

# Particularities Regarding the Evolution and Role of Foreign Direct Investments in Romania's Economy

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## Abstract

*Criticized by some, praised by others foreign direct investments are a financial flow with a major impact on the economies of many countries. In an increasingly globalized world, the process through which multinationals open production and distribution branches over the entire surface of the globe is something as natural as possible.*

*After the fall of communism in Europe, Romania has been a favorite destination for many foreign investors, fact which requires a careful analysis on the dynamics and structure of foreign direct investment flows attracted by Romania. I have also tried to highlight the nature of the link between the flow of foreign direct investment attracted by Romania and the variations recorded in the economic development of our country.*

*Given all the positive and negative aspects presented, foreign direct investments are a reality for Romania, and future policies promoted in the area should stimulate the entry foreign capital firms whose work will generate a high level of content of knowledge and technology directly impacting the improvement of the economic efficiency at national level.*

**Key words:** foreign direct investments, flow, stock, economic growth, correlation

**J.E.L. classification:** F21, F23

## 1. General aspects regarding foreign direct investments

It is obvious that the vast majority of the people of a country want to benefit in the future from a standard of living higher than that of the present. To achieve this objective, the main direction in which this action must be taken is to ensure sustainable economic growth, a fact supported by the political class in the country. Economic development, accompanied by a fair distribution of its effects, ultimately lead to improve the living conditions of the population.

To ensure GDP growth, the necessary capital flows should be ensured. For the construction of production units, a state can access certain external loans, which through judicious management, ensure economic development and constitute a source of additional budget revenues, the profits made by these companies are returned to the state as shareholder. Another solution is the foreign investment that can be attracted by a country. Attracted foreign investment by the domestic capital market represents an extremely volatile source of capital, it is extremely difficult for a country to build factories with money entering and leaving the country with extraordinary speed. In this context, attracting foreign direct investment is advisable. Besides the fact that it will not generate foreign debt, through the control exercised by the foreign investor over the economic unity, foreign direct investment generates profits without effort from the host country. We must not forget that on one hand besides the financial inflow, the foreign investor transfers important knowledge management skills, marketing skills, etc., to the host country and on the other hand in many cases it invests in building productive halls, mounting equipment etc., elements that make the investment hard to abandon. Essentially in a foreign direct investment, the investor is more involved and more responsible than the investor who speculates on the capital market in another country. We must also take into consideration that the jobs created by FDI provide higher wages than local wages in comparable industries and there is a transfer of technology.

In the speciality literature, the attractiveness of a particular host country to a foreign investor is usually determined by three elements:

- national policies on FDI materialized especially in treatment of domestic companies with foreign capital;
- facilities targeting the investment incentive system for investors, system which is predictable and transparent;
- the economic factors characterizing the host country, which generally refer to the market size and its evolution trends, natural resources and manpower available for existing infrastructure and opportunities arising from the ability to purchase or merge with businesses local. (Popa S. 2012, p 91-92)

In other words, multinational companies - which are the structures that provide the bulk of foreign direct investment flows - invest in countries that provide higher profit rates than those registered in their own country. Usually those profits are transferred to the investor's home country, generating a series of discussions and controversies in the host country around the moral issues arising from this.

## **2. The evolutionary trends of foreign investment flows at a global scale**

The aftermath of the Second World War was characterized by the pursuit of many national liberation movements initiated by existing colonies at that time. The result was the formation of numerous independent states that politically were no longer controlled by the metropolis, but where economically strong dependence was still existing.

The desire of the young states, mainly under-developed countries developing countries, to develop by themselves led to the adoption of laws that limited the access of foreign capital in general, and especially that from the metropolis. This led to a relatively slow economic development of the newly independent states.

Since the 80s developed countries have passed a series of regulations favorable to foreign investors, and the approach was followed in developing countries. In the last 24 years of the total of 2,634 adopted regulations relating to foreign investments globally, 85% were favorable to foreign investors. We can say that most of the world countries show a favorable attitude towards foreign investors.

