

## UNDERSTANDING FOREIGN DIRECT INVESTMENTS SPILLOVER MECHANISMS IN THE ROMANIAN ECONOMY

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**ABSTRACT:**

*THIS PAPER INVESTIGATES THE SPILLOVER EFFECTS OF FOREIGN DIRECT INVESTMENTS IN THE ROMANIAN ECONOMY ANALYZING THE REVENUE MADE FROM FOREIGN DIRECT INVESTMENTS IN THE PERIOD 2003-2017. IN CONTRAST TO EARLIER LITERATURE THAT EMPHASIZES THE EFFICIENCY OF FOREIGN DIRECT INVESTMENTS IN PRODUCING POSITIVE SPILLOVERS, THIS STUDY IS ANALYZING ALSO THE CAPACITY OF LOCAL CLIMATE TO DEAL WITH THESE LINKAGES BETWEEN FOREIGN AFFILIATES AND THEM. HOWEVER, POSITIVE SPILLOVERS ARE THOSE ABOUT EVERYONE ARE LOOKING FOR. LOCAL ECONOMIC ENVIRONMENT TENDS TO ATTRACT PRODUCTIVITY SPILLOVERS FROM FOREIGN INVESTMENTS, BUT THEIR IMPACT AND DIVERSITY MAY VARY DUE TO THE CAPABILITY OF THE RECEIVER TO ASSIMILATE THE CHANGES.*

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**KEYWORDS:** FOREIGN DIRECT INVESTMENTS, ECONOMIC ENVIRONMENT, SPILLOVER EFFECTS, PRODUCTIVITY, DEVELOPMENT

The trend of new economic realities shows that foreign direct investment (FDI) plays an important role for the economy of a country, as they represent a real engine of growth and modernization. The receiving country is depicted, as a general rule, via the academic discourse, as well as political and economic discourse, as enhancing several positive effects due to capital flows. The effects generated are more beneficial for the countries facing processes of modernization and development: emerging economies and economies in transition.

It has been recognized that the maximizing benefits of FDI for the host country can be significant, including transfer of capital, advanced technology, knowledge management, and especially, access to new markets. Spillovers can take place both within the same industry (intra-industry) and at an inter-industry level<sup>2</sup>.

The periods of economic growth are characterized by attracting significant influxes of foreign direct investment<sup>3</sup>. The importance of the investments is reflected by their conversion

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<sup>2</sup> Muhammed Benli, *Productivity spillovers from FDI in Turkey: Evidence from quantile regressions*, Theoretical and Applied Economics, Volume XXIII (2016), No. 3(608), 178.

<sup>3</sup> Robert Lipsey, *Interpreting developed countries' foreign direct investment*, (NBER Working paper no. 7810, 2000), 72.

into tangible assets and capacity to boost domestic investments through novelty and competitiveness. Generating positive effects as a result of direct foreign investments existence do not represent a guaranteed fact. Even if there are fewer chances to face negative effects, it must not be neglected that they can arise (such as monopoly, the undermining of certain economic sectors, privatization faulty, pollution etc.). In such cases, host countries authorities should entail conditions facilitating the leverage effect on positive consequence or reducing negative effects on economic growth.

FDI is also viewed as a way to generate growth and development, without involving debts for the recipient State. They are seen as complement to domestic investments, adjuvant of economic development<sup>4</sup>. They are not only economic agents; but also factors of social and cultural life development. Through the technology transfers achieved with investments, are taking place not only large economic transactions of a part of the research and development activity beyond the boundaries, but it is also developed a powerful synergy through the fusion of science with the production<sup>5</sup>.

The existence of direct foreign investments affects the development of the recipient country by direct or indirect effects, due to the spillover phenomena. Therefore, it is much easier to identify and quantify the effects and the impact on economical scale, than on social scale. Economic theory states investment, either internal or external, represents the most important factor of development. Therefore, if to the internal capital flow is added external capital; it works like a catalyst for growth and development. In addition of financing with foreign capital, the foreign direct investments, through technology and know-how, they encourage links with local companies, fact that contributes significantly to economic revival. On the basis of these arguments, developed countries and those in the developing process provide incentives to encourage foreign investors to choose their savings<sup>6</sup>. Whether FDI brings benefits to local firms in the host economies is largely dependent on the region's capacities, including the technology gap between MNEs and local firms<sup>7</sup> and the absorptive capabilities of local firms to emulate and integrate the knowledge from MNEs<sup>8</sup>.

The impact can be quantified by identifying and analyzing the income of FDI. To generate a current study, we will identify in the graph below the ISD revenues in the Romanian economy for the period 2003-2017.

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<sup>4</sup> Huang et al, *Regional innovation and spillover effects of foreign direct investment in China: A threshold approach*, (Regional Studies, 2010), 592.

