

## LOHN PRODUCTION – AN ECONOMIC OR SOCIAL MEASURE?

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*The rapid Romanian disintegration of the planned economy and the economic crises after 1989 imposed the large amounts of activity in the production units; the easiest way of maintain these of units – with no effects – was the subcontracting for the re-exportation system. This system is very important for foreign (commerce: over 75% of Romanian export to the European Union is in subcontracting for re-exportation system. This huge percent is possible because the subcontracting for re-exportation system allows a better management of the production capacities in order to maintain jobs or to create new ones, and in this way the competition producers a more important roll in what cancens the demands of consumers and it attracts foreign investors, also.*

**Key words:** *subcontracting, production capacities, trade*

If in 2007 Romania was still considered to be “the workshop of the EU”, as a consequence of the increase of the wages and implicitly of the production costs, the lohn production will no longer be profitable for the foreign companies, which at the moment are interested in the country because of its cheap manufacturing costs. Thus we can expect economic shocks: with no markets, no brand on these markets, without any competitive spirit and with no money, the respective industries are facing the risk of colapse. Thus, the exports of the textile, clothing, leather and shoe industries, which are considered nowadays an important element in maintaining the economic balance of Romania, will prove to be inexistent, now that the lohn contracts are no longer available.

In spite of all these arguments against engaging in lohn activities, Romania has accepted this system even in conditions of great economic crisis. Against the baground of the conflict situation in Jugoslavia, which was considered “the champion of lohn production”, lohn production providers have redirected their interests towards the textile, clothing, leather and shoe industry in Romania also because of the low production costs, and the cheap and qualified labour force existing in our country.

At the moment, due to the low profits which are obtained as a result of these activities in Romania, specialists claim that the lohn type of manufacturing looses its lucrativeness in our market, the interest of lohn partners is directed towards countries which are cheaper than Romania (The Republic of Moldavia, The Ukraine, etc), that is, towards countries whichs have the lowest wages. The interest in the Romanian market is fadding because of the fact that unemployment is no longer an accutely and severely widespread phenomenon, but also because of the emigration of the specialized labour force in search of better payed jobs.

Due to the way in which the lohn process operates, it cannot be considered a solution for the modernization of the economy, on the contrary, it is a means of increasing the technological delay which separates the *commissioner* (the one that provides the materials and raw material, the production documentation – models, projects, designs, etc.- accordging to which the manufacturing of the finished product is carried out and sets the technical parameters and quality indicators for the fisihed product) and the *manufacturer* (who commits himself to manufacture the finished product according to the technical norms set by the *beneficiary* by the dates stipulated in the lohn contract). The system in which a large part of the textile and shoe industry in Romania operates, also known as lohn system/ OPT (Outward Processing Trade) implies the subcontracting of some orders for producers and distrubutors from the developed countries. Thus, we are dealling with a temporary import of materials and raw materials, their processing and the re-exportation of the product to a developed country. Usually, this re-exportation is made under an internetionally well-known brand on the market. In such a developed market, where image and brand mean everything, **to be the supplier of some well-know companies is an honourable and somehow comfortable position.** Directly or indirectly, the large companies provide all that is necessary for the processing of the order, from the models and materials, to consulting (assistance), quality control and shipping means, and often finance the modernization (refurbishment) of the processing factories.

We must mention the fact that, on the one hand, Lohn production was the alternative chosen by the transnational companies, in the absence of an attractive medium for direct investment, in order to benefit from the cheap labour force in Romania, and on the other hand, it was a means of surviving for the Romanian companies during the transition period. Seen as a commercial operation destined mostly to increase the infusion of foreign currency, in the last decades Lohn processing has constantly had the lead over other products within the Romanian exports. This solution is not a favourable one for the Romanian economy, because the increasing of the products exported in the Lohn system has occurred to the prejudice of the exports of cars, machines electrical appliances, food products, etc, that is, of products which have a high added value. According to the statistics of The Ministry of Economy and Trade, in 1989, Lohn production represented 13% of exports, in 1996 it started to triple: 31,2% in 1996, 30,2% in 1997, 34,1% in 1998, 34,6% in 1999, 35,4% in 2002 and 34% in 2005 (the main goods are clothing, textiles, footwear and leather goods).<sup>80</sup>

