THE VICIOUS CIRCLE OF FDI AND CONSUMPTION IN ROMANIA

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Significant inflows of foreign direct investment (FDI) in Romania's recent years have been accompanied by en excessive enthusiasm, originated in their association with an outstanding economic growth. The aim of this paper is to show the contribution of FDI to an unhealthy economic growth in Romania, due to the vicious circle between FDI and consumption. We found that these two variable self induce themselves. In a paradoxical way, the effects of the world economic crisis will disengage this vicious circle. Macroeconomic policies will have to address (i) the promotion of FDI which finance investment and not consumption, meant to contribute to an increase in aggregate output and to a sustainable economic growth; and (ii)the attraction of FDI inflows to deficient sectors, like industry and agriculture.

1. Introduction

Taking into consideration the FDI inflows that penetrated into the Romanian economy and the evolution of the economic growth rate (see Table 1), we proceed with an interrogation: is it positive or not the fact that in 2004 the FDI inflows tripled and, in the same time, the country experienced an economic growth of 8%? Were the two evolutions correlated, and if so, was the FDI induced economic growth a healthy one?

Table 1: FDI inflows and real economic growth rate in Romania, 2000-2007

Romania	2000	2001	2002	2003	2004	2005	2006	2007
FDI inflows (mil USD)	1057	1158	1141	2196	6436	6483	11366	9774
Real ec. growth rate (%)	2	6	5	5	8	4	8	6

Source: UNCTAD

The enthusiasm associated with FDI inflows during transition period begins to fade, due to perverted effects, such as the absence of positive externalities, the bankruptcy of local producers, the adverse selection practiced by foreign investors which are oriented towards the most productive companies, repatriated profits and relocation. To these we can add a series of effects that may occur in a crisis context: domestic assets sold for under evaluated prices, reversible FDI, capital flows towards home countries. Therefore, a more cautious and subtle approach is needed. We will develop in this paper yet another argument, the fact that the demand and the supply as aggregates of promoting economic growth condition the FDI impact.
The production function approach shows the functional relationship between different production factors (namely labour, capital and technology) and aggregate output. This approach takes into consideration only the supply side (factor inputs and their productivity) and ignores the demand side (Gore C., 2007).
In particular the Solow growth model shows the impact of an increase in capital stock on national income and how it can affect productivity through technological change. A critique brought to

this model is that it assumes the returns to capital and labor to be equal to their marginal productivity. If earlier neoclassical growth models used assumptions of perfect competition and diminishing returns to scale, Romer (1986) and Lucas (1988) introduced externality effects of knowledge spillovers and have endogenised technical change.

According to these models, current consumption should be sacrified for the purpose of increasing production capacities. Another source of capital should come from abroad (especially FDI). A lot of attention has been paid to the role of FDI in increasing the overall productivity of the host country, through technology transfer and productivity spillovers. In a supply oriented growth model, FDI appears as a main driving force behind the industrial restructuring and expanding of export capacity (Hunya G., 2003).

Nevertheless, the boost of consumption, the lack of domestic savings, external savings inflows, the structure of FDI inflows and the increasing current account deficit made us believe that a supply oriented growth model does no longer explain the economic growth experienced by Romania in recent years.

Although theoretically controversial, the demand-led growth theory seems to be better adapted than the growth model based on the production function to the situation of less developed countries (Gore C., 2007). According to this theory, the output capacity of an economy increases as a response to an increase in demand, in a totally opposite manner than in classical growth theories (Say's law). This alternative approach rejects the approach based on the production function which explains the growth only by the supply of production factors and their productivity, ignoring the role of the demand in this process. The theory of the demand-led economic growth has a starting point the assumption that, in any point in time, the use of the productive resources can vary according to demand conditions. Moreover, the cumuli of factors and technologic progress are ultimately influenced by demand. Among those preoccupied by the demand-led growth, we mention Setterfield in 2002 and Blecker in 2002, both quoted by Gore C. (2007). We identify two approaches: (1) the economic growth as a result of an increase in demand, development of production capacities through investment and their interaction: (2) economic growth explained by aggregate demand level and income distribution between salaries and profits[221]. With this theoretical support, we accept the hypothesis of the demand-led economic growth.

The article is structured as follows: sections 2 and 3 argue the FDI contribution at an unhealthy economic growth in Romania (section 2 presents the first sequence of the vicious circle FDI-consumption and the section 3 refers to the second sequence). Section 4 concludes, also sketching some implications in terms of public policy.

