

The Effects of Offshoring on Trade in Services. Evidence from Romania

Agnes Ghibutiu*

Irina Dumitriu**

Abstract

Relying on insights from theoretical and empirical contributions on the issue of services offshoring, the paper aims to explore the effects of this phenomenon on Romania's trade in services, by looking at its evolution during the 1995-2006 period in terms of dynamics, size and composition. Given the multiple shortcomings of statistical data and instruments available currently for tracing and measuring offshoring activities, the paper adopts a three-tier approach – i.e. based on official trade and FDI statistics, as well as additional information from private sources – to find evidence for enhanced services offshoring in the Romanian economy. The results of the empirical investigation underpin our assumption that the remarkable growth rates of exports in some individual services categories, accompanied by the positive changes under way in the patterns of Romania's trade in services, are largely attributable to intensified offshoring activities. Even though the interpretation of the final results remains subject to caveats, the findings of the paper confirm that the large amount of anecdotal evidence on the country's increased attractiveness for offshored services is supported by official data. An examination of Romania's potential as location for offshored services in the European and global context is closing our discussion, followed by conclusions and some policy considerations.

Key words: trade in services, FDI, offshoring, Romania

JEL classification: F14, F21, F23, L80

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* Senior research fellow, Institute of World Economy, Bucharest. E-mail: agnesghibutiu@clicknet.ro

** Business consultant and associated professor, Academy of Economic Studies, Bucharest.

E-mail: dbirina@yahoo.co.uk

Introduction

During the last two years, Romania has caught increasingly the attention of media reports both domestically and internationally for its high potentiality as host country for offshored services. Particularly its vast talent pool and modern ICT frameworks are considered to make it a leading player in Eastern Europe. Moreover, Romania is now seen by some analysts as becoming “Europe’s India” in terms of offering offshoring solutions to the rest of Europe. Obviously, it is quite exaggerated to relate Romania, or any other East European country, to the Indian model. There are many reasons for which such a comparison is unsustainable.

Nevertheless, it is worth investigating what are the facts behind the hype. Such an investigation is all the more timelier, as over the last couple of years services offshoring ranked among the most hotly debated topics in the context of international economics. Besides, the highly dynamic developments revolving around this phenomenon continue to widely focus the interest of economists and politicians, as well as the public at large.

In the absence of a commonly agreed definition of “offshoring” in the public debate or in the economic literature, the phenomenon has been frequently described as the process of relocation of service activities/functions to lower cost destinations outside national borders. By assuming the perspective of the country of origin, such a description contributed largely to portraying services offshoring as a one-way process from a high-wage location to a low-wage destination from Asia or Eastern Europe, by which the former would be greatly affected. Especially its potential threat to employment fuelled considerable concern in the home countries, mostly developed countries.

Until very recently, Romania did not rank among the most attractive locations for services offshoring worldwide. Moreover, the country’s involvement in export-oriented global FDI projects related to offshored services (such as IT services, call centres, shared services centres, etc.) was rather insignificant compared with other new EU member states (NMSs), e.g. Hungary, the Czech Republic or Poland. Therefore, the question arises: What happened in the last years so as to give rise to such great expectations?

The present paper attempts to find the answer to this question. It represents a first step in the analysis of the impact of services offshoring in Romania. Its aim is to piece together the scattered available evidence on services offshoring into an overall picture on the dynamics, scale and characteristics of this phenomenon, and to assess the extent to which the resulting picture is consistent with the image conveyed by the large amount of anecdotal evidence, according to which Romania is arising as an increasingly attractive location for offshored services in the European and global landscape.

Section 1 lays out the starting point of the analysis, by giving a brief summary of the main insights into the offshoring topic emerging from the current literature. It then goes on to define what in the paper is meant by “services offshoring” and to set out the methodology underlying the analysis. Relying on official trade statistics complemented by company-level data, Section 2 documents a set of features about Romania’s trade in services which might be relevant for enhanced services offshoring. In Section 3, official data on FDI as well as proxies will be used to underpin the observed trends in services trade. Section 4 investigates Romania’s potential as location for offshored services, and highlights its strengths and weaknesses. Section 5 concludes and puts forward some policy considerations.

