

FOREIGN DIRECT INVESTEMENTS AND ECONOMIC GROWTH IN ROMANIA

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Abstract. Transition economies are a special case in what concerns foreign direct investments (FDI) and important attention has been paid to the level of FDI in these countries, considering the assumption that they are essential for economic development. The first part of this paper focuses on FDI inflows and trends of the basic macroeconomic indicators in Romania, showing that foreign capital has played an important role in Romania's economy. The second part aims to determine whether foreign direct investments are associated with economic growth and if the presence of foreign investors conducted to a higher standard of life. The results indicate that foreign direct investments contributed to higher economic growth rates during 2000-2010 and had a favorable effect on the economy.

Keywords: Foreign direct investments, Romania, economic growth, emerging countries, gross domestic product.

Jel classification: F21, F23

1. Introduction

In 1989, with the fall of the Berlin Wall, Central and Eastern European countries walk towards a new era, the transition to market economy. To achieve this goal, countries should conduct a series of reforms in an attempt to integrate their economies in the international economic network. Foreign direct investment (FDI) were considered crucial for the former communist countries: they were a source of capital (due to low savings rate and high capital cost, FDI were the main way of obtaining capital), could contribute to the increase of productivity by implementing new production methods and training, could contribute to the creation of competitive products and increase of exports, could provide access to new technologies, especially given the huge technological gap created between these states and the rest of world during communism (EBRD 1998).

The present study examines the FDI in Romania between 2000–2010 and their effects in promoting economic growth. The analysis is divided into two parts: the first part presents the characteristics of the FDI trend in Romania, while the second part illustrates the role of FDI on economic growth by developing an econometric model.

2. Literature review

Empirical studies have generally led to conflicting results regarding the role and impact of FDI on host states. The studies regarding the FDI impact

in Central and Eastern European countries are few, especially in what concerns the less developed states of the region, such as Romania, probably due to lack of data required for the investigation.

Unlike international portfolio investments that are motivated by interest rate differential- increasing the volatility of capital, FDI have a long time horizon, being more stable and with limited mobility, representing more than a simply transfer of capital (Bird, Rajan 2002). Growth models have started with the neoclassical models (Solow and Swan) in the 1960s that relied on capital and labor, FDI being considered not to influence long-term economic growth, but only the income level. Recent studies of endogenous growth models show that items omitted by the neoclassical models may explain long-term growth (Lee, Gordon, 2005). Recent theories of economic growth models highlight the importance of technologies and information in achieving economic growth. As transnational corporations are the main drivers of technology transfer and of the activities of research and development, FDI are an important way of disseminating these elements on a global scale.

In general, when we speak of the link FDI-economic growth we usually assume that FDI are those that influence the growth rate. Such a hypothesis is based on the ability of foreign direct investment to influence the growth factors such as: investment, technological progress, human capital. But the link FDI – economic growth may be a bi-directional one, rapid economic growth leading to

an increase in FDI. The following table presents a summary of studies on the causal link between FDI and growth:

Table 1. FDI and economic growth - literature review (Source: created by the author)

Authors	Goal of the research	Results and conclusions
Bloomstrom, Lipsey and Zejan (1994)	FDI effects on economic growth	positive, but it depends on the income per capita in the host country
Balasubramaniam, Salisu and Sapsford (1996)	FDI effects on economic growth	positive effect if the country has an export-oriented strategy and negative effect for an import substitution strategy
De Mello (1997)	FDI effects on economic growth	positive for countries with high income
Borensztein, Gregorio, and Lee (1998)	FDI effects on economic growth	Positive, but it depends on the level of education
Bosworth and Collins (1999)	FDI inflows effects on economic growth	Positive
Zhang (2001)	FDI effects on economic growth	different effects
Carkovic and Levine (2002)	FDI effects on economic growth	no effects
Bengoa and Sanchez-Robles (2003)	FDI effects on economic growth	positive but it depends on the economical conditions of the host country
Choe(2003)	FDI effects on economic growth	economic growth contributes to the increase of FDI
Alfaro(2003)	FDI effects on economic growth	the effects depend on the sector of the investments: positive for the manufacturing sector, negative for the primary sector and inconclusive for the service sector
Hansen and Rand (2004)	FDI effects on economic growth	positive effect
Kholdy and Sohrabian (2005)	FDI effects on economic growth	no effects
Chowdhry and Mavrotas (2006)	FDI effects on economic growth	bi directional effect