Starting with 1999, Romania has become the most important exporter of clothing (garments) in all this continent of Lohn production which is represented by Central and Eastern Europe, and, at the same time, the main supplier for the EU. Poland, the former regional leader, cannot manage to get back on track mainly because of the wages, which are twice as much as in Romania. Other important players on the Lohn market are Hungary (with an export of 1107 million dollars in 2000) and Bulgaria (691 million dollars). The 'boom age' came to an end in 2005 when the EU completely liberalized the import of this sort of products, opening the door for cheaper exporters like China, Bangladesh, Pakistan and, not the least, Turkey (5860 million dollars in 2000).<sup>81</sup>

The Romanian export, which has risen above 10 million ever since 2000 and reached almost 26 million in 2007, presents a few characteristics: it is highly geographically concentrated (in 2007 78% to the EU respective 76% to developed countries), is dominated by products which require a large number of primary products and manufacturing processes (the clothing and shoe industry holds 35% from the total) and is composed mostly of products manufactured in Lohn system) (95% of the products of the clothing and shoe industry, 72 % of the total exports to the EU). In these terms it can occur for the Romanian export to be confronted with a decrease, because the Lohn system could disappear, as Lohn production represents a combination of circumstances given by the cheap working force.

Besides the explanation given by some people, that Lohn production has spread in Central and Eastern Europe, and implicitly in Romania, because of the cheap labour force and a certain inaction on the part of the managers in what concerns the need to approach/penetrate foreign markets, there is also a series of economic reasons. The rapid extension of Lohn production within the West-East relationship is justified by the extremely unbalanced structure of the former communist economy, and implicitly, the delay existing between an overproductive and inefficient production system and an almost nonexistent marketing and distribution system. Thus, the production on commission, with the *commissioner* handling the marketing of the final product, was a means of getting over this situation and allowing the Romanian producers to access the foreign markets. Then the precarious technology available in the economy made it impossible for the Romanian producers to engage directly in the external markets in conditions of full competition. Lohn production made possible the refurbishment of some companies, their adjustment to the new technological and commercial requirements.

Specialists consider Lohn production as a two edged weapon. It has advantages and disadvantages, the balancing of which is very important. Which are the advantages and limitations of the Lohn system as only 20-25% of the exported value remains in the country, and the Lohn production factory gets 10% from the selling price of the product and the employee gets around 1%? The most obvious advantages of the Lohn system from the point of view of the economic and social nature of this phenomenon are:

- as a commercial operation, it contributes to the influx of foreign currency into the country;
- it employs a significant part of the work force, mostly women;
- it improves the quality of the labour force by using the know-how of the foreign partner;
- it facilitates the opening towards the external market;
- the managers and employees get accustomed to the western standards;
- the foreign partners support the modernization of the technology;
- the direct contact with the tendencies of the development of the external market.

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<sup>80</sup> www.dce.gov.ro

<sup>81</sup> \*\*\* - *Capital* Magazine, no.32, 7th August 2002, pp.18

There are a few limitations hidden behind these advantages, limitations which should not be neglected:

- it is considered to be a national income export: the income of the exporter is smaller than the income of the one who is exporting his own production;
- it leaves the national creativity unexploited;
- it only partially supports the increasing of the international specialization (vertically);
- the unfavourable circumstances existing at one point in the external market can determine the importer to give up the Lohn system based activity;
- the increasing of the prices of the factors used in the production of the finished product generates the price risk for the exporter;
- the marketing of the product in the external market under the name of the commissioning company, makes it impossible for the national brands to penetrate the foreign markets;
- the profit margin is reduced to less than half and it is calculated only for manufacturing, not for the whole product
- the accumulation occurs slowly, the resources available for investment are limited;
- it does not allow a medium or long-term production planning.