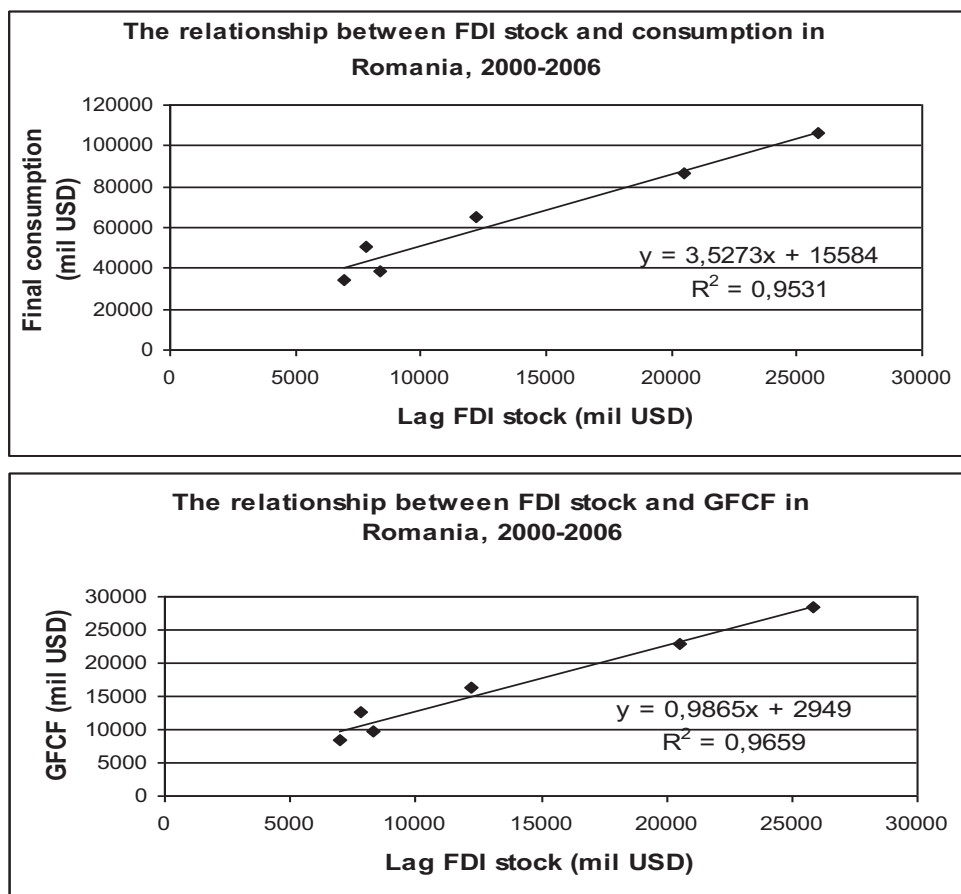## 2. FDI generating consumption and their impact on economic growth

As follows, we will sustain the hypothesis of an unsustainable economic growth in Romania, based on an excessive consumption, supported by foreign investment inflows. In fact, we deal with a vicious circle that allows FDI and consumption to auto maintain themselves and generate unhealthy economic growth.

Even since 2005, EBRD noticed the economic growth in Romania as a result of increase in private consumption. In the same time, EBRD warned about the effects of consumption increase, such as import growth and the aggravation of current account deficit. To solve this situation, two solutions were claimed: 1. Improvement of competitiveness and 2. Attracting FDI destined to finance the excessive consumption (Veselin A., 2005). Unfortunately the second solution seems to be favored. In 2006, EBRD explains the FDI growth by reduced credit interests and by the forthcoming EU membership; in the same time, the credit policy, by the diversification of banking products, contributed to consumption growth (Banila I., 2006). The consumption growth

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221 The economic growth is restraint by the low level of salaries and consumption. .

was mostly influenced by the increasing volume of retail sales, being more obvious to population level than to public administration (Davidescu L, 2006).

