geographic position.

The exports of the manufacturing industry remained the predominant ones even during the years of the economic crisis which favors more this type of products. Due to this specialization of Romania, this moment could be more easily speculated.

According to Henriot (2003), who evaluates each industry's contribution to the balance of trade of a series of EU countries between 1993 and 2000, Romania was specialized in the textile industry and the metal production, which are activities with small value added, determining small revenues to both the population and the public budget. Respecialization becomes more difficult as specialization is more profound.

### ***3. Case study: the specialization of the South-West Oltenia region***

#### **3.1 The investment profile of the South-West Oltenia region**

The South-West Oltenia region is situated in South-Western Romania at the border with Bulgaria (in the South) and Serbia (in South-West) and it comprises five counties: Dolj, Gorj, Mehedinți, Olt and Vâlcea. A main characteristic of its geographic position is that it is bordered in the South by the Danube river offering enhanced transport and tourism opportunities.

In 2011, the population of this region consisted in 2.23 million people (the sixth region in the country), representing 10.43% of Romania's population. The population density is relatively small: 76.43 people/km<sup>2</sup> comparing to 89.7 people/km<sup>2</sup> – the national average. The rural population has a percentage of 52.25% in 2010 (The National Institute of Statistics), also larger than the national level (47.75%). In order to have a more modern economy the proportion of urban population should be changed, substituting the occupation in agriculture with employment or entrepreneurship in industry or services. The present patterns of urbanization have their origin in the recent communist history. Urbanization was forcedly made in the communist times, concentrating the population in a few urban centers and setting industries of large proportions. These were inefficiently organized and uncorrelated with the necessities and real possibilities of the national economy, nor with the local tradition and people's orientation. Consequently, after the fall of the communist regime, a disintegration of these industries followed. Some of them were transformed by privatizations, which in part were made very rapidly: Șantierul Naval Turnu Severin (ship building), Aluminiu Slatina (aluminum factory), Fabrica de Țevi Slatina (pipe factory), Vagoane Caracal (train wagon factory) and Turnu Severin and others were made very late and with serious losses in terms of working places and resources: Electropuțere, Combinatul Chimic, Avioane, etc.).

After a strong resistance from the population, transition was finally made, following a period of economic recovery beginning with 2002, the main activities being: constructions, services and industry. Although agriculture holds an important share of the region's activities, it has faced a permanent decline (following the situation from the entire country), regarding the cultivated surfaces.

Production from agriculture has met an increase of 46.8% from 2001 (3.69 billion RON) to 2006 (5.52 billion RON) based on a general growth of food prices, as a consequence of market liberalization. In 2008, the largest share of the population was still occupied in agriculture (38%), industry (21%) and trade (11.32%).

Regarding the business turnover of the companies from the region in 2009, 40.2% is held by trade, 33.2% industry, services 17.3% and constructions 9.3%. Agriculture is mainly an occupation of small households for self consumption, rather than large farms organized as companies, because in communism the private property was taken by the state and small farms were merged in agricultural cooperatives and with the fall of the regime properties were returned to the old owners. Consequently, many years were lost in which foreign competitors found new methods of organization, they made land mergers in large parcels and invested in technology. Therefore the Romanian agriculture today is inefficient and too expensive to be able to bring profits to the small farmers.

The GDP of the South-West region reached 40340 billion RON<sup>1</sup> in 2008, representing 7.8% of the national GDP, while in 2009 it decreased to 39953 billion RON (the share from the total was 8%) due to the economic crisis<sup>2</sup>. Foreign direct investments were constantly increased in the South-West Oltenia region, from the perspective of number of FDI companies, while the FDI stock was amplified more rapidly showing a spurred trust of the investors. After the EU accession of Romania, the growth in the stock of FDI had the highest rate, until 2009-2010 when it diminished considerably due to the economic crisis (FDI stock grew only with 6% comparing to 173% between 2007 and 2009).