There are also hostile situations in this area transposed into national legislation which led to nationalizations, Venezuela and Brazil representing examples. Noting that to such an attitude some multinational companies also contributed, whose behavior was characterized by predominantly operating in their own interests, exploiting the natural resources in the host country, sometimes with a disastrous impact on the environment.

As a result of the favorable regulatory framework promoted by most countries after 1980, the annual values of foreign direct investment experienced a continuous growth trend between 1980-2000. The next three years were characterized by a strong decrease in the flow of foreign direct investment, in 2003 it represented approximately 40% of the corresponding value of 2000. In 2004-2007 foreign direct investment grew strongly reaching a maximum of \$ 1.8717 trillion. 2008 and 2009 saw significant falls of foreign direct investment flows globally that dropped sharply amid the global financial crisis and increased with some fluctuations in the coming period, reaching in 1762, billion dollars in 2015, value close to the level reached in 2007. (<http://unctad.org/en/Pages/statistics.aspx>)

Worth noting that in the period 2011-2014 the cumulative flows of foreign direct investment annually in developing countries and transition countries have surpassed the flow in developed destination countries, a trend that we can consider as correct, given on one hand the need for the development of poorer countries, and on the other hand, the lack of capital of such countries.

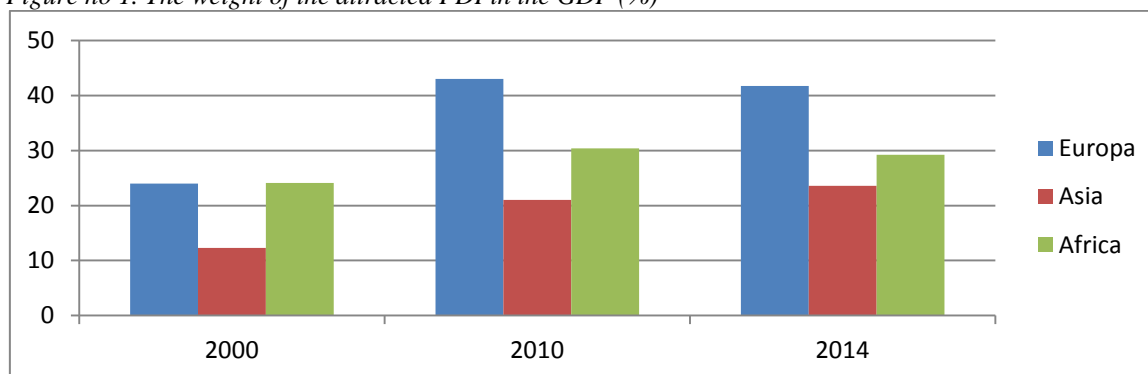
Table no 1. The evolution of FDI flows at a global level and per country categories

	1980				2015			
	Inflow (\$ bn)	%	Outflow (\$ bn)	%	Inflow (\$ bn)	%	Outflow (\$ bn)	Inflow (\$ bn)
<b>World</b>	701,1	100	558,9	100	24983,2	100	25044,9	100
<b>Developed countries</b>	406,6	57,9	488,2	87,3	16007,3	64,0	19440,8	77,6
<b>Developing countries</b>	294,5	42,1	70,7	12,7	8374,4	33,5	5296,3	21,1
<b>Transition countries</b>	0	0	0	0	601,3	2,5	307,7	1,3

Source: <http://unctad.org/en/Pages/statistics.aspx> and [http://unctad.org/en/PublicationsLibrary/wir2016\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf)

Regarding the evolution of the foreign direct investment stock, it's been a substantial increase in the between 1980-2015. In terms of the share of different categories of countries in the total stock of FDI worldwide, there has been a decrease in the share of developing and transition countries in what concerns investments attracted and an increase of the share of this category of countries in investments made abroad. It is good that we are witnessing a growing role of developing and transition countries in investments made abroad, but we must remember that few countries from this category have shown a major investment potential abroad and investments are overall of a regional character.