Figure 1: Correlation between FDI stock, final consumption and gross fixed capital formation in Romania, 2000-2006

The relationship between FDI stock and consumption in Romania, 2000-2006

$y = 3,5273x + 15584$
$R^2 = 0,9531$

Final consumption (mil USD)

Lag FDI stock (mil USD)

The relationship between FDI stock and GFCF in Romania, 2000-2006

$y = 0,9865x + 2949$
$R^2 = 0,9659$

GFCF (mil USD)

Lag FDI stock (mil USD)

Source: authors calculus based on UNCTAD Handbook of Statistics Database and FDI Database

Romanian authorities stay passive face to these warnings. Only in 2008, BNR (Romanian National Bank) sent signals that qualified the economic growth as being "overheated", asking to pass from an economic growth based on consumption to one based on supply and productivity gains. We add opinions from other economic analysts that stress the GDP contribution of some sectors as constructions[222] – which are consumption generators, and less of industry and agriculture, which are sustaining supply (Serbanescu I., 2008).

We hereby try to verify the hypothesis that FDI contribute to economic growth by the consumption generated in Romania in the year that follows the FDI inflow (see Fig 1).

The correlation we obtained has a high explicative power (R^2= 0.95), and the positive coefficient shows that at a 1% increase in FDI stock, the Romanian consumption increases by 3.5%. FDI's impact on consumption is much more important that on gross fixed capital formation (GFCF): for a 1% growth of FDI stock, GFCF in the following year increases with only 0.98% (R^2=0.96). As a consequence, in Romania FDI changed their initial destination, that of financing the investment deficit, fueling in exchange the consumption.

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222 Due to artificial price increase in real estate sector

According to the last BNR report on FDI, dating from 2007, the most attractive sector for foreign investors is financial intermediation and insurances, representing 23% from the total FDI, followed by retail (14%) and by constructions and real estate transactions (8%)[223]. The preferred sectors by foreign investors are those sectors destined to artificially and excessively grow consumption, by stimulating the demand of goods, of credits destined to finance goods' acquisition, or buildings.

In this matter, we must add the fact that consumption is the element that sustained economic growth, as we can see from Figure 2.

Figure 2: GDP, final consumption, gross fixed capital formation and FDI stock evolution in Romania, 2000-2006
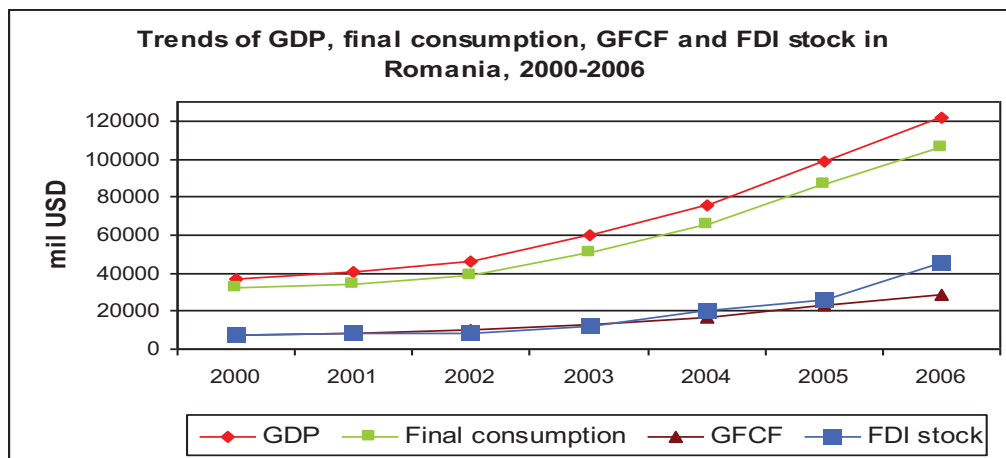
Source: authors calculus, using data from UNCTAD Handbook of Statistics Database and FDI Database

Since 1990, consumption represented between 76% and 90% of GDP, while gross capital formation represents only 14 to 23% of GDP.

Therefore, the influence of FDI on economic growth in Romania has been accomplished in an unhealthy way, by supporting consumption, which has reached nowadays concerning rates.

**3. Consumption as a catalyst of FDI inflows and the impact on economic growth**

The relationship between the FDI and consumption is not unidirectional, but interdependent. Figure 3 is therefore suggestive.

An increase by 1% in final consumption leads to an increase of 0.66% of FDI stock in the following year. We found that FDI's influence on consumption is more noticeable that the reverse one, but the existence of this interdependence maintains a vicious circle.

Intuitively, the consumption growth is accompanied by an import increase, which will destabilize the commercial balance and therefore the current account. In order to finance the current account deficit FDI is needed. In this manner we may explain the relationship between final consumption and FDI. The evolution of all these variables is presented in figure 4.