### **3.2 The South-West Oltenia's resources and industries**

In order to understand the investment potential of the region, a review of its main advantages must be sketched. The most known advantages of the South-West Oltenia region are represented by its natural resources: agricultural land (Dolj, Olt, Mehedinți counties), large forest areas (Mehedinți, Gorj, Vâlcea counties), coal (Gorj, Vâlcea counties), oil and natural gas (Dolj, Gorj counties), as well as the largest hydropower potential from Romania (Mehedinți, Gorj, Vâlcea counties).

The car building industry is well diversified (cars, tractors, airplanes, ship building) and could be developed, the first step being streamlining and modernization. In some cases very important measures were taken, for example the acquisition made Ford when it bought a very large local plant from Craiova city.

The electric and thermal power plants represent a rich historic inheritance based on the coal and hydrological resources of the area, which can be found predominantly in this region. The metallurgical resources have also led to the development of connected industries: nonferrous metal processing – the only aluminum factory in the country. There are very well qualified people in the chemical industry, in wood processing and furniture, exploiting the forests from the region. The light industry has become very competitive in the last years and it compounds numerous small and medium enterprises and a few companies with foreign capital representing large investments.

The economic activity is highly concentrated in this region, mainly in low-tech industries. Cojanu and Pîslaru (2011) identified three main agglomerations based on the criteria of size, concentration and specialization: mining of lignite (Gorj county), production of electricity (Gorj county) and manufacture of inorganic basic chemicals (Mehedinți county). The problem is that this specialisation is concentrated in large inefficient companies, with an insignificant number of SMEs and they are not well integrated in the vertical chain of production (leaving an opportunity to develop industries on a higher level of processing).

### **3.3 Investment opportunities for valuating the potential of South-West Oltenia region**

After a series of interviews with specialists from the Regional Development Agency South-West Oltenia (RDA Oltenia)<sup>3</sup>, between May and June 2012, we sketched the main investment opportunities in this region.

<sup>1</sup> RON = Romanian national currency. 1 EUR ≈ 4,6 RON (July 2012)

<sup>2</sup> The National Institute of Statistics, 2009

<sup>3</sup> The Regional Development Agencies were created to implement the European Union regional policy and they have role of: contributing to the durable development and prosperity of each region by sustaining investments, industrial restructuration

Firstly, the main challenges of this region consist in a modernization of the industries from the point of view of technologies which are used in its traditional industries, as well as the technological knowledge, the management, the development and establishment of new companies based on advanced technologies, where the numerous natural resources can be used in a more efficient manner, targeting the existent national and international demand.

These are not only challenges, but suggestions for development, to which we add that they could be overcome by diversifying the economic activities and the decrease of the dependency level on the quarrying industry. This objective can be achieved, in a considerable proportion by attracting foreign direct investments, especially greenfield, in high-tech industries were Romania, as well as this region, owns plenty assets, except for sufficient technological and financial capital. To benefit from positive externalities from these foreign companies (for which the RDA Oltenia makes sustained efforts to attract) is necessary to strengthen the small and medium enterprises (SMEs), which are very few especially in this region. While the foreign direct investment companies would bring innovation, SMEs would have an important role in the absorption of the know-how among the domestic companies, would serve several market niches which are not yet targeted and would bring a plus of flexibility to the region's economic structure. For all of this, the South-West Oltenia region, as well as other development regions needs medium and long term strategies to be correlated with the macroeconomic strategies.

Apart from these industries based on the natural resources, the South-West Oltenia region has a high touristic potential, the health spas holding an extended market among European tourists. Considering this opportunity, in 2010 there were initiated a series of investments using European grants in the health spas from Olănești but also investments for launching winter sports tourism in the region: the construction of a sky track in the Vidra-Obârșia Lotrului resort.

Regarding the natural landscape, which could also bring new incomes from the tourism development, the South-West Oltenia region is very rich: Ciurumela forest from Poiana Mare, ornithological reservation from Ciuperceni (Calafat), paleontological reservation from (Craiova), the wild peonies reservation from Plenița, etc. These sites could become attractive after building new accommodation capacities which could offer various ways of recreation. Especially for the domestic tourists, there are several cultural objectives that belong to the national history and a series of monasteries which are already very appreciated, but several accommodation places must be built around them.

