Foreign Direct Investments in Romania: Between Lost Opportunities and Regional Challenges

Alexandra HOROBEȚ

Department of International Business and Economics at

The Bucharest University of Economic Studies

Abstract:

Romania's position in the Central and South-East European region is not necessarily a comfortable one from the FDI perspective. As a late player in relation to inward FDI flows, marked by political and legal instability and a lack of a coherent strategy for attracting FDI, Romania has the lowest FDI stock per capita in the region. Unfortunately, in recent years, a decoupling of wage increases from labor productivity eroded one of the country's significant competitive advantages, and added to the heightened officials' aggressiveness towards foreign investors. If we want to benefit from FDI presence, public policies should be oriented towards a structural and strategic approach aimed at capitalizing on all the opportunities provided by FDI, and focusing on two complementary and mutually enforcing measures: improving the capacity of local companies to "learn" and "absorb" knowledge and technological developments from MNC, but also directing FDI towards activities with high added value. Ultimately, this means less emphasis on incentives for foreign investors and more accent on education, training and regional development.

Keywords: *Foreign direct investments, Romania, Central and Eastern Europe, technological intensity, absorption capacity*

Foreign investments have played a fundamental role in Romania's hard transition from communism to a more developed and sophisticated economy, as well as, incontestably, in the country's affirmation of its European identity. Moreover, this role has not ended yet and is our responsibility to capitalize in the future the many lost opportunities in regards to the presence of

This work is licensed under a Creative Commons Attribution 4.0 International License
©Alexandra Horobeț. ISSN 2344-2352 (Online).

foreign direct investments (FDI) in the Romanian economy and society as a whole, on one hand, and by intelligently overcoming the numerous challenges that we face at regional level (and not only).

This topic is on the Romanian public agenda for quite a long time, accompanied, unfortunately, by a more hostile attitude towards multinational enterprises in the last 3 years. As an observation, the interest was mostly directed towards the size of FDI flows and stocks and much less towards other attributes of the FDI presence in Romania that need awareness in order to positively transform our relationship to foreign investors, as a host country.

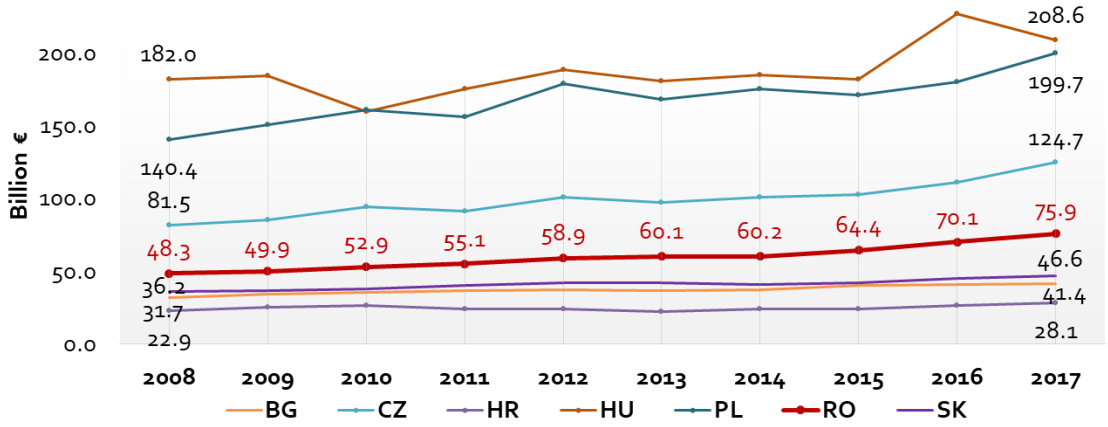
My research on this topic for a number of years has revealed some thought-provoking insights that could form the foundations for a suitable design of supportive FDI public policies in Romania.

Besides a general perception that the FDI received by Romania is high and there is no reason to be concerned, I would like to open the FDI box and briefly explore it from two complementary perspectives: which are the structural attributes of FDI in Romania and where is the country placed in relation to its neighbours - countries with a similar economic and social past, now EU members as well?