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223 Even though manufacturing industry counts for 32% of FDI stock in Romania, investment in this sector splits into various branches, therefore none of them has more than 8% of the total FDI stock.

Figure 3: Final consumption – FDI stock correlation in Romania, 2000-2006
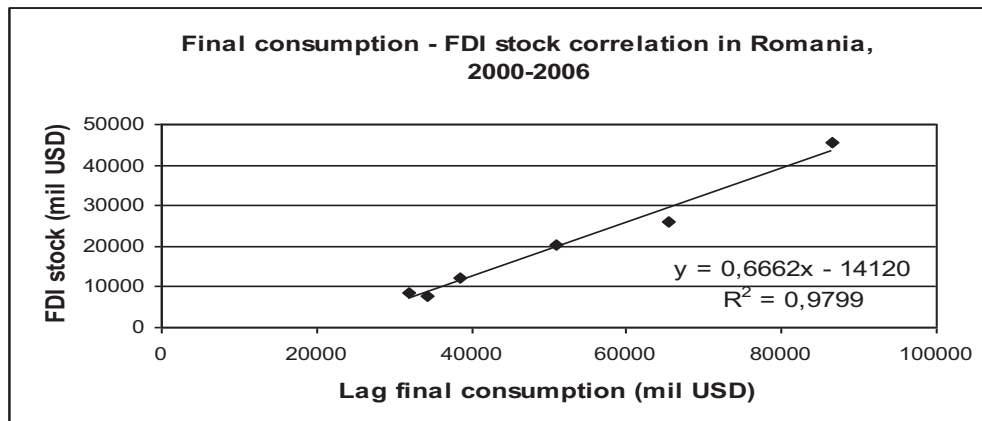
Final consumption - FDI stock correlation in Romania, 2000-2006

$y = 0,6662x - 14120$
$R^2 = 0,9799$

Source: authors' calculus based on UNCTAD Handbook of Statistics Database and FDI Database

Figure 4: The evolution of final cunsumption, imports, current account and FDI stock

The evolution of final cunsumption, imports, current account and FDI stock in Romania, 2000-2006

Final consumption — Imports — Current account — FDI stock
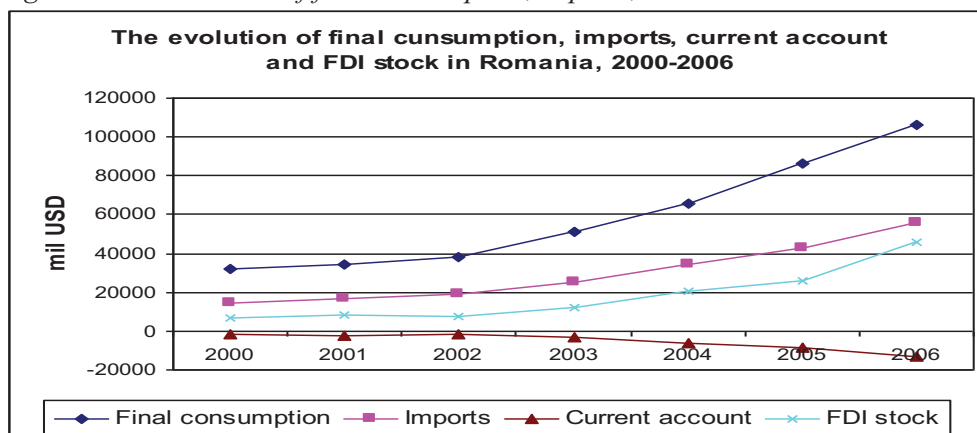
Source: authors, using data from UNCTAD Handbook of Statistics Database and FDI Database

Therefore, a 1% increase in consumption is accompanied in Romania by a 0.53% increase in imports, under the conditions of an insufficient domestic supply; moreover, the 1% growth in imports generates the destabilization of the current account with 0.27%. The increase of the current account deficit with 1% leads to the growth of the FDI stock with 3.22%.

Therefore, we have reached the conclusion that FDI generates consumption; consumption at his turn generates FDI, which again encourages consumption etc. We can observe now the vicious circle that leads to an unhealthy economic growth based on consumption. Moreover, we assist in this way to a FDI, rather than investment, financed consumption. FDI adapts themselves in his way to the needs of financing the current account deficit, but in the same time, sustain consumption, destabilizing the payments balance.