Figure no 1. The weight of the attracted FDI in the GDP (%)



Source: <http://unctad.org/en/Pages/statistics.aspx> and [http://unctad.org/en/PublicationsLibrary/wir2016\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf)

The degree of dependence of the economy of a country or an area can be determined by the share of the stock of investment in the GDP. As highlighted in Figure No. 1, this indicator has increased in all three analysed continents. The largest share of the foreign direct investment stock to GDP is owned by Europe, an region with an appreciable level of development. This high percentage is due to a good economic performance recorded by many developed European countries showing interest for foreign investors, but also by pressing capital needs from the former socialist countries of Central and South-eastern Europe. The extraordinarily growth in GDP in Asia coupled with the domestic capital available led to a relatively low share of FDI in the GDP for this continent. Relatively low in terms of records and the recalled indicator is Africa, where there is an acute lack of adequate financial resources.

### 3. The impact of foreign direct investments on the Romanian economy

Due to the promoted government policy and legislation during communist Romania, the country was not, in general, considered as an attractive country for foreign investors.

After the events of 1989, the legal framework of our country has changed fundamentally, Romania turned into a major opportunity for investors through the facilities and incentives for them but also through the generous offer resulting from the privatization process of the Romanian companies with state capital.

In the first half of the ninth decade of the last century, although foreign investors were positively discriminated against domestic investors, at least due to the exemption from corporation tax, average annual foreign direct investment in Romania were modest.

The change in decision makers, following the elections in 1996 led to the lands property investment legislation and increased the opportunities for foreign investors to participate in the privatization process. However political instability and frequent legislative amendments have made the average annual inflows of foreign direct investment values somewhat higher than previously, but still modest when compared with the opportunities and the need for capital of Romania.

Joining NATO and the clear prospects of joining the European Union resulted in an exponential increase in the flow of foreign direct investment attracted by Romania since 2003. This trend was maintained until 2008. It should be noted that during this period acquisitions were privatized by foreign investors in particularly attractive economic units such as those in the extraction, processing and distribution of oil, the natural gas distribution sector, the electricity distribution etc.

The spread of the global financial crisis since 2009, resulted in a considerable reduction in foreign direct investment flows to Romania, our country being heavily dependent on foreign markets and therefore vulnerable to disturbances recorded in the world economy. The value of the average annual FDI flows entered in Romania in the period 2009-2014 is only \$ 3.3 billion, a value that is only 24.6% of the level achieved in 2008 according to UNCTAD.

Unfortunately, in recent years there is a tendency to cap these flows, the range 3-3.5 billion is far below the values recorded before the crisis. What is worrying is that this evolution took place in a context in which the values of FDI flows attracted worldwide and by most former socialist countries, which are now members of the EU, showed recovery trends with the annual value surpassing, in some cases even exceeding the one before the crisis. (<http://unctad.org/en/Pages/statistics.aspx>)

The stock of foreign direct investment attracted by Romania represented \$ 60.7 billion at the end of 2014, the main areas that attracted funding source are: industry (48.7%), financial intermediation and insurance (13.0%), trade (11.7%) etc.

The countries that have invested the most in Romania, are in the following order: the Netherlands (23.6% of all incoming FDI stock), Austria (16.1%), Germany (12.4%), Cyprus (7.1%) and France (6.8%). The presence of Austria, Germany and France in the top five foreign investors in Romania is not surprising, their presence is easily felt in our economy through numerous acquisitions made in the privatization process. Unusual is the presence as leader of Holland, which may be motivated by the transnational companies opening branches in there, these branches later becoming investors in Romania. This phenomenon is caused by tax arrangements, and political stability that characterizes the Netherlands. Also in the category of novelty we can consider Cyprus, however this can be justified by its status of tax haven. Cypriot firms have been established and used by foreign investors from various countries, including Romania. Through these companies anonymous investors have made foreign investments in Romania, mainly through the privatization process.