The picture of inward FDI in Central and Eastern Europe countries is summarised in Figures 1 and 2. The stock of FDI in Romania reached 81 billion € at the end of 2018, and is almost equally split between equity capital and reinvested earnings. FDI stocks were just over one third of Romania's GDP, on a descending trend as a result of GDP growth. A similar trend is observable for the other countries in the region but FDI stocks are generally above 50% of their GDP (except for Poland and Croatia). Concerning is that countries with lower FDI volumes have a better performance than Romania in attracting FDI. The best times for FDI in Romania were between 2003 and 2008 (before joining the EU and immediately after the accession), when FDI flows rose more than five times. At the end of 2018, FDI companies employed around 1.3 million people, a third of the labour force in the Romanian private sector, with uninterrupted hiring over the years, despite sometimes stagnant turnover. Nearly half of the total FDI was directed to industry – 41%, which means that the investments were significant both in terms of volume and long-term horizon. At present, the share of gross value added of foreign companies exceeds 60% in automotive and

ICT industries, and foreign companies' labour productivity is double compare to that of domestic companies, fuelled by higher investments per employee[1].

Figure 1. Stock of FDI in Central and Eastern Europe countries, 2008-2017



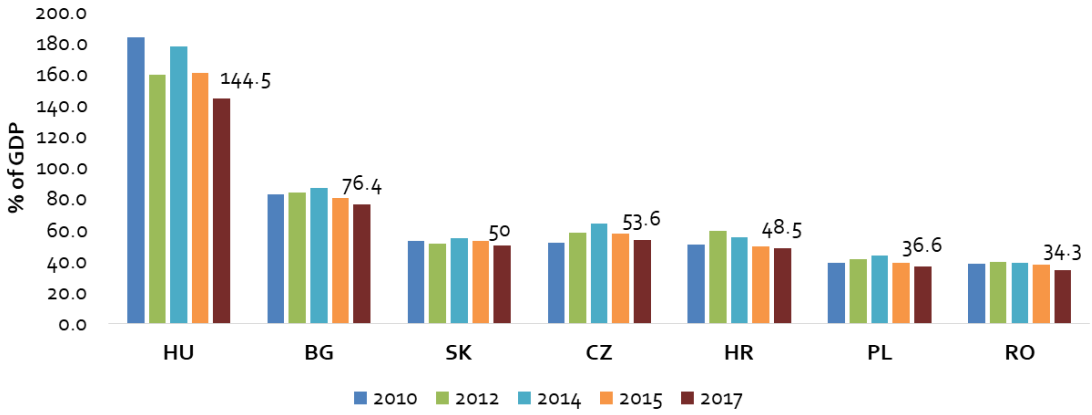
Note: BG – Bulgaria, CZ- Czechia, HR – Croatia, HU – Hungary, PL - Poland, RO – Romania, SK – Slovakia

Data source: Eurostat, National Bank of Romania, UNCTAD

The level of FDI per inhabitant in Romania is significantly below our peers' level – see Figure 3. The good news is that Romania enjoys the highest growth rate in FDI per inhabitant, but the not so pleasant news is that this is also driven by the decrease of the population (Romania's rate of population decline was the highest in the region (-1.26%)). Actually, growing labour shortages as a result of migration and younger people migration, specifically, create a serious challenge for Romania. If we add to this population aging, skills mismatches and a problematic participation in the labour market for women, older people, young people or people from rural areas, the picture is more dramatic.

[1] Alexandra Horobet, Oana Popovici – Investițiile străine directe și importanța lor în România, Studiu Foreign Investors Council and The Bucharest University of Economic Studies, 2017, https://fic.ro/Documents/view/Studiu-Investitiile-straine-directe-evolutia-si-importanta-lor-in-Romania. For more insight into For more insight into FDI in Romania, please see https://fic.ro/investitiile-straine-din-romania, https://fic.ro/Documents/view/Report-Foreign-Direct-Investment-Development-and-Importance-in-Romania.

