Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 5, Issue 3

8.02.2008

ECFIN COUNTRY FOCUS

Highlights in this issue:

- **Strong wage growth has increased cost pressure on low value-added industries**
- **Growing importance of services and higher value-added manufactures but still at an early stage**
- **Need to address macro-imbalances, continue reforms in the business environment and tackle skill shortages**

FDI in Romania: from low-wage competition to higher value-added sectors

*By Stefaan Pauwels and Lorena Ionita**

Summary

Over the past four years, Romania has benefited from record FDI inflows, thanks to macroeconomic stabilisation, strong GDP growth, large-scale privatisations and the prospect of EU membership. However, privatisation-related FDI flows are slowing down since 2007, which have been an important source of capital inflows over the past decade. Furthermore, successive wage negotiations have driven up unit labour cost, affecting Romania's international competitiveness, especially in light industry, in favour of low-cost Asian countries.

Faced with slowing FDI inflows and at the same time with large catching-up needs (in 2007, Romania's GDP per capita stood at just below 40% of the EU27 average in purchasing power standards), it is time for Romania to step up efforts to attract investment in higher value added sectors, which are less dependent on low wages, by further improving the business climate, upgrading infrastructure and developing labour skills. Increasing external imbalances make the need for policy measures which ensure continued FDI inflows particularly acute.

This Country Focus analyses the size and composition of FDI flows to Romania and identifies some key policy messages for maintaining the country's attractiveness to investors. It compares Romania's performance with central and eastern European countries, where FDI has proved to be a key catalyst in moving up the value chain, and hence speeding up convergence.

Recent developments

Romania has become one of the main beneficiaries of FDI flows in central and eastern Europe

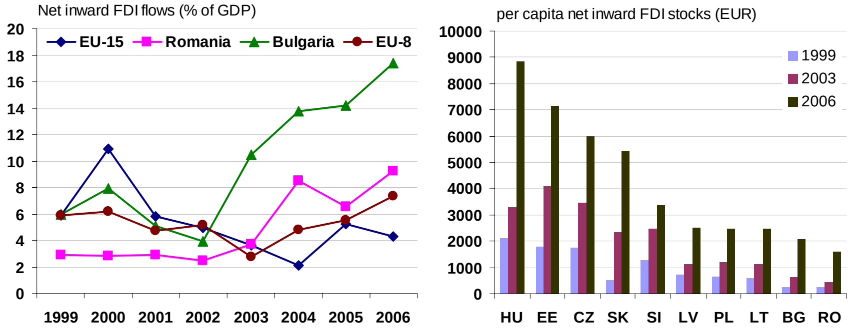
Over the past few years, Romania has benefited from increasing FDI flows. Although its per capita FDI stock is still relatively low, representing roughly 35% of that of its central and eastern European neighbours in 2006, it has increased six-fold since 1999.

This catching-up process accelerated from 2004, with net inward FDI flows as a share of GDP exceeding the inflows recorded in both the eight central and eastern European countries which joined the EU in 2004 (hereafter referred to as the "EU-8") and the EU-15 (see graph 1). Romania has overtaken the Czech Republic as the third largest destination of FDI flows amongst recently acceded Member States in 2006, after Hungary and Poland.

80% of the total FDI stock comes from the EU. About 50% of the total comes from just three countries: Austria, the Netherlands and Germany. Western European investors also predominate in most other central and eastern European Member States.

*** Directorate for the Economies of the Member States.**

Graph 1: Inward FDI flows and per capita FDI stocks



Source: Eurostat, UNCTAD

With the privatisation programme now largely over, total FDI flows are slowing down

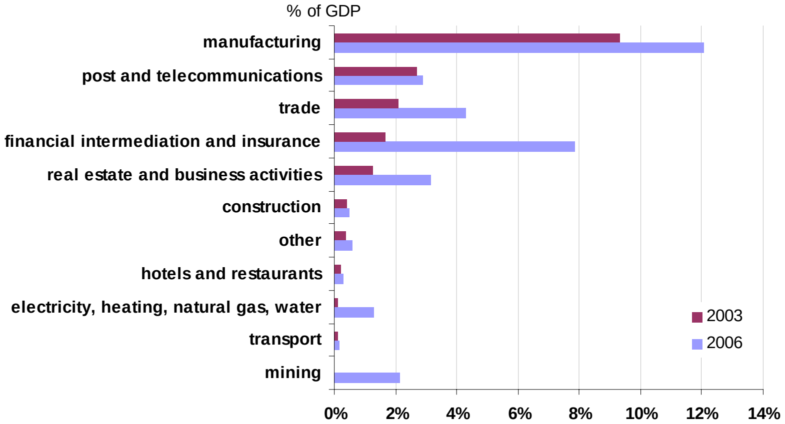
However, preliminary data for 2007 show that the steep increase in FDI inflows may not continue. In the first three quarters of 2007, total FDI flows declined to 6.5% of GDP, from 8.4% in the same period in 2006. This is mainly the result of the declining importance of privatisation-related FDI, which used to be significant in sectors like public utilities (gas, electricity, telecommunications), banking and the construction sector and is estimated[1] to represent roughly half of total FDI stocks. Although several privatisations are still pending, the bulk of the programme is now over. Yet, the volume of non-privatisation-related FDI seemed to have remained broadly stable between 2006 and 2007, according to currently available data.