The studies presented above highlight the need to fulfill some conditions in order for FDI to have positive effects: a certain level of education, a minimum level of technology and macroeconomic stability, favorable business environments, even the sector where FDI take place can influence the link FDI-economic growth. The research of the effects of FDI on economic growth is far from complete, there is no conclusion widely accepted. The different results obtained depended on country-specific examined factors, the analyzed periods, the economic and technological conditions of the host country.

3. Characterization of FDI in Romania

The liberalization of capital in Romania in 1990 did not lead automatically to increases in FDI levels, the country initially attracting modest levels compared to other former communist countries. The period 2000–2010 includes the FDI boom in Romania, followed by the financial crisis that left an important mark on FDI, which in 2008 registered a sharp decline. Between 2000–2010, FDI in Romania can be split in three periods, with different characteristics: the first period between 2000 and 2003, second period is between 2004 and 2008, the last period includes the financial crisis 2009–2010.

3.1. FDI in the period of 2000–2003

Since 2000, Romania has entered the stage where it becomes attractive to foreign investors and this is felt immediately in the FDI received, but growth rates remained low until 2003. Mass privatization and favorable investment climate led to changes of the FDI situation in Romania. (Danciu, Gruiescu 2010; Brancu, Lucaciu 2009). The starting of the negotiations for the accession to the EU also increased investors' confidence in Romania's potential. Romania's UNCTAD's performance index changes from 85 (in 1996) to 60 (in 2003) (UNCTAD 2006).

After the fall of communism, CEE countries liberalized foreign capital flows, but the FDI inflows distribution in these countries will be uneven. As in the first years of transition, privatization was the main way of attracting foreign direct investment by most communist states, the methods of privatization and economic reforms have influenced investors in choosing a state instead of another. The mass privatization chosen by Romania was unattractive and unfavorable to foreign investors and the slow progress of the transition to a market economy led to small inflows of FDI in Romania, in spite of the low cost of the labor

force, one of the lowest in the CEE. (Sinn, Weichenrieder 1997). Thus, investors have turned to other countries of the region such as Hungary, Czech Republic and Poland, countries that reached soon a macroeconomic stability and whose economic reforms were more advanced. While Hungary recorded investments worth over 1 million dollars, in Romania most projects were under \$ 50,000 (UNCTAD 2004).

While for the countries of Central Europe the privatization process is coming to an end, we can say that in Romania it really begins in 1997, with positive consequences on foreign investment. FDI have started to rise since 1997 and maintains a constant level until 2003. For Romania, 2000 equates to the beginning of a period of economic growth and gradual reduction of inflation rate, after 10 years of disturbing evolutions. As a result, between 2000 and 2003 the largest and most important privatizations took place: Romanian Development Bank is acquired by Societe Generale, Dacia car factory is bought by France's Renault and Sidex steel plant is sold to the NHL Ispat in 2000. Agricultural Bank has been owned by Raiffeisen Bank since 2003 and the following year the Austrian OMV buys 33 % stake of Petrom for 900 million dollars. The initial investment made by the NHL Holding in Galati steel plant led to a further investment of 100 million dollars in 2003, and the integration of Romania into the international chain of NHL has led to exports of over 70 % of the total production (exports of an industry that was facing bankruptcy before privatization). In 2003, 50 % of manufacturing production and exports were made by foreign subsidiaries present in Romania (Hunya 2004; Larive 2005).