1. General Background for Analysis

1.1 Scarce knowledge about services offshoring

According to a pertinent remark by Kirkegaard, “few new topics in international economics have risen faster to the top of the political agenda, while simultaneously so poorly understood and quantified, than outsourcing in recent years”.¹

Indeed, despite ranking high on the media and policy agendas, knowledge about the complex issues involved in the phenomenon of services offshoring is still scarce.

Research on this topic continues to be greatly hampered not only by the unavailability of adequate official data and statistical instruments to quantify its real size and impact, but also the absence of an international consensus on what offshoring actually means. Lack of progress in harmonising internationally the definitions, data classifications, as well as data collection itself, greatly restricts the scope for comparison of the various studies on the extent and effects of offshoring and hence the formulation of sound and consistent policy recommendations (van Welsum and Reif, 2006).

Nevertheless, the growing number of theoretical and empirical contributions has shed more light on this multifaceted topic. By and large, the new insights gained from research have contributed to a better understanding of the nature of services offshoring, its driving forces and dynamics as well as its impact. And most importantly, they have been helpful in channelling the initially heated debate on a less emotional track and in placing the expectations and fears of offshoring into a more balanced perspective.

The one-sidedness of approach prevailing in the ongoing debate on offshoring – i.e. as a one-way process typically from developed to developing and transition countries – explains to a large extent why the bulk of academic research has focused so far on the potential employment effects of services offshoring in developed countries. Far less empirical contributions have been devoted to investigating its trade effects.²

Particularly scarce is systematically led academic research on the impact of services offshoring in the host countries, and specifically in the NMSs.³ This is in sharp contrast to the large amount of recent estimates by international consulting firms, which are viewing the NMSs as increasingly attractive locations for services offshoring both in the European and the global context. Nevertheless, a general consensus seems to emerge in the literature, that European enlargement has rendered NMSs increasingly desirable targets for services offshoring.

¹ Quoted from Kirkegaard (2007, p.2).

² Limited research has been carried out to date on the relationship between offshoring and trade in services. The topic has been addressed, among others, by: van Welsum (2004), OECD (2004), Amiti and Wei (2004), Pain and van Welsum (2004), van Welsum and Reif (2005, 2006), van Welsum and Vickery (2005), WTO (2005). However, services trade has been only marginally tackled from the angle of host countries, and exclusively within the analyses on employment effects of offshoring in developed countries.

³ According to our knowledge, only few attempts have been made thus far to investigate services offshoring in the NMSs. Apart from the contribution by Stare and Rubalcaba (2005), the few studies dealing with offshoring in the context of EU enlargement are only tangentially discussing services offshoring, and are focused primarily on manufacturing. Cases in point are: Hunya and Sass (2005) and Marin (2006).

1.2 Brief review of the main findings from research

A brief review of the main insights emerging from the literature on the topic of services offshoring may provide both a good starting point and a general background for analysing the phenomenon in the context of the Romanian economy.

Adopting a **firm-level view**, services offshoring is arising as an attractive business model to which companies increasingly resort in response to intensified global competition. By focusing on core activities and by outsourcing other tasks, firms may consolidate or enhance their competitiveness through specialization and more efficient organization, cost cutting, economies of scale and spreading risks (OECD, 2004). Essentially, offshoring of business processes by firms is not an entirely new phenomenon. Manufacturing firms have sourced components from other countries for many years, while the outsourcing of business processes within a country has existed in some form for centuries (UNCTAD, 2004; Kirkegaard, 2005). New are however the forces which are driving and shaping services offshoring in the present global economic setting, and subsequently its dynamics, the forms it may take, as well as its scope.