Changing sectoral composition

While the services sector has recorded the largest increase in FDI stocks …

Major shifts are taking place in the sectoral composition of FDI flows to Romania. Investors' interests are diversifying from exploiting low-cost advantages towards higher value-added production with a stronger emphasis on Romania's growing domestic market. This is reflected in the rising share of the services sector as a destination of total FDI flows. At the same time, the manufacturing sector is undergoing significant transformations.

Graph 2: Sectoral breakdown of inward FDI stocks



Source: Eurostat, National Bank of Romania

In the services sector, the large population and rising living standards have attracted significant FDI flows in financial intermediation and insurance, quadrupling the FDI stocks in this sector as a share of GDP between 2003 and 2006. The increase in insurance can also be attributed to the anticipation of the introduction of a voluntary pension pillar in 2007 and of a compulsory second pension pillar in 2008. Furthermore, both wholesale and retail trade, and real estate and business activities doubled their FDI share as a percentage of GDP over the same period.

… the manufacturing sector remains the largest single FDI beneficiary, but is undergoing significant structural transformations.

However, the largest single beneficiary in terms of FDI stocks remains the manufacturing sector, which held more than 1/3 of the inward investment positions in 2006. While FDI stocks in this sector as a share of GDP increased overall between 2003 and 2006, they have also undergone some major reallocations within the sector. FDI in the (lower-end) clothing and wearing apparel sector has decreased, while it has increased in higher value-added segments like the furniture sector and in transport equipment.

Transforming the manufacturing sector – a comparison with the EU-8

Despite clear signs that FDI is moving Romania up the value chain…

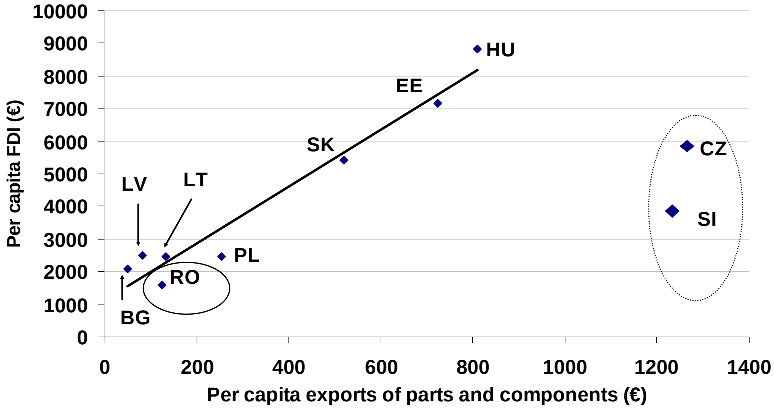
Some of the central and eastern European countries have experienced a similar transformation process in the manufacturing sector. In the early stages of transition, their industrial base relied more on unskilled-labour-intensive activities. Later on, the centre of gravity shifted towards more value-added skill- and capital-intensive sectors such as the automotive and IT industries.

FDI has been highly instrumental in bringing about this change. In particular, countries which have experienced the largest FDI inflows have also witnessed the largest increase in skilled-labour and capital-intensive exports. In order to assess where Romania stands in this transformation process, the following paragraphs will compare Romania's FDI and export performance with the EU-8.

… there is ample room for catching-up in terms of per capita FDI stock and exports

- The World Bank (2005) uses the share of trade in parts and components in total manufacturing exports as a general indicator for the presence of skilled-labour- and capital-intensive activities. In Romania, this indicator is showing a clear upward trend, increasing from 8% in 1999 to 14% in 2006, almost closing the gap with the EU-8 average of 15%. However, when expressed in per-capita terms, the absolute volume of exports in parts and components is still very low at €125 in 2006, compared to €632 in the EU-8. FDI may play a major role in boosting the low export volumes, as shown by the high and positive correlation[2] between the two variables in graph 3.