3.2. FDI in the period of 2004–2008

In 2004 economic growth rate reached 8.4 %, and in 2008 it reached 9.4 %, while inflation fell from 45 % in 2000 to levels with only a figure in 2005, up to 4.8 % in 2007. The reduction of the tax incentives after the EU accession and the increase of labor costs in Central European countries made that, starting from 2004, Romania to become more attractive to foreign investors. These elements, along with improving economic conditions, the perspective of EU accession and the beginning of privatization in the service sector, led to new investment waves in Romania (Larive 2005). In 2004 Romania doubled its FDI respecting to the previous year and in 2008 it reached the highest level, FDI increasing by 40 % compared to 2007, growth that has placed Romania in second place in the CEE, immediately after Poland. In 2008, while financial crisis broke out in developed countries,

the economic growth of over 9 % recorded by Romania and the accession to the EU a year before have created prerequisites for attracting new investments flows.

The legal framework has changed continuously to stimulate foreign investment and changes lead to flexible and more adapted legislation to nowadays' business environment. Changes in land ownership and the privatization started in the services sector have led to major waves of FDI between 2004 and 2008 (Larive 2005).

In 2007, green field FDI stock had come to represent 55 % of the total FDI received by Romania, investors capitalizing the opportunities offered by this country. For Romania, the activities of foreign branches implies in the second decade of transition a positive impact on the trade balance, resulting in 70.8 % of the exports in 2007 and 59.2 % of the imports. In late 2007, most of the FDI stock is found in industrial manufacturing (33 %), financial intermediation and insurance (23 %) (RNB 2008).

In 2005 the largest Romanian bank is sold to the Austrians from Erste, this investment consolidating Austria's position as the leading investing country in Romania. Main investing countries are from the EU: Austria (21 %) is followed by Netherlands (16 %) and Germany (11 %), these three states holding 45 % of total investments (RNB 2008).

3.3. FDI in the period of 2009–2010

In the middle of the financial crisis, the FDI in Romania fall sharply by 65 %, following the global trend, but the stock is up 2.4 % in 2009. Sharp decline of GDP in 2009, along with the increase of investment's risk and the growth of the risk aversion of the investors caused FDI decline. For Romania, green field FDI accounted only for 19 billion euros in 2009, and mergers and acquisitions were worth only 34 million euro. The rest of the investments consisted in the development of existing companies. At the end of 2009 the Netherlands becomes the main investor (21.1 %), while Austria placed in second and most investments are still made in the manufacturing industry. The impact of FDI on the trade balance continues to be positive in times of crisis, foreign affiliates making 69.8 % of the exports in 2009 and 72.4 % in 2010. In 2009, Romania's current account deficit is covered by foreign direct investments and capital transfers at a rate of over 82 % (RNB 2010, 2010b, 2011).

4. Methodology and data

To analyze the impact of FDI on economic growth in Romania we will use an econometric model based on multiple regression. Multiple regression equation is taken from the model developed by Makki and Somwaru(2005) to analyze the impact that foreign direct investment and trade have on the development of economic growth. Makki's research made for a period of 30 years and 66 developing countries led to positive results, showing that FDI and trade positively affect growth. From the model of Makki and Somwaru we have taken the first two equations, and the third one was created by adding only one exogenous variable, namely the inflation rate. The link between inflation rate and economic growth rate is a fairly recent element in the literature. Romania was a country that had problems with hyperinflation after 1990s, which is why this indicator is important in analyzing economic growth.

We apply the regression equations on the economic indicators of Romania for the period 2000–2010. Our analysis, thus, extends Makki and Somwaru's research among Central-Eastern European Countries and includes the period 2000–2010. Regression's equations are as follows, where the endogenous variable is GDP growth (growth rate as per capita):

$$g=c+ a_1*FDI+a_2*HC+a_3K+a_4*TRD+a_5*g_0+e$$

$$g=c+ a1*FDI+a2*HC+a3K+a4*TRD+ a5*FDI*TRD+a6* FDI*HC+ a7*FDI*K+a8*g_0+e \quad ,(2)$$

$$g=c+a1*FDI+a2*HC+a3K+a4*TRD+ a5* FDI*TRD+a6* FDI*HC+ a7*FDI*K+a8*IRT +a9*g_0 +e \quad ,(3)$$

where:

- g – the growth rate as per capita,
- FDI – foreign direct investment (% GDP),
- TRD – the value of trade with goods and services (% GDP),
- HC – human capital stock,
- K – domestic investments level (%GDP),
- g_0 – the initial GDP per capita,
- IRT – inflation

To these are added the interaction of FDI with trade, human capital and domestic investments.