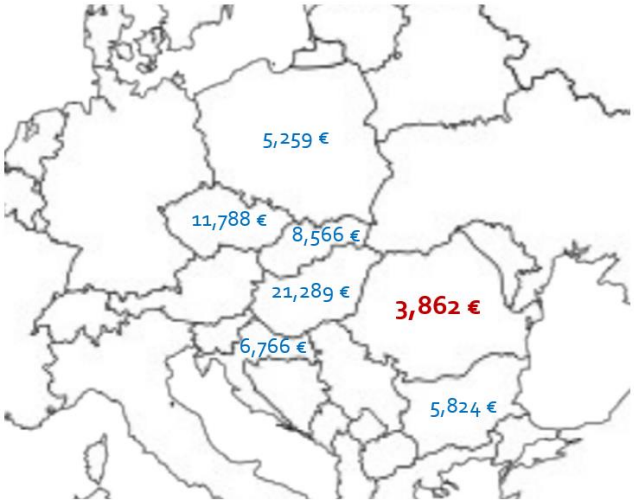
Figure 2. FDI stock as share in GDP (%), Central and Eastern Europe countries - 2010-2017



Note: BG – Bulgaria, CZ- Czechia, HR – Croatia, HU – Hungary, PL - Poland, RO – Romania, SK – Slovakia

Data source: Eurostat, National Bank of Romania, UNCTAD

Figure 3. FDI per inhabitant, Central and Eastern Europe countries - 2017

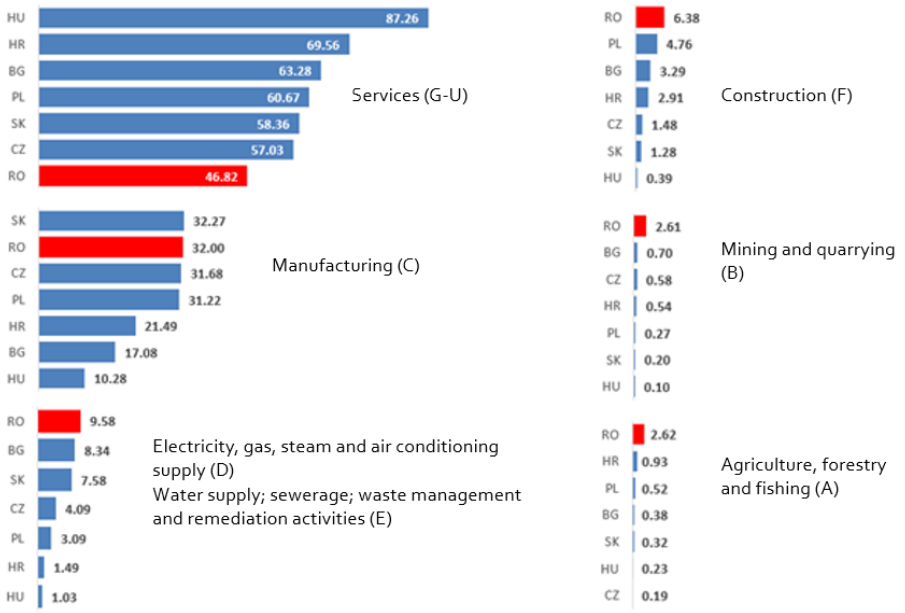


Data source: Eurostat

Romania has a different landscape of FDI stocks' destination by economic activity compared to the countries in the region. Of most concern is our inability to attract FDI towards the services sector – we have the lowest share of FDI compared to our regional peers, almost 47% of the total, with the next ranked country - Czech Republic - ahead of us by more than 10 percentage points and the rest of the countries with much higher weights, even 87%, in the case of Hungary – see Figure 4. Given the global reorientation of FDI flows towards services in the last decades,

largely supported by technological developments, this is an opportunity that we have not been able to fully capitalize so far.