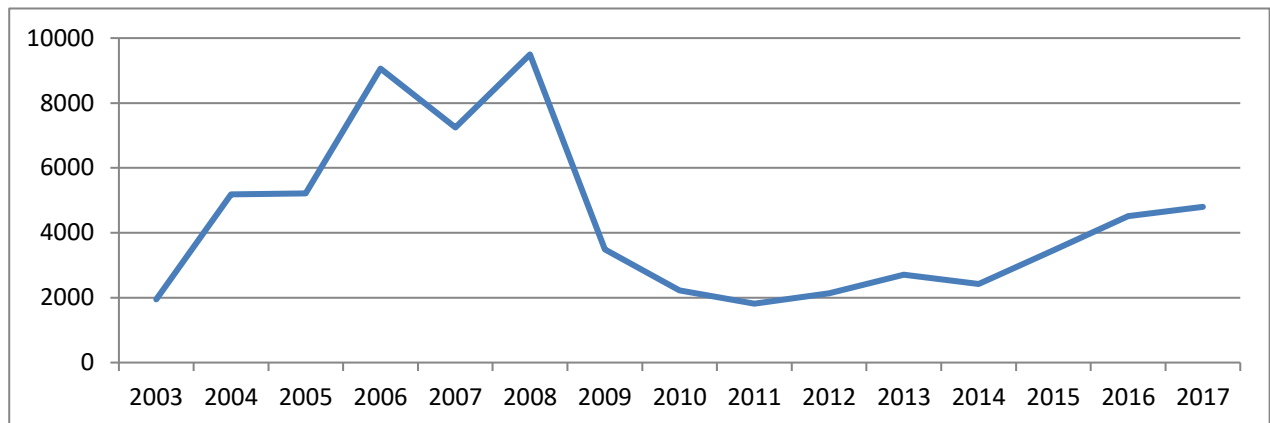
<sup>5</sup> Michael Porter, *The Competitive Advantage of Nations*, Free Press, New York, 1990, available at [<https://hbr.org/1990/03/the-competitive-advantage-of-nations>].

<sup>6</sup> Laura Alfaro, *Foreign Direct Investment and Growth: Does the Sector Matter?*, Harvard Business School, Boston, 2003, available at [<http://www.grips.ac.jp/teacher/oono/hp/docu01/paper14.pdf>]. 2.

<sup>7</sup> Naotaka Sawada, *Technology Gap Matters on Spillover*, 2010, Review of Development Economics, Volume 14, Issue 1, 107.

<sup>8</sup> Ford et al, *Foreign direct investment, economic growth, and the human capital threshold: Evidence from US states*, Review of International Economics, 2008, 102.

Figure 1. Revenue made from foreign direct investments in the period 2003-2017



Own processing after data supplied by [www.bnr.ro](http://www.bnr.ro)

Overall, the revenues are directly proportional to the volume of foreign direct investment. It can be observed a revenue decrease concomitantly with the volume of direct foreign investments decrease in the context of the economic crisis. Therefore, if the revenues are higher, the reinvested profits will rise too, and the distributed dividends will be bigger. The choice to reinvest a part of the revenue is transposed into increasing the economic and social impact of the investment. As a general rule, reinvestment with a higher percentage than dividend distribution is preferred<sup>9</sup>.

Empirical results show that there exists a bi-directional relationship between economic and social effects of foreign direct investments. Consequently, the buyers have access to a diverse range of products and services at the best rates, due to the competition between economic actors. It should be noted that there are cases in which a foreign investor imposes itself on the market, leading to a monopoly situation. In this case, the economic and social effects are negative, because of the price increased.

Foreign direct investments have the capacity to generate new jobs, both directly (in new enterprises), and indirectly (subcontracting or supplies and services provider companies). Although, new technologies, more performing, may reduce the number of employees, in the long term contributes to the development of new economic activities or attracting new foreign companies to settle down, which generates new jobs<sup>10</sup>. Therefore, policymakers need to maintain or enhance the capability of local buyers to integrate the advanced products and services purchased from foreign firms<sup>11</sup>.

As regards cultural and educational impact of FDI, it transposes into practice through the establishment and the activity of cultural institutes (French Institute<sup>12</sup>), but also by

<sup>9</sup> See the distribution of FDI incomes in the National Bank of Romania's statistics.

<sup>10</sup> Cătălin Postelnicu, *International investments in economic development equation*, (Presa Universitară Clujeană, Cluj-Napoca, 2001), 183-184.

<sup>11</sup> Chengchun Li, Yun Luo, *Spillover Effect of Foreign Direct Investment: Evidence from the West Midlands of England*, *Economic Issues*, Vol. 24, Part 1, 2019, 5.

<sup>12</sup> For more information on the French Institute's work in Romania, please consult [<http://www.institutfrancais.ro/>].

agreements on educational cooperation between universities in order to facilitate the transition from school to working life for the future employees<sup>13</sup>.

In addition, technological innovation may represent the argument of some strategic partnerships in the field of research between two or more States. Intensifying cooperation, attracting foreign expertise, establishing scientific collaboration and research framework, but also identifying new areas of cooperation, provides sufficient grounds for partnership development.