As most studies show that for developing countries: trade, foreign direct investment and capital stock, have a positive effect on economic growth, we are expecting also for Romania to have

positive results, although the period chosen is one that includes the financial crisis, with significant impact on various macroeconomic indicators. The purpose of this research is to estimate the impact of FDI on economic growth and how this impact takes place. Data were taken from World Development Indicators, indicators published by the World Bank and from International Monetary Fund (rate of inflation) for the period 2000–2010.

Human capital is important because the absorption of new technologies requires a certain level of human capital and may limit the ability of absorption (Borensztein *et al.* 1998), as well as the impact on productivity. The stock of human capital is taken from WDI (World Development Indicators), the indicator calculated by Barro-Lee in 1993, namely the average number of years of high school male population aged over 25 years old, which is considered to be an indicator of higher importance compared to school literacy rate for analyzing human capital stock. Barro (1996) shows that human capital (calculated by the indicator above) has a significant positive influence on economic growth (an additional year of schooling leads to an increase of 1.2 % growth rate).

The correlation between international trade and economic growth has been subject to studies since 1776, and the effects considered were of positive nature, which led to the gradual reduction of trade barriers. Dollar (1992), Sachs and Warner (1995) explored the links between trade and growth, and Balasubramanyam *et al.* (1996) concluded that countries that have an export-oriented strategy benefit from the positive effects of FDI. World Bank highlights the importance of trade, arguing that open economies lead to economic growth and the IMF believes that reduced export revenues could contribute to increased volatility in debt crises (Spanu 2003).

Inflation is also important not only for economic growth, but also for the level of FDI attracted as high inflation rates could be an impediment to FDI, since it represents macroeconomic instability and the risk of devaluation in time of the actives bought.

This research aims to analyze the link between FDI and economic growth in Romania for the period 2000–2010. Methodologically, the regression model was solved by OLS method (Ordinary least squares). Unfortunately OLS method has drawbacks and limitations, the most frequently being the endogenous problems that may influence FDI coefficient and standard error.

5. The results and their interpretation

This paper analysis the FDI and economic growth relationship, after controlling for other growth determinants. In this section we present the results of our empirical analysis. The below table shows the results of the three regressions:

Table 2. FDI and per capita GDP growth: 2000-2010

Dependent Variable: G			
Independent variable/ regression no	1	2	3
C	-38.632 (0.551)	85.358 (0.875)	-186.3 (0.3893)
FDI	1.4031 (0.067)	-16.174 (0.835)	19.704 (0.472)
HC	16.248 (0.495)	-26.653 (0.893)	-0.5095 (0.3264)
K	1.4457 (0.075)	2.3481 (0.648)	-0.5095 (0.75)
G0	-0.0244 (0.015)	-0.0242 (0.178)	-0.0313 (0.0661)
TRD	-0.4087 (0.529)	1.5999 (0.805)	-0.5208 (0.7856)
FDITRD		-0.486 (0.769)	0.2429 (0.6451)
FDIK		-0.1877 (0.836)	0.4071 (0.326)
FDIHC		5.8765 (0.836)	-8.6054 (0.4269)
IRT			-0.3732 (0.1141)
R-squared	0.8714	0.881	0.9962
Durbin-Watson stat	1.7273	1.524	3.0057