Graph 3: Strong correlation between the per capita FDI stock and the importance of trade in parts and components (a) (2006)

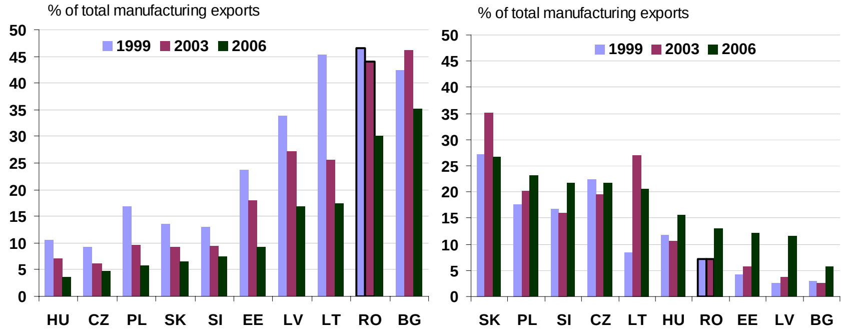


Note: (a) Parts and components refer to all items containing "parts of" or "components of" in the SITC goods classification.
Source: Comext

- An analysis of individual sectors confirms the above trend, with the importance of clothing and leather in total manufacturing exports diminishing. As shown in graph 4 (left-hand panel), Romania's exports still rely strongly on this sector, although its share clearly diminished from 47% in 1999 to 30% in 2006, following increased competition from lower-wage Asian countries. Although interesting at the initial stages of development, these generally unskilled-labour-intensive exports often rely on contracts, whereby the raw materials are imported and subsequently assembled based on the buyer's specifications. FDI levels are usually low, making contracts highly volatile, which allows global buyers to switch easily to cheaper suppliers. Knowledge transfer is limited. The declining trend in this sector is likely to continue over the coming years.

- On the other hand, the transport equipment sector has recorded one of the strongest FDI inflows in recent years, mainly in the sub-sectors of motor vehicles and shipping. Companies from all over the world are now producing vehicles and/or spare parts in Romania, thanks to the well-trained labour force. Furthermore, Romania's long standing ship-building tradition has allowed it to benefit from the increasing international demand for ships. Altogether, the share of transport equipment in total manufacturing exports increased to 13% in 2006, up from 7% in 2003 (see graph 4, right-hand panel). Although still at a distance from the EU-8 average of 18%, the Romanian economy is set to become a more important player in this field. In addition, knowledge transfers in this sector are relatively large.

Graph 4: share of clothing and leather (left) and transport equipment (right) in total manufacturing exports (%)



Source: Comext

In sum, there are clear signs that Romania is gradually making the transition from low-wage competition towards higher value-added sectors, following the earlier experience in the EU-8. However, in per capita terms, both FDI stocks and exports are still significantly below EU-8 averages, suggesting that ample room for catching-up remains. The next section will look into the main determinants of FDI and how their relative importance changes as the economy moves up the value chain.

Drivers of FDI

Wage developments have outstripped productivity growth, weighing on Romania's international competitiveness

Fuelled by large privatisation programmes, foreign investors were attracted by Romania's relatively low unit labour cost, proximity to the euro area, sound macro-economic fundamentals (successful disinflation, high growth) and its already increasing domestic market potential. However, the boom of privatisation-led FDI, which represented about half of the FDI inflows in recent years, is now largely over. Furthermore, Romania's low-cost advantage is gradually eroding in certain sectors. While hourly labour costs remain low, even by eastern European standards (see graph 5, left hand panel), a tightening labour market and skill shortages, partly due to large outward migration, have contributed to significant increases in private sector wages, which are growing by about 20% annually. Although this wage level is still competitive in higher value-added industries, increasing competition from Asian companies is being felt in the traditional low-wage sectors such as clothing and leather. Indeed, a growing area of concern is that wage developments have outstripped productivity growth in the last two years. This has led to a sharp appreciation of the real effective exchange rate[3], adversely affecting Romania's international competitiveness (see graph 5, right-hand panel). Finally, the economy is showing clear signs of overheating, with a high and widening current account deficit (projected at close to 14% of GDP in 2007), growing labour shortages, strong wage growth and rapid increases in household borrowing. The depreciation of the Leu and other supply-side factors, against the backdrop of strong domestic demand dynamics and non-restrictive fiscal and public wage policies have triggered a sudden increase in inflation since August 2007.