Bresser-Pereira&Gala (2008) argue that, in medium income countries, with insufficient capitals, financing the current account deficit by external savings (FDI) leads to an increase in consumption, much more than the increase in gross capital formation or in aggregate demand[224]. Therefore, there is a problem of insuffience of agreggate demand for countries accepting to finance economic growth by external savings. These countries will accumulate debt in order to consume and not to invest and grow.

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224 The cumulated demand for consumption goods and investment goods

Why an economic growth based on consumption in Romania? An economic growth based on demand/consumption was easier to put into place than a growth based on supply, due to an industry and agriculture sectors insufficiently developed, not capable of sustaining a supply that should respond to the demand in Romania. Analyzing the contribution to GDP of different sectors (see Figure 5) we notice the importance of Services. Industry and agriculture prove themselves much less important. While the contribution of industry and agriculture to GDP was in continuous descent, services faced ascension, bypassing 50% in GDP.

Figure 5: GDP contribution of different sectors
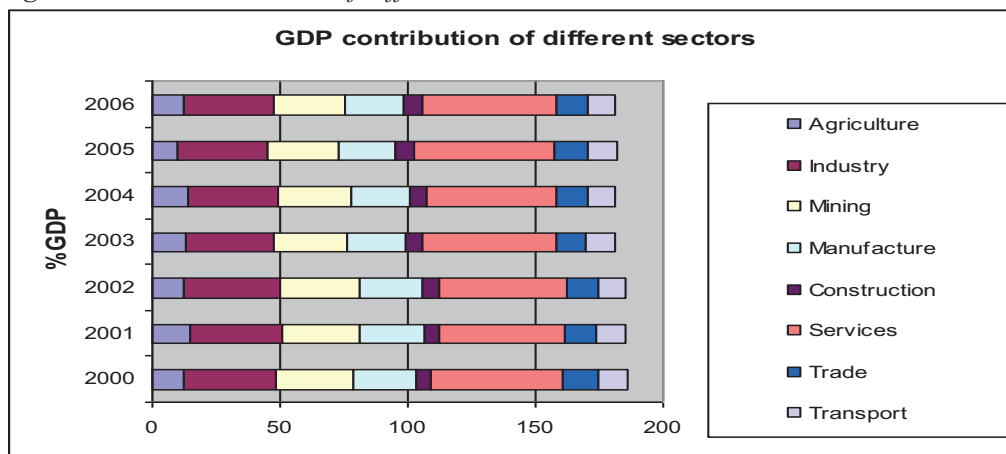
Source: authors, using data from UNCTAD Handbook of Statistics Database and FDI Database

4. Conclusions

Taking into consideration the present context of the world economic crisis, we are preoccupied by FDI and consumption perspectives, sources for the unhealthy economic growth in Romania.

The crisis effects on FDI can be summarized as follows: (1) investors' strategies will be affected by the turbulences on the world financial market and will reduce FDI in Romania; (2) investors may reoriented from developed markets confronted with recession towards countries less affected by the crisis, as Romania; (3) the restrictive credit policy now put into place in Romania discourages foreign investors.

As for the effects of the crisis over consumption, we can state that the reduction of the population's income and the prudent credit policy of BNR (National Bank of Romania) and commercial banks will discourage consumption in Romania. The two effects put together, that of FDI and consumption in crisis context will disengage the vicious circle, stopping from alimenting an unhealthy economic growth. In a paradoxical way, the crisis, by its effects, creates the premises for reconsidering the growth generating factors and the support for investment (domestic and foreign) as catalyst of economic progress in the long run.

Some sources anticipate a reduction of FDI inflows in Romania, reaching in 2013 the existent level of 2004. This assumption is not to be excluded, because that level of FDI is real one, since future years' performances only artificially generated FDI inflows by an increased consumption.

Which would be the implications in terms of public policies? (1) Reconsidering the factors generating economic growth; (2) Shifting from a consumption-led growth to a growth based on supply and gains of productivity; (3) Reversing the ratio Industry&Agriculture/Services in favor of the first, in order to sustain the supply by domestic investment and to promote a healthy economic growth; (4) Increase of net export and maintaining under control the current account deficit; (5) Promoting FDI that finance investment and not consumption, in order to contribute the growth of the aggregate supply and to a sustainable economic growth; (6) Attracting FDI in

deficient sectors, as Industry and Agriculture; (7) Putting into place an active fiscal policy to restrict consumption and encourage investment (domestic and foreign).

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