(*) in brackets we have the p-value

Regression (1) emphasize that economic growth is positively influenced by foreign direct investment, domestic capital level and human capital. The coefficients are statistically significant at 5 % level only for the initial value of GDP, while the positive signs of FDI and K show a direct link between economic growth and FDI and domestic capital, but they are statistically significant at a value of $p = 0.1$, a level that is considered acceptable. The coefficient of the human capital even if positive is not statistically significant, which is surprising since the values for Romania are much superior of the minimum level indicated by Borensztein *et al* (1998). An explanation could be the quality of the workforce and in order for the human capital to positively influence economic

growth; Romania needs to increase its share of highly skilled workers. The negative sign of the trade balance shows that it has a negative effect on economic growth (the higher imports are respecting to the exports, lower the GDP/capita) but the coefficient is not statistically significant. Practically the result of our regression confirms the results of Makki and Somwaru (2005) regarding the correlation FDI-economic growth or that of Borensztein *et al* (1998). Our conclusions confirm also the results of the research of Misztal (2010), research made for the same period and same country but using a totally different econometric model. The result is contrary to that obtained by Balasubramanyam *et al* (1996), for which only countries that have export-oriented strategy benefit from the effects of FDI (since for Romania we have a deficit of the trade balance). The value of R^2 shows that the model is well defined and that 87 % of the variation of growth is explained by the variables included in equation 1.

Adding the interaction between FDI and trade, human capital and domestic investments in a second equation, the results of the regression change significantly, FDI's coefficient becomes negative, as well that of the human capital, but all coefficients of equation 2 are statistically insignificant. Seeing this surprising result, we tried to improve the second model by adding a new endogenous variable, namely inflation. Since Romania has had very high levels of inflation, we considered essential to include this element in the regression equation. Equation 3 appears to explain 99 % of the variation of economic growth but all coefficients are again statistically insignificant. Since Romania started to attract FDI with some delay respecting to other ex-communist countries, maybe it hasn't arrived to the minimum level of maturity that allow other elements to benefit from the interaction with foreign capital. Taking into account that the major part of FDI took place through privatization and the enterprises bought had to be restructured first, only after that they achieved a certain level of competitiveness they could produce spillovers to the entire economy.

The value of Durbin – Watson statistics, too high in the third equation and of low value in equation 2 indicates that the hypothesis H_0 of no correlation among errors cannot be entirely dismissed. So we have a degree of autocorrelation of errors, which may explain in part the results of the regression's coefficients.

Of the three regressions used, only the first one is statistically significant and confirms our expectations regarding the positive impact of FDI on economic growth in Romania. Introducing the interaction between FDI and other three variables

changes the results of the regression. The quality of these regressions is being influenced by the small number of observations included in the model (11) and the period chosen, as it covers the time of the crisis. As Romania becomes a host country for foreign investors only in 1990 and the values received initially were negligible, the first 8–10 years of transition practically cannot be included in such a study. A way of increasing the number of observations would be analyzing quarter's data, but we do not have the necessary information for all variables of the model. We expect that the longer time period will pass the stronger the results will be.

In all three regressions, we may face endogenous problems, moderate correlation between variables and the correlation of errors.

6. Conclusions

FDI evolution after 1990 had the same trend as for all transition economies, but the values were very modest. During 2000–2010, Romania registers a boom in FDI, becoming the second host country in Central and Eastern Europe after Poland. The progress of privatization, favorable macroeconomic conditions both in Romania and abroad, joining the European Union has created important prerequisites for attracting FDI. The peak is reached by Romania in 2008, even during the outbreak of the crisis, but next year, the decline is felt strong.

In this paper a regression analysis was done and 3 regressions were tested. Econometric analysis shows that FDI has contributed to the growth rate of GDP per capita for the period 2000–2010, but there was no positive influence on economic growth through interaction with human capital, domestic investment and international trade, but research is limited by the small number of observations included in the model and endogenous problems.

A clear conclusion comes out, that FDI conducted to economic growth in Romania (even if the variable was robust only in the first regression), while human capital; trade and domestic capital are not a precondition of the positive effects of FDI.

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