Romanian companies with foreign direct investment are the key participants in Romania's foreign trade. The share of exports of goods made by these companies in the total Romanian exports of goods in 2014 was 70.9% and 64.7% in the imports of goods. Export and import services shares stood at 51.0% and 51.2%. (<http://unctad.org/en/Pages/statistics.aspx>)

This raises the questions about the economic and social impact on sustainable development which foreign direct investments produce on the host country.

In terms of the impact on GDP growth, some authors believe that FDI positively influences the evolution of the gross domestic product, while other authors bring arguments to the contrary. It seems that the truth is somewhere in the middle, usually FDI generates in the host countries' economies both beneficial and less beneficial effects. There are countries like Singapore, Brazil, Thailand and to some extent China where foreign direct investment has played an important role in their economic development, and countries (Japan is an example) whose development was supported primarily by domestic capital.

Coming back to Romania, the country's gross domestic product increased between 1989-2014 from 42.6 billion euros to 150.3 billion euros, the multiplication being 3.5 times. Over the same period the stock of foreign direct investment attracted by Romania increased from virtually 0 to \$

60.7 billion. The evolution of the two indicators can lead us to the conclusion that foreign direct investments have contributed significantly to GDP growth of Romania.

To highlight the extent to which there is a direct link between the change in FDI inflows and changes in Romania's gross domestic product we use the correlation coefficient calculation.

For ease of calculations and tabular representation we denote by x the inflows of foreign investment in Romania and with y Romania's gross domestic product.

Table no 2. The variation of FDI inflows and GDP in Romania

	X	Y	X Y	X <sup>2</sup>	Y <sup>2</sup>
2005	6,1	99,6	607,56	37,21	9920,16
2006	10,8	123,5	1333,8	116,64	15252,25
2007	9,7	171,5	1663,55	94,09	29412,25
2008	13,4	208,1	2788,54	179,56	43305,61
2009	4,6	167,4	770,04	21,16	28022,76
2010	3	167,9	503,7	9	28190,41
2011	2,3	185,3	426,19	5,29	34336,09
2012	3,1	172	533,2	9,61	29584
2013	3,6	192	691,2	12,96	36864
2014	3,2	200,1	640,32	10,24	40040,01
Total	59,8	1687,4	9958,1	495,76	294927,5

Source: <http://unctad.org/en/Pages/statistics.aspx>

$$r = \frac{n \sum xy - \sum x \sum y}{\sqrt{n \sum x^2 - (\sum x)^2} \cdot \sqrt{n \sum y^2 - (\sum y)^2}} = \frac{10 \cdot 9958,1 - 59,8 \cdot 1687,4}{\sqrt{10 \cdot 495,76 - (59,8)^2} \cdot \sqrt{10 \cdot 294927,5 - (1687,4)^2}} = \frac{99581 - 100906,52}{\sqrt{(4957,6 - 3576,04) \cdot (2949275 - 2847318,76)}} = \frac{-1325,52}{37,16 \cdot 319,30} = \frac{-1325,52}{11865,40} = -0,111$$

The reduced negative value of the correlation coefficient implies that between the inflows of foreign direct investment and the development of the gross domestic product in Romania there is a reverse link of low intensity.

To highlight the proportion of the total variation of Romania's GDP is determined by the foreign direct investment flow variation we have calculated the coefficient of determination (k = r<sup>2</sup>)

$$k = (-0,111)^2 = 0,012$$

The conclusion is that only 1.2% of GDP variation in Romania is caused by variations in the flow of foreign direct investment attracted by Romania, meaning that 98.2% of gross domestic product variations are generated by the influence of other factors such as domestic investment, labor productivity etc.