Seen from a **world economy perspective**, services offshoring reflects an ongoing shift in the patterns of production and trade in services with wide-ranging consequences for the international division of labour. As such, it is a relatively recent development in the global landscape, i.e. a new form of globalisation, driven by mutually reinforcing technological, economic, institutional and organizational factors. It may be seen as a particular form of trade, enabled by increased tradability of services due to rapid advances in ICTs in conjunction with liberalization of trade and FDI flows at the national, regional and global level. As a result, services activities are now less constrained in their choice of location than they have been traditionally, meaning that many types of service categories that were previously only tradable through the movement of provider (i.e. through face-to-face contact) can be now supplied from remote locations. For many firms in all sectors this means that the production of various ICT-enabled services may be “outsourced”, i.e. turned over to other specialized companies. And if it can be outsourced, then it can generally also be offshored (Kirkegaard, 2005). Moreover, by fragmenting the production of ICT-enabled services internationally – in locations situated outside the firms’ home countries – in line with the comparative advantages of different locations and the competitiveness-enhancing strategies at the firm level – companies can gain economies of scale from consolidating and standardizing their services activities across the globe (UNCTAD, 2004). While ICTs and continuing efforts to liberalize trade and FDI have made services offshoring feasible, the emergence of a global labour market for skilled workers – with many developing and transition countries characterized by relative abundance of skilled labour, available at low wage – turned services offshoring into a profitable way of doing business in an increasingly competitive global environment.

While the gains from services offshoring at the firm level are straightforward, i.e. enhanced competitiveness – due to lowering costs, increases in productivity and quality of services – its **impact from a macroeconomic perspective** is, however, to a lesser extent clarified. Hence, its implications in an economy-wide sense continue to be a subject of controversy. Especially its potential disruptive effects on employment in the developed countries continue to fuel concerns among policy makers and the broader

public, yet to a far lesser degree among economists. Actually, the findings of numerous recent empirical investigations on the labour market-effects of services offshoring in the high-wage countries confirm the conclusion drawn earlier by Amiti and Wei (2004), according to which “the risk of services offshoring dramatically reducing job growth in the advanced economies has been greatly exaggerated”.⁴ It is also important to note, that several recent studies have emphasized the relatively modest size of services offshoring if viewed from a macroeconomic perspective. Even though the figures on annual growth rates of services offshoring put forward by different media reports from private sources might look spectacular, when related to total inflows and outflows in the relative labour markets, or to total services trade, the figures seem to be far less impressive (WTO, 2005).

The new international division of labour emerging under the form of services offshoring is now basically regarded as a **win-win game**. There is large agreement among the analysts that the economic benefits – the outcome of specialization based on comparative advantage – are accruing to participants at both ends of the process.⁵ Host countries are considered to gain in terms of employment, upgrading of skills, capital inflows, technology transfer and increased trade flows, including the opportunity to enter new industries before domestic demand can support them. Home countries are seen to benefit from enhanced competitiveness, enlarged access to cheap and high-quality services, and the opportunity to move up the skill and technology ladder. Yet it is also largely admitted that fast changes in international specialization may lead to tensions (notably due to displacement of workers), and may imply adjustment costs that governments, enterprises and individuals will have to bear. Just like all forms of international trade – whether in goods or services – offshoring is likely to bring about both winners and losers, with the key question for policy-makers being the design of proper policies to ensure that the former compensate the latter.

Against this brief picture of services offshoring from a global perspective, the question then becomes, just what are the trends, characteristics and drivers shaping the offshoring landscape in Romania as a host country?

1.3 Terminology and methodology

Before moving to the analysis, we will provide the terminology and methodology underlying it. Starting point of our analysis is the assumption that a typical consequence

⁴ Quoted from Amiti and Wei (2004, p.18). For similar conclusions, see: van Welsum and Reif (2005; 2006), Jensen, Kirkegaard and Laugesen (2006), Kirkegaard (2005; 2007).