Another investment opportunity is represented by agriculture, which is still lagging in terms of efficiency, due to lack of technology and skills, but also a poor organization of the cultivation, harvesting, collection centers and dissolution, an extremely common problem in Romania. The advantages are: a good rich and clean soil, appropriate climate, very small prices for agricultural land and a large domestic and regional market.

The environment is affected by the polluting and inefficient industries (due to the amount of power which is used), and the dependence of the region on the quarrying industry remains high until new investments are made. This investment in environmentally friendly equipment is strongly sustained by the EU structural funds.

#### **4. Conclusions**

The Romania's specialization and exports are for the most part influenced by the foreign direct investments as foreign affiliates proved to be the major exporters and importers in Romania. The importance of the FDI in trade makes foreign companies part of any future strategy Romania may take regarding its trade and specialization. The cheap labor force led to massive investments in low-tech industries for which the spillovers on the economy are very modest.

The South-West Oltenia region became extremely attractive to foreign investors after the period of transition finished and during the crisis it had the highest rate of growth. Unfortunately the investments are taking place in sectors that produce modest value added, being on the same level with the rest of the region. The development of the region can be accomplished through more technological investments and taking advantages of the touristic potential of the region.

## Acknowledgement

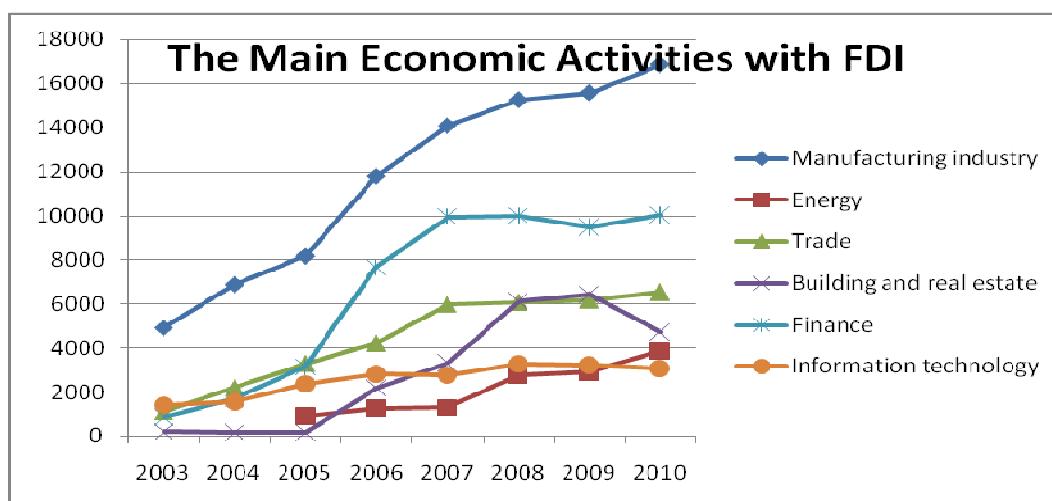
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## 5. Figures and Tables

Figure 1: The main economic activities with foreign direct investments in Romania (FDI stock in million euros, NACE rev. 2)