It should be emphasized that in 2014 the share of foreign direct investment stock in the GDP was 36,6%, much higher than the existing worldwide value 32,1%. These figures highlight the fact that on one hand Romania's economy recorded a higher level of globalization than the world average, and on the other hand, the number of unit value of foreign direct investment attracted for obtaining a value unit gross domestic product is higher in Romania compared to the world average. That conclusion leads to the idea that the impact of FDI on increasing the efficiency of the Romanian economy is relatively minor.

Greenfield investments represent 54% of the stock of direct investment attracted by Romania at the end of 2014. Apparently 54% is a good level comparable with the situation worldwide. Every year there is a significant number of mergers and acquisitions between the largest companies which causes a considerable weight of mergers and acquisitions in the global flows of foreign direct

investment. Greenfield investments ensure a greater (comparable to other forms of investment) technology transfer and number of jobs in the host country. The remaining 46% of the stock of foreign direct investment attracted by Romania is represented by mergers and acquisitions resulting mainly from foreign investors in the Romanian privatisation.

Some considerations related to the concrete way in which in the last 25 years, foreign capital entered Romania, and the effects that it has generated on our economy will be presented in the following paragraphs.

In the early years of the transition period from planned economy to market economy, **the Romanian banking system** registered a series of bankruptcies, with a particular impact on the national economy. Several private banks were bankrupted among which we can mention: Dacia Felix, Columna Bank, Bankcoop, Banca Religiilor, Credit Bank etc. Bad loans have rocked to a greater or lesser extent the state banks. Banca Agricola and Bancorex were significantly affected and for their salvation the Romanian state had to allocate large amounts of money, given the relatively small size of the state budget revenues. These cataclysms in the Romanian banking system were possible amid the existence of elusive regulations and insufficient controls from the institutions. Regardless, the extremely high proportion of bad loans in the total loans cannot be justified. Multibillion dollar losses incurred by the Romanian state and directly or indirectly by our population had a major negative impact on the national economy only due to the desire to create Romanian capitalists.

The prices at which the Romanian state sold most banks in Romania can be considered derisory in comparison to the value of their assets or the value at which the Romanian Commercial Bank was privatized.

To avoid the collapse of the banking system, Romania acted for the privatization of state owned banks, this being the express recommendation of the IMF. The action proved to be beneficial, the banking system perturbations decreasing substantially over the period that followed.

Currently the banking market in Romania is about 90% controlled by banks with foreign capital, and it has proven to be extremely profitable. In 2008, amid high profit margins, Romanian banks with majority foreign capital registered a rate of return on equity of 29.4%, a level which is two times higher than the average of EU member countries. (<http://www.ziare.com/economie/stiri-economice/bancile-romanesti-cele-mai-profitabile-din-ue-875498>) The value of this indicator during the crisis considerably reduced, in recent years Romania recorded again enviable values. The rate of return on equity was 7.6% in September 2015 in Romania and 6.4% in the EU, reaching 13.2% in Romania in late 2015. (<http://www.ziare.com/bnr/banci/pe-hartie-bancile-din-romania-sunt-de-doua-ori-mai-profitabile-ca-media-ue-explicatiile-bnr-141195>)

Another sensitive area in any economy is represented by the national **energy market**. Romania has privatized most of the electricity distribution business, the main beneficiaries being foreign companies such as ENEL, CEZ and E.ON. The proceeds from these transactions to the Romanian state, from foreign investors, can be said to be modest but acceptable due to the investments that were being made by the mentioned companies. By performing only slight investments the principal actors in the transport and distribution of electricity made possible record energy losses in the network equivalent to 1.88 billion euros for the period 2010-2014, this was supported in most cases by consumers through the unjustified, in many cases, increase of the distribution tariffs easily approved by the Autoritatea Națională de Reglementare în domeniul Energiei (ANRE). Between 2010-2014 energy tariffs increased by 33.3% for households and 21.7% for other consumer categories, this increase was caused by higher charges related to the transportation and distribution of electricity. To all this it is added the dubious transactions with green certificates, the including in the depreciated value assets which were not directly used in upgrading the distribution network etc. The mentioned actions call into question the work of some of the electricity transmission and distribution companies in Romania. Moreover, the annual profit rate recorded by most of the main actors in this area ranged between 15% and 25% in the mentioned time interval. (<http://www.comisarul.ro/articol/cutremurul-vine-de-la-curtea-of-accounts-thieves-in-743687.html>)

Majority foreign-owned firms operating in Romania in the distribution of electricity achieved profit rates significantly higher than the average across the group to which they belong.