*Everywhere in the world, research is considered as a factor of progress: progress of knowledge, which is itself a value, but also economic progress, because innovation is a key factor of the competitiveness. Global challenges represent important research and innovation engines. However, we have to keep in our countries research and innovation capacities, sources for maintaining competitiveness and employment<sup>14</sup>.*

Accordingly, we note foreign direct investments effects are wide and diverse, influencing each other, whether they have a positive or negative character. Consequently, we can say that foreign direct investments benefits (regardless of their nature) do not appear and do not accrue automatically, because the level of their impact differs from one host country to another. On short term, benefits are represented by increased productivity and emergence of new products at lower prices. But on long term, the advantages can be amplified if the beneficiary of the investment is interested by them and is able to extend and to develop them<sup>15</sup>.

Regarding local factors affecting negatively the trajectory of FDI in developing countries, we enumerate medium or low levels of education, poor technological development, and defective/inadequate legislation of the investment sector or weak competition between the market participants. On the other hand, the success of foreign direct investments is greater in the Member States which have an advanced level of education, technology and infrastructure. States which such a portfolio, reflects stability and sustainability, and implicitly a guarantee for investors.

On the other hand, human resources and economic environment are strongly influenced by the impact of FDI, either by their quantity, either by their quality and action strategy. Both positive effects (increased quality of life, technology and education investments) and negative effects (unemployment rate is the most common), affects human capital, engine of economic, social, cultural and education development in every society. Due to its financial, technological and managerial contribution to the development of the economic structure, FDI provides an important driver for growth and social development as a whole.

In Romania, foreign direct investment has a particular character, because after the fall of the communist regime, Romanian economy was not ready to join the international markets. The transition of former communist states from Central and Eastern Europe to viable market

<sup>13</sup> European Studies Faculty, Babeş-Bolyai University, *Studies offer*, available at [<http://euro.ubbcluj.ro/studii-politice-europene-comparate-lb-franceza/>].

<sup>14</sup> François Saint-Paul, former Ambassador of France in Bucharest, *Partnership between Romanian Institute for Atomic Physics and French Atomic Energy Commission*, available at [<https://www.agerpres.ro/sci-tech/2015/04/01/parteneriat-intre-institutul-roman-de-fizica-atmica-si-comisariatul-francez-pentru-energie-atmica-14-39-09>].

<sup>15</sup> Pack Howard, Saggi Kamal, *Inflows of foreign technology and indigenous technological development*, Review of Development Economics, 1997, 88.

economies has been facilitated by the increase of foreign investments in the region. Moreover, for some, these investments have paved the way for a new process: European Union integration.

Advanced technologies that come with foreign investors also increase labor productivity. Although, the number of employees may fall, capital gains remain stable. Jobs are created in the sector where the investment takes place but may also occur in related sectors which determine the ultimate goal of the investment. GDP growth is strongly influenced by increased exports. Given the potential of FDI in maximizing benefits through exports, increased FDI benefits GDP in the host economy. Thus, starting from a brief analysis of indicators such as increased jobs, exports, labor productivity and technological progress; we conclude that living standards increase proportionally with GDP growth, driven largely by the volume of investment. In the end, all components of productivity; technological progress, technical efficiency change and scale efficiency change significantly contribute in explaining the spillover effect growth<sup>16</sup>.

Further, increased imports (investment development requires imported materials or machinery) or unemployment rate might be needed in order to make work more efficient. These measures can generate state-level increases to support a higher number of unemployed people. However, these are usually short-term effects, because in the long term, any investment gain determines benefits and increases living standards.

The graphs cited in this paper, shows that economic growth was largely influenced by important foreign capital inflows. Following the investment market dynamic, foreign investors are outsourcing their capital due to tax benefits in host countries. Thus, they sell at the same price but with lower production costs, which results in a higher profit that is also reflected in GDP growth in the host country.

Regardless French capital destination, Greenfield investments, acquisitions or capital increase, benefited all Romanian economic sectors: machinery industry, telecommunications, commerce, agriculture and food industry, construction materials, finance-banks or energy.

From the data presented in this paper it follows that foreign direct investments, including French investments, represent an important driver of economic, social, educational and technological growth. We note a functional relationship between state-investor, based on the ability to attract as much capital as possible from a resilient economy, and on the other hand, by maintaining the performance of economy due to large number of investors.

Therefore, by boosting economic development, FDI can play an important role in modernizing used technologies, improving organizational management, and increasing the invested capital. FDI flows are stimulated and driven by the price benefits differentials in terms of output from another country, as well as by the size of the national market, by its development potential and by the potential competition. On the other hand, foreign investors are strongly motivated by new markets that could increase their revenues and reduce their costs.

Consequently, economic and legislative conditions have encouraged investments in Romania, which have had a significant impact on state growth and development in the post-communist period. Therefore, the impact of FDI on country's economy may be different from one case to another due to different economic, political and social contexts, as well as by the type and the volume of foreign capital invested.

<sup>16</sup> D.W. Sari, N.A. Khalifah & S. J. Suyanto, *The spillover effects of foreign direct investment on the firms' productivity performances*, Journal of Productivity Analysis, 2016, Volume 46, Issue 2-3, 224.

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