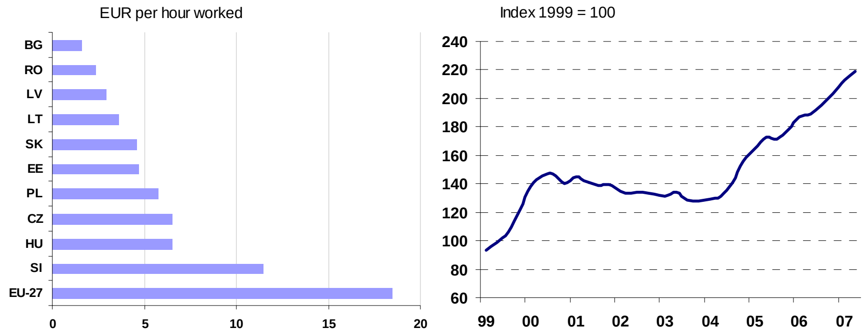
Now that the "low-hanging fruit" has largely been consumed, what factors will stimulate further investment in higher value-added sectors? The experience in the EU-8 has taught that as industry restructuring progresses, the relative importance of cheap labour declines and other factors such as the business environment and infrastructure come increasingly into play (e.g. Demekas, 2005). The availability of skilled labour will also become a more prominent prerequisite for foreign investors.

Despite huge progress in these areas, some major challenges still remain. With respect to the quality of the business environment, in 2007 Romania has moved up from 55th to 48th place in the World Bank's Doing Business report, but still ranks in the lower half among the EU Member States. One of the key problems which negatively impact the business environment is weaknesses in the public

Future FDI flows will be driven by improvements in the business environment, infrastructure and labour skills, embedded in a sound macroeconomic framework

administration and legislation. This concerns in the first place direct business dealings with the administration (such as delays in obtaining authorisations, a high tax compliance cost, lengthy procedures for registering property) and labour regulation rigidities, in particular the rigidity of working hours and of hiring and firing. Other points to watch in the public administration are (a) the need to speed up the absorption capacity of EU structural funds, (b) strengthen the supervisory and regulatory authorities (in particular the enforcement of competition rules), (c) step up the fight against corruption and (d) improve the functioning of the judiciary. The European Commission December 2007 Strategic Report which includes an assessment of Romania's July 2007 National Reform Programme submitted in the framework of the Lisbon Strategy identifies the strengthening of administrative capacity as one of the areas of highest priority.

Graph 5: hourly labour cost in EUR (left) and real effective exchange rate developments [(a)] (right)



Note: (a) based on unit labour cost, comparison with 36 industrialized countries (the 27 EU countries, Norway, Australia, Canada, Japan, the United States, Mexico, New Zealand, Turkey and Switzerland).
Source: Eurostat, DG ECFIN estimates

Further reforms are also necessary in the area of infrastructure, in particular the modernisation of the road network. Here too, rapidly improving the framework for private sector investment and employing EU structural funds more effectively can help achieve progress (see also the 2007 EBRD Transition Report).

Moreover, some challenges remain in the area of labour skills, where improving the skill match between education and labour market requirements is particularly important as stressed in the Commission December 2007 Strategic Report mentioned above. Firstly, partly as a result of large outward migration, skill shortages have been amplified and have become one of the top business concerns both at the higher end of the spectrum, and with respect to unskilled workers, for example in sectors like construction. Secondly, Romania needs to increase the share of population with tertiary education, which currently stands at half the EU-27 average. Finally, early school drop-out needs to be tackled.

Last, but not least, in the light of the recent signs of overheating, Romania should preserve sound macroeconomic fundamentals and address the growing external imbalances to maintain investors' confidence. In this context, fiscal policy has an important role by cooling down internal demand, while also improving the quality of public finance, in particular through a shift towards growth-enhancing investment, as highlighted in the Commission recommendation for a Council Opinion on Romania's December 2007 Convergence Programme.

Conclusion

Romania's patterns of FDI and foreign trade clearly show a transition from a competitive advantage in the lower-end of the value chain (in particular textiles and leather) towards services and higher value-added manufacturing sub-sectors, following the example of many of its central and eastern European neighbours. However, this transition is still at an early stage. Moreover, the level of per capita FDI stock and the share of high value-added manufacturing exports are still relatively low compared to most of the recently acceded Member States.

In order to attract investments in higher value added sectors, which is necessary to maintain rapid real convergence, Romania should strive to further improve the business climate. The most important measures are: cutting red tape, improving the regulatory environment, strengthening administrative capacity, upgrading the existing infrastructure and continuing the reform of labour markets and education systems. In addition, given clear signs of overheating, it is essential that Romania preserves sound macroeconomic fundamentals, by pursuing an appropriate mix of policies, in particular a prudent fiscal policy, and by taking measures that can help to keep wage developments in line with productivity growth.

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[1] As precise data on privatisation-related FDI are not available, the share of "mergers and acquisitions", as opposed to "greenfield investment" is used as a proxy (based on data from the National Bank of Romania).
[2] In 2006, the correlation between per capita exports of parts and components and per capita FDI is 98% among the countries in graph 3, excluding Czech Republic and Slovenia.
[3] However, recent data suggest that this trend might be reversing, following the depreciation of the RON since August 2007.

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