Source: The National Bank of Romania

Figure 2: The Stock of FDI according to the technological level

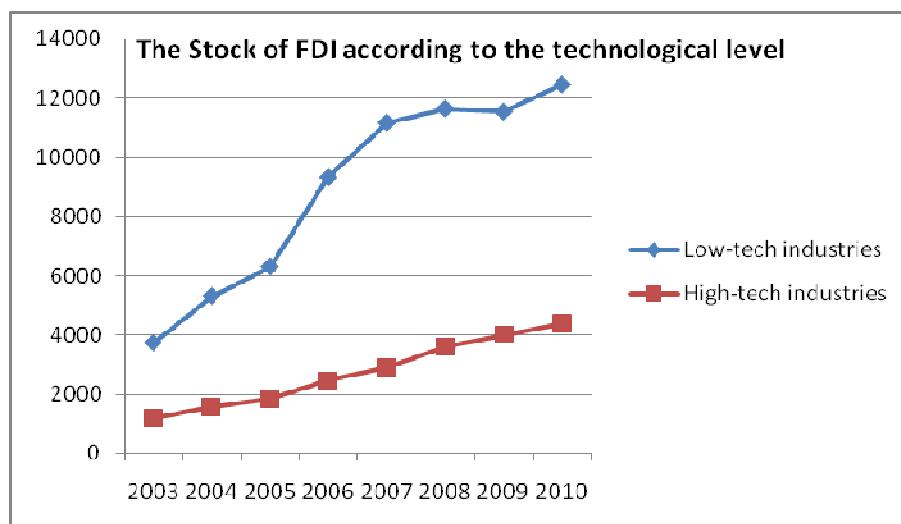
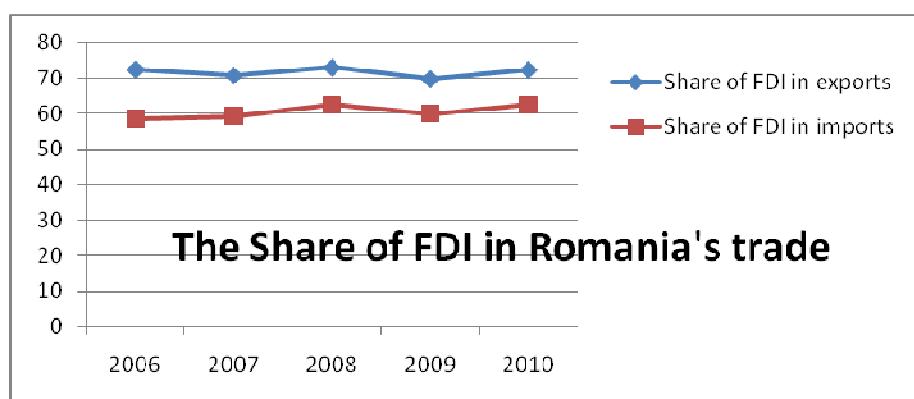
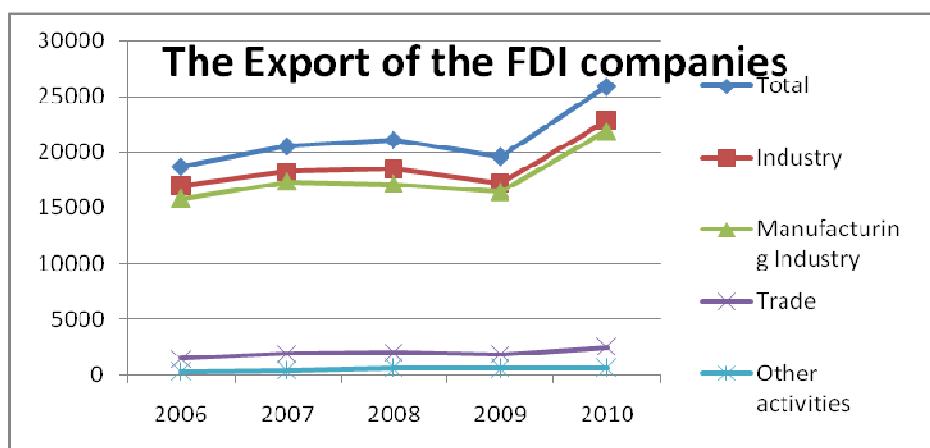
Source: The National Bank of Romania<sup>4</sup>

Figure 3: The Share of FDI in Romania's trade



Source: The National Bank of Romania

Figure 4: The Exports of the FDI companies in Romania



Source: The National Bank of Romania

<sup>4</sup> The delimitation between low-tech and high-tech industries is made according to Eurostat classification [http://epp.eurostat.ec.europa.eu/statistics\\_explained/index.php/Glossary:High\\_tech\\_classification\\_of\\_manufacturing\\_industries](http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Glossary:High_tech_classification_of_manufacturing_industries)