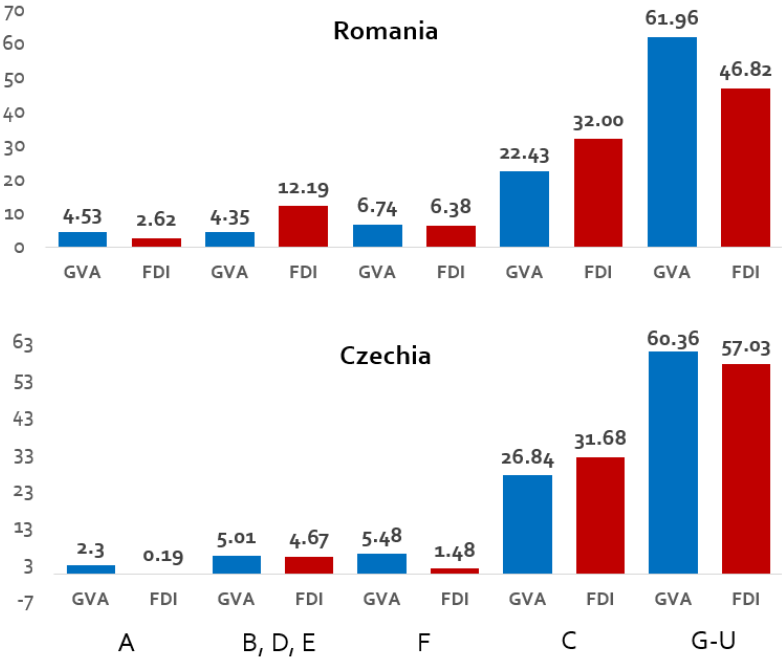
Figure 4. Distribution of FDI stocks across economic sectors (% of total, 2016)



Note: BG – Bulgaria, CZ- Czechia, HR – Croatia, HU – Hungary, PL - Poland, RO – Romania, SK – Slovakia
Data source: Eurostat

I would add to this the conclusions of an analysis of FDI stock distribution across sectors based on the share of Gross value added of these sectors at economy-wide level – and this shows that Romania attracts FDI in low value added sectors, as opposed to the neighbouring countries where FDI are oriented to sectors with a higher contribution to the gross value added – see Figure 5. The graphs show only a comparison with the Czech Republic, but similar conclusions can be drawn when comparing Romania to each of its neighbours.

Figure 5. Gross value added and FDI stocks across economic sectors, 2016



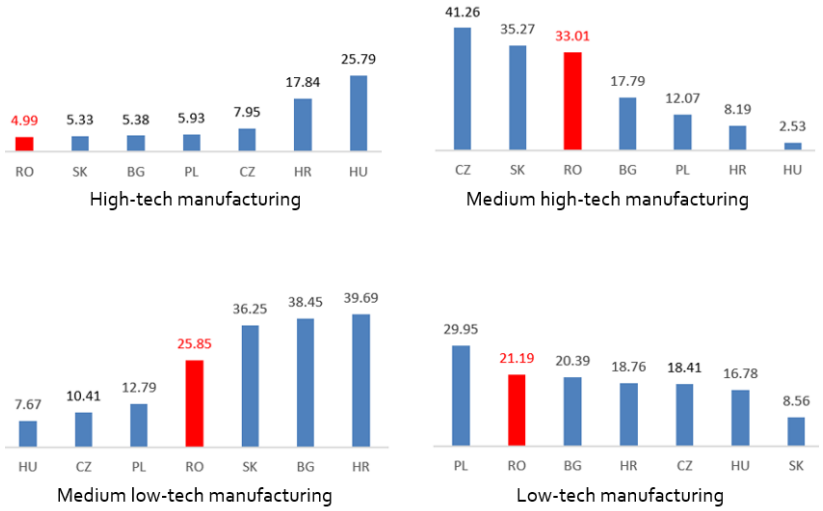
Note: A - Agriculture, forestry and fishing; B - Mining and quarrying; C – Manufacturing; D - Electricity, gas, steam and air conditioning supply, E - Water supply; sewerage; waste management and remediation activities; F – Construction; G-U - Services

Datasource: Eurostat

Another relevant part for the FDI landscape in Romania is that they are oriented towards industrial sectors with a medium to low degree of technological intensity[1]. The medium low-tech (MLT) sector hosts over a quarter of FDI stocks, followed by the low-tech (LT) with over a fifth. In the high-tech (HT) sector, FDI stocks are only 5% of all the FDI stocks in the manufacturing sector, which is the lowest level in the region. In this framework, there is a strong need to stimulate an orientation of FDI towards industries with high technology level, in order to avoid a specialization in industries with low added value and low technological intensity. Entering such a vicious circle will be very difficult to remedy later, also given our neighbours' advancement in this respect.

[1] The European Commission and Eurostat use an aggregation of the manufacturing industry according to technological intensity and based on NACE Rev.2. The manufacturing industries are included in four categories: high-technology, medium high-technology, medium low-technology and low-technology industries. For more information, see https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:High-tech_classification_of_manufacturing_industries and

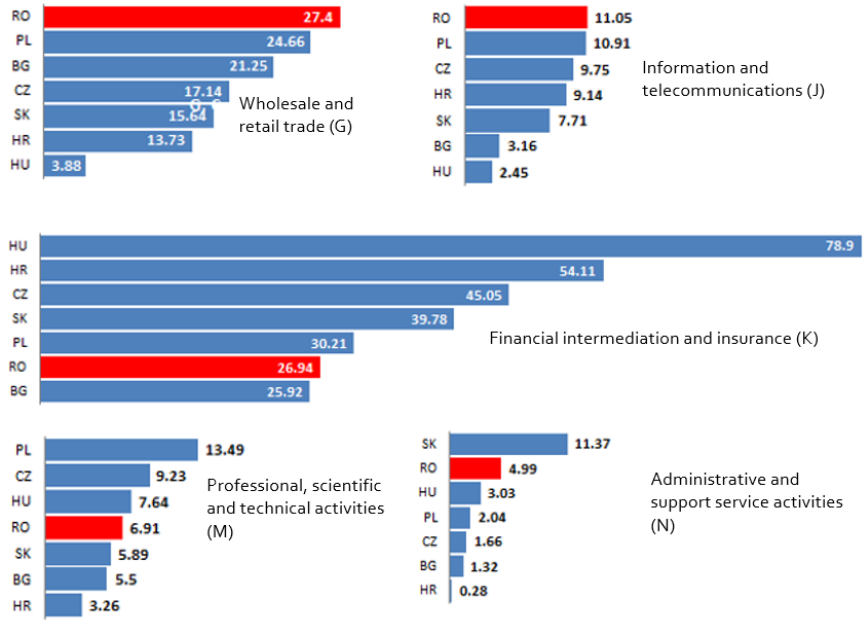
Figure 6. FDI stock in manufacturing industries, based on technological intensity (% of total FDI stock in manufacturing, 2016)



Note: BG – Bulgaria, CZ- Czechia, HR – Croatia, HU – Hungary, PL - Poland, RO – Romania, SK – Slovakia
Data source: Eurostat

Moving to services, the most targeted component by FDI is wholesale and retail trade – and we hold the highest share of FDI in trade in the region (27%), which is, again, one of the least knowledge-intensive services. The second main focus of FDI is financial intermediation and insurance, although with a significantly lower share in total FDI compared to our peers – see Figure 7. The good news coming from the services sector is that Romania holds the highest share of FDI in the Information and Telecommunications sector, included in the category of knowledge-intensive high-tech services. This is explained by the exemption from personal income tax for IT employees, but also by the smaller investment volume needed to start business in this sector - generally, the entry barriers into the industry are relatively low. At the same time, it is questionable whether the tax exemption will endure and whether FDI in this sector will further continue; looking at our regional peers that do not offer FDI such incentives, the answer might be positive, though.

Figure 7. FDI stock in services (% of total FDI stock in services, 2016)

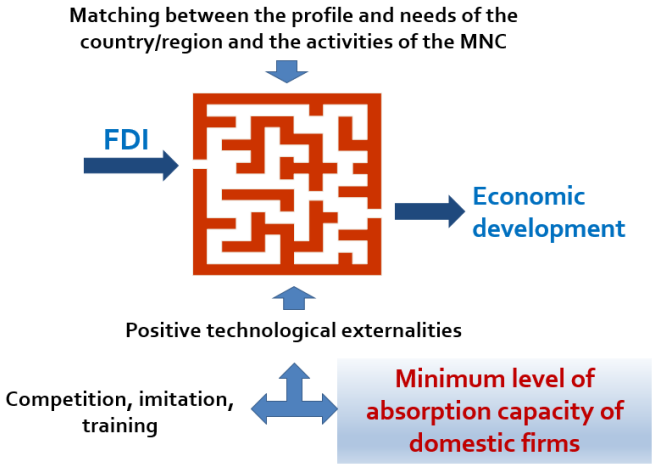


Note: BG – Bulgaria, CZ- Czechia, HR – Croatia, HU – Hungary, PL - Poland, RO – Romania, SK – Slovakia

Data source: Eurostat

FDI flows do not necessarily stimulate economic development if there is no matching between the profile and needs of the country or region and the activities of the MNC. FDI are a mean of transferring technology and knowledge from the parent to the affiliates in the host country and then further to the domestic firms and we know, from existing studies, that positive technological externalities are intensified by competition, imitation and training. BUT they also depend on the technological and social capabilities of the subsidiaries in the host country and of the domestic firms with which they interact. For such effects to occur, a minimum level of absorption capacity of local firms is required – see Figure 8. A high technological gap between local and foreign firms inhibits the positive effects on performance, which means that the ability of domestic firms to decode and use new knowledge elements depends to a large extent on their existing knowledge stock.

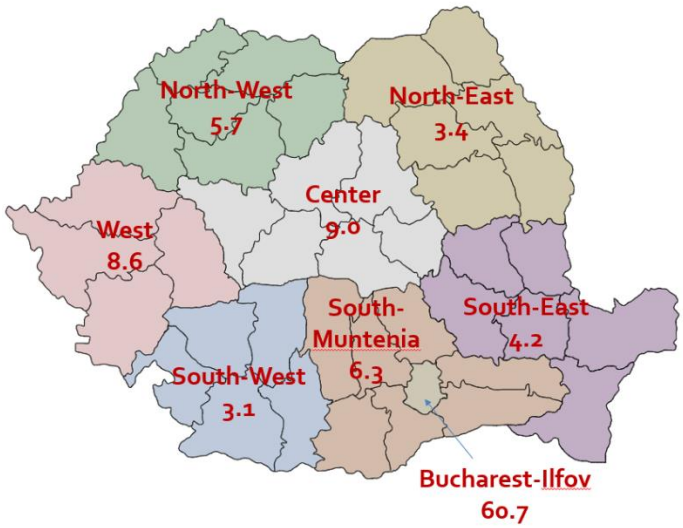
Figure 8. Absorption capacity of FDI – a logical structure



I propose you now to take a look at the FDI stock distribution across Romania's development regions[1] – Figure 9. 60% of the FDI stock is in the Bucharest-Ilfov region, but this is misleading because investment is measured at headquarters' location and most foreign companies are located in Bucharest. After the Bucharest-Ilfov region, most FDI are directed to the Central and Western regions of Romania, due to their proximity to the rest of the EU and the enhanced infrastructure. I would say that this map shows the "regional disorientation" of FDI in Romania, driven by various determinants, of which the most important are the infrastructure lack and quality, workforce migration towards EU and the institutional dysfunctionalities at regional level. Again, all these mean lost opportunities for Romania in its relationship to FDI and in terms of development.

[1] Romania's development regions (8) are included in the EU NUTS classification used to define regional boundaries and determine geographic eligibility for structural and investment funds. For more information, see https://ec.europa.eu/eurostat/web/regions/background

Figure 9. The regional disorientation of FDI in Romania (% of FDI stocks, 2018)



Data source: National Bank of Romania

Qualitative infrastructure is critical for economic growth, and in Romania much still needs to be done to upgrade the country's infrastructure to European standards. Although all governments have declaratively acknowledged the important role that infrastructure plays, the pace of progress has been extremely slow, given the low absorption of EU funds for this purpose and the limited state budget funds that can be allocated. The lack of a proper infrastructure resulted in missed foreign investments – maybe the best examples are the Renault factory opened in Tanger (Morocco) and the Mercedes-Benz investment in Kecskemet (Hungary in 2016), but there is a long list of companies that have considered Romania as a possible investment location and have decided, eventually, to locate their new production facilities in other countries in the region). Over the medium and long-term, this major deficiency creates a strong liability for Romania in the competition towards attracting FDI and not only.

Research has documented the so-called "agglomeration effect", as MNCs tend to locate their activities in areas where other companies are already present (either a "follow the leader" FDI or FDI reassured by the others' presence in a host country)[1]. At regional level this is seen in the existence of well-specialized regions in terms of sector or industry. While for the industry are

[1] Jones, J. (2017) Agglomeration economies and the location of foreign direct investment: A meta-analysis, Journal of Regional Science, 5, 731-757; Barry, F., Görg, H., Strobl, E. (2003) Foreign direct investment, agglomerations, and demonstration effects: An empirical investigation, *Review of World Economics*, 139, 583-600; Barrell, R., Pain. N. (1999) Domestic institutions, agglomerations and foreign direct investment in Europe, European Economic Review, 43, 925-934;

attractive the regions that have a higher concentration of companies operating in the same sector, for services concentration is usually in prosperous areas, benefiting from highly skilled workforce and knowledge-intensive services. This generates a lost opportunity for Romania.

In this framework there is no surprise to discover that Romanian regions are all below the EU average in terms of their competitiveness (as revealed by the most recent European Regional Competitiveness Index[1]) – with only 4 out of 8 improving their competitiveness compared to 2016. True, a similar pattern is valid for all regions in CEE, with the exception of capital regions in Poland and Czech Republic and of another Czech region.

There are many explanations that can be advanced for the existing state of FDI in Romania, in terms of both size and structure. I would mention just a few more, adding to the previously discussed ones:

- Romania was a late player in the CEE region in relation to FDI, due to the effective opening of the country towards foreign investors at the end of the '90s; this meant that FDI were benefiting from the other countries' competitive advantages first and only later they "discovered" Romania
- Political and legal instability was a rather permanent issue before 2000 (just remember the turbulent 1996-2000 period, a lost one from nay perspectives), but, recently, legal instability was coupled with legal aggressiveness towards the business environment in general and the foreign investors in particular (I think we all remember the hostile discourses against MNCs in the last three years)
- The wage policies in the same last three years, focused on wages increases decoupled from labour productivity eroded significantly one of the competitive advantages that the country enjoyed, in the form of workforce lower cost
- And, in the end, Romania never had a coherent strategy for attracting FDI, either in sectorial/industrial terms or in regional terms. To a large extent, all FDI were equally treated, disregarding their size, orientation and potential effects in the economy (positive or negative). True, there were various explicit incentives awarded to foreign investors (and promises, some of them unaccomplished), but no long-term vision over how to benefit from the FDI presence has never existed.

[1] https://ec.europa.eu/regional_policy/en/information/publications/working-papers/2019/the-european-regional-competitiveness-index-2019

The impact of FDI on any host country's economy is felt directly or indirectly – directly, by providing jobs in the economy, creating new production capacities and the taxes paid to the state budget; indirectly, by exposing local companies to advanced technologies, as well as to knowledge and management practices, transmitted by multinational corporations. This transmission takes place through demonstration effects, through integrating local companies in value added chains and through competition. If we want to benefit from FDI presence, the design of public policies needs to be oriented not only towards increasing the stock of FDI, which is a desirable goal in a first phase of attracting FDI, but, more importantly, towards a structural and strategic approach aimed at capitalizing on all the opportunities provided by FDI. This request a focus on two complementary and mutually enforcing measures, which influence each other: improving the capacity of local companies to "learn" and "absorb" knowledge and technological developments from MNC, but also directing FDI to activities with high added value. Doing so means less emphasis on incentives for foreign investors and more accent on education, training and regional development.

Last, but not least: Romania's position is the South-East European region is not necessarily a comfortable one from the FDI perspective. Besides the traditional competitors in the CEE, EU members now, we should not forget other neighbours that are not EU members but aim towards membership (Western Balkans, Serbia, Ukraine, Moldova), but also more distant players such as the Caspian Sea countries, that address foreign investors with competitive advantages not easy to ignore: lower labour costs, big markets and natural resources.

I would like to end my paper with a little insight from my research into the Renault investment in Mioveni a few years ago[1]. I asked Dacia-Renault's CFP which was the most difficult thing Renault had to deal with after purchasing Dacia. To my surprise, he said "taking the hammers out" – at the time, no one could find two identical Dacia cars, since the mechanics were adjusting everything using their hammers. All the hammers were out in three years, which is quite a long time. I hope that it will take us less than three years to design and to start implementing the needed strategy towards FDI that could address many of the challenges we face.

[1] https://fic.ro/Documents/view/Report-Foreign-Direct-Investment-Development-and-Importance-in-Romania

Selected bibliography:

- Barrell, R., Pain. N. (1999) Domestic institutions, agglomerations and foreign direct investment in Europe, European Economic Review, 43, 925-934
- Barry, F., Görg, H., Strobl, E. (2003) Foreign direct investment, agglomerations, and demonstration effects: An empirical investigation, *Review of World Economics*, 139, 583-600
- Casi, L., Resmini, L. (2010). *Evidence on the determinants of foreign direct investment: the case of EU regions*, Eastern Journal of European Studies, 1(2): 93-118.
- Cohen, W. M., Levinthal, D. A. (1990). *Absorptive capacity: a new perspective on learning and innovation*. Administrative Science Quarterly 35: 128–152.
- Dunning, J.H. (1973). *The determinants of international production*, Oxford Economic Papers, 25(3): 289-336
- Dunning, J.H. (2001). *The Eclectic (OLI) Paradigm of International Production: Past, Present and Future*, International Journal of the Economics of Business, 8(2): 173-190
- Hafner, K. A., Kleinert, J. (2018). *FDI Flows and Regional Development: Lessons for Transition Countries*, în Ateljevic, J., Budak, J. (editori), Entrepreneurship in Post-Communist Countries. New Drivers Towards a Market Economy, Springer International Publishing.
- Horobet, A., Popovici, O. – Investițiile străine directe și importanța lor în România, Studiu Foreign Investors Council and The Bucharest University of Economic Studies, 2017, https://fic.ro/Documents/view/Studiu-Investitiile-straine-directe-evolutia-si-importanta-lor-in-Romania
- Jones, J. (2017) Agglomeration economies and the location of foreign direct investment: A meta-analysis, Journal of Regional Science, 5, 731-757
- Malecki, E. (1997), *Technology and Economic Development: The Dynamics of Local, Regional and National Competitiveness*, 2nd edition (Addison Wesley Longman: London).
- Pelegrin, A., Bolance, C. (2008). *Foreign Direct Investment in Manufacturing, Do agglomeration Economies Matter?*, Regional Studies 42(4): 505-522.
- Porter, M. (2003). *The Economic Performance of Regions*, Regional Studies, 37(6-7): 549-578

- Pusterla F., Resmini L. (2007). *Where do foreign firms locate in transition countries? An empirical investigation*. Annals of Regional Science 41.
- Sipikal, M. (2011). *Concentration of FDI and regional disparities - The role of regional policy*, ERSA conference papers, European Regional Science Association.
- UNCTAD (2019). World *Investment Report. Special Economic Zones.* New York: United Nations. 2019.
- World Bank (2020). *Markets and People. Romania Country Economic Memorandum*. International Development in Focus. Washington, DC: World Bank.
- Zhang, Y., Li, H., Zhou, L.-A. (2010). *FDI Spillovers in an Emerging Market: the Role of Foreign Firms' Country Origin Diversity and Domestic Firms' Absorptive Capacity*, Strategic Management Journal, 31: 969–989.