⁵ According to standard economic theory, an economy should benefit overall from services offshoring and the increased specialisation it brings about, provided it is capable to adjust, by facing the short-term costs implied (e.g. under the form of job losses). Ultimately, the efficiency and productivity gains achieved through offshoring in the long term would enhance the overall growth and employment opportunities of both the home and host economies. Nevertheless, some economists are questioning the beneficial effects of services offshoring particularly for the developed countries. They argue that offshoring is going to change the current patterns of specialization, by which developed countries are assumed to have traditionally a comparative advantage in knowledge and high-skill intensive goods and services. In other words, precisely in those areas in which Western companies are now facing increasing competition from developing and transition countries endowed with abundant and relatively cheap high-skilled labour, which can be now traded globally thanks to ICTs (van Welsum and Reif, 2005).

of a decision taken at the level of a firm located abroad to offshore services to Romania should be a rise in the country's exports of services as it becomes the new location from which the service supplies are sourced thereafter.

Definition

From the great variety of concepts used currently to describe the phenomenon, we have opted for "offshoring" as the term most popularly used so far in the economic literature.⁶ Further, we have chosen to rely on the definition provided by the OECD (2004, p. 89), as it seems to be the most adequate for our investigation. Accordingly, we understand by "services offshoring" the international sourcing of IT and ICT-enabled business services (such as customer services, back-office services and professional services), under its both forms, i.e.:

- "*international outsourcing*", by which we mean the sourcing of a service from an independent supplier (third-party service provider) located abroad (i.e. unaffiliated trade); and

- "*captive offshoring*", by which we mean the sourcing of a service from an affiliated firm abroad (i.e. FDI and intra-firm sourcing, or affiliated trade).

We will use the generic term "offshoring" throughout the paper, unless otherwise specified.⁷

Methodology

It is largely acknowledged that official statistics are not adequate for measuring the extent and dynamics of services offshoring. It is not only that statistics cannot keep pace with the highly dynamic developments related to offshoring, which is a phenomenon at the firm level, but the statistical system itself makes any meaningful measurement difficult. Major shortcomings related to the statistical system are arising from the absence of a commonly agreed-upon definition on offshoring, the multitude of forms offshoring may take, the lack of concordance between the current definitions and the existing statistical concepts and classifications of industries and officially collected data.⁸

⁶ The terms used for the conceptualization of the phenomenon differ greatly across the authors, even though their meanings are often very close, or are even overlapping. Offshoring, outsourcing, offshore/international outsourcing, cross-border outsourcing, insourcing, inshoring, nearshoring, externalisation, relocation, delocalisation, international sourcing, production fragmentation/relocation, global sourcing and global supply chain management – are some of the most frequently used terms.

⁷ Evidently, the issues and concepts implied in the phenomenon would require a more rigorous qualification. It is, however, out of the scope of this paper to enter the "offshoring" *versus* "outsourcing" debate. We only stress that we assume the importance of keeping "offshoring" and "outsourcing" decisions distinct – as *location* choice and *mode* choice decisions respectively, along with Markusen (2005, p.20).

⁸ The shortcomings of the current statistical systems and the inherent difficulties in tracking and measuring services offshoring activities have been largely addressed in: OECD (2004), Amiti and Wei (2004), WTO (2005), van Welsum and Reif (2005; 2006), Kirkegaard (2005; 2007), etc. The situation is even more complicated in Romania, where upgrading of the statistical system started only recently, and the official data collection is still in its infancy, particularly in those fields which are relevant to gauging offshoring – namely, services sector and TNCs data.

Therefore, in our attempt to gauge the evolution and extent of services offshoring in Romania we will adopt a three-tier approach.

Firstly, we will rely on balance of payments (BoP) trade statistics and derived official data (proxies) to identify emerging trends in the evolution and composition of Romania's trade in services, which might be put on account of increased offshoring.

Secondly, we will try to trace evidence for increased offshoring in Romania on the basis of available official FDI data, i.e. BoP statistics and data from the National Trade Register. This investigation is aimed at complementing the insights gained from trade statistics, especially as according to estimates services offshoring takes place predominantly through captive offshoring.

Thirdly, we will confront our findings in terms of official statistical data with evidence derived from different private sources, which are useful in catching those early emerging developments that the official statistics are not yet equipped to reflect or do