Figure 5: The Map and Geographical Framing of the South-West Oltenia Region

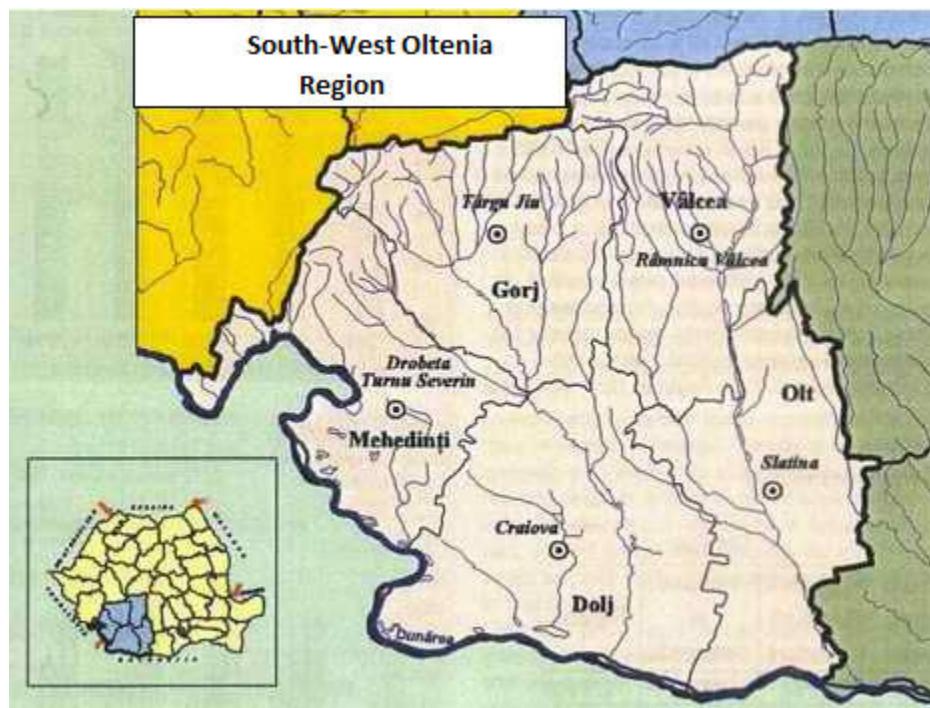
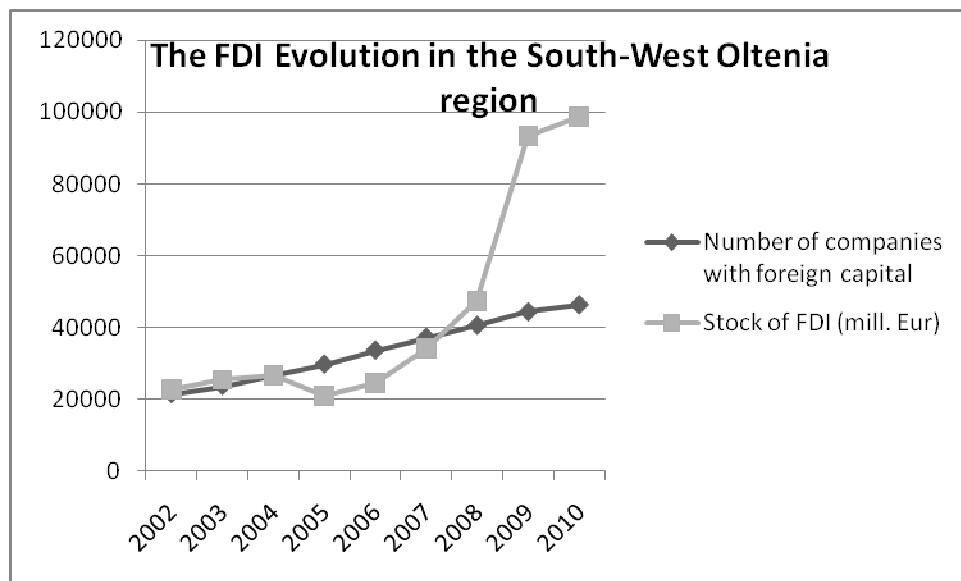


Figure 6: The FDI evolution in the South-West Oltenia region



Source: The National Trade Register Office, 2012