With all the limitations of Lohn production – the absence of the Romanian manufacturer from the international market, him depending on the commissions from the commissioner, the low price due to the increment only on the manufacturing, etc – it must not be seen as a mostly negative phenomenon. We must mention that this operation made possible the survival of some industries, which otherwise would have been insolvent (unsuccessful).

The removal of the custom taxes between Romania and the EU on 1 January 2002 created favourable conditions for production. At the moment, products such as hosiery, clothing and footwear are Romanian merchandise which is requested for import due to the price-quality equation, a ratio which is also determined by the fact that the employees producing them have the lowest wages. The most part of the exports is still represented by the clothing and shoe industry. The clothing and footwear exports have reached 35,5 % of the total exports in 2007, dropping from 35,7% in the previous year, and after having gained in 2000 30% over the figures reached in 1999 (the Lohn produced goods represented almost 90% of the exports of the clothing and shoe industry in 1999, about 98% in 2002 and dropped to only 60% in 2006, the remaining percentage representing exclusively complete exports of goods.

A large part of these exports goes to the Italian and German markets, which are also the most important commercial partners of Romania. If we take into consideration the fact that the clothing and shoe industry represents a sector of activity in which the export production is conditioned by the import of materials, the comedown of the proportion between the export of clothing and the import of textiles, from 10,5 in 1996 to 8,6 in 2007, illustrates a deterioration of the export capacity of the branch. This means that a part of the imports of textile materials was destined for the internal market which has become more attractive for the inland producers. To this we add the decreasing of the internal offer of materials and accessories, imports of such goods being favourable for inland production, too.<sup>82</sup>

At the moment, Romania is situated on the first place, being the largest clothing exporter for the European Union and getting ahead of Poland. But clothing is not the only branch where Lohn production was applied. Another sector is information technology, where Romanian IT programmers are paid less than the western ones. The method of Lohn production must not be dismissed or blamed because it represented an important stage in the development of an industry, in the process of becoming a functional free market economy, being the only possibility for the development of a sector. The large specialised clothing and shoe industry companies are continuously moving their production units to areas with lower production costs. But we must mention that not only prices are taken into consideration, sometimes the productivity of labour being more important, implicitly the quality-price relation. If a low productivity is combined with an instable economic climate, the investors avoid the countries with cheap labour force like Moldavia or The Ukraine.

The competitiveness of the Romanian goods on the markets of the developed countries is also supported by the commercial agreements to which Romania has adhered. The first measure undertaken by the EU for the Romanian textiles industry was the reduction of custom taxes, and subsequently beginning with 1997 their complete removal. At the same time, beginning with 1995 the quantitative limitations for 13 categories of textile products

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<sup>82</sup> \*\*\*- Capital, no.11, 24 March 2005

have been eliminated and, where the quotas were kept, the export rates were increased; the quotas have also been removed starting with 1998. At the same time, one also conceded in other markets: with the signing of a bilateral agreement with the USA in 1995, the quotas for export removed for 114 categories of textile products were, and for those remaining, the quotas were significantly increased.

In the present day situation, the Romanian manufacturers should take into consideration not only the Lohn production supply (delivery) but also the inland and external supplies, especially under their own brand. If this situation will not change in the future, we will continue to have an economy which allows only a very slow accumulation of resources for development. Thus, a country with such an export structure cannot aspire to reach prosperity taking into consideration the fact that the years to come are more and more dominated by notions like 'integration', 'globalization', etc.

That is why the main concern of the companies which operate in Lohn system should be to maintain and improve their position on the global market, to create some forms of cooperation with partners from the developed countries, to modernize their technology and, not the least, to create their own marketing and distribution networks.

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