In 2004 the process of privatization of the two Romanian **gas distribution** companies was started. As a result of the privatization of gas distribution, a few millions of Romanian consumers are provided for by two companies with majority foreign capital (French and German respectively).

The Petrom privatization occurred in 2004. Although Petrom was the only producer of oil and second largest gas producer in Romania, before being privatized the company incurred losses of 240 million euros, generated by a bad administration, oversized staff (over 50,000 employees) and associated companies on the supply chains and distribution of Petrom. Despite these shortcomings, the economic potential of Petrom was enviable. The Romanian state received the amount of 669 million euros for the disposal of 33,34% Petrom shares. In the same time, OMV was able to participate with 830.6 million euros in the capital increase of Petrom, reaching 51.01% of the shares. Many analysts have concluded on several occasions that the amount with which Petrom was privatized was far below the market value at the time, as confirmed by the substantial profits made by Petrom in the aftermath of privatization. Romania also undertook not to amend the fees charged for each ton of oil extracted Petrom, for a period of 10 years, this given the fact that oil is a non-renewable, depleting resource. The royalty received by the Romanian state was established in 2004 while the price of a barrel of oil was around the value of \$ 40. Meanwhile oil prices experienced substantial growth reaching values in excess of \$ 150/barrel, whilst the fee charged by the Romanian remaining stable since 2004. We must note that the fee charged by the Romanian state is much lower than that charged by other European countries and is even lower than the fee charged by some African countries, where exploitation conditions are riskier than in our country.

The Dacia Pitesti privatization can be considered as a remarkable success, not necessarily due to the \$ 50 million sale price but especially due to the economic impact that it has generated. The investment made by Renault in Dacia Pitesti have turned this company into the largest Romanian exporter. Dacia Pitești provides employment to 17,000 Romanians. In the absence of the French investor, Dacia Pitesti could have had the same fate as Rocar. Romania being unable to cover the necessary buses, tractors or combines. Export being out of the question.

#### **4. Conclusions**

A country's economic development cannot be achieved without investment, whether foreign or domestic. Avoiding overheating the economy is done by reducing investments and eliciting crisis is done through increasing the investment volume. We can therefore state that investment is the determining factor in the economic development of a country.

The volume of foreign direct investment attracted by Romania is relatively high by reference to its gross domestic product, which shows an increased globalization of our economy. On the other hand we must stress the important role played by domestic investment in the development of the Romanian economy.

Many of the foreign direct investments attracted by Romania have resulted in the acquisition by transnational companies of local companies with majority state ownership in oil extraction, gas and electricity distribution, banking etc. In reality the Romanian state has privatized firms that held a monopoly in a certain area, the profitability potential being high. In general, a monopoly is not advisable. In the speciality literature it is accredited the idea that private companies holding a monopoly is a more dangerous situation than when the monopoly is held by local companies with majority state ownership. The abusive behaviour and sometimes at the limit of the law which certain investors had in Romania is an argument to support this idea.

Of particular interest for Romania are greenfield foreign direct investments, where the transfer of technology ensures an increasing the number of jobs.

Based on the experience of the last 25 years, it is necessary for Romania to establish and implement a coherent policy in the investment field for the benefit of the national interest, policy meant to ensure sustainable the development of our country.

Lastly, state institutions that ensure the regulation and control in areas of great importance (banking, energy, mining, etc.), need to demonstrate through the undertaken measures the proper behaviour towards both the Romanian State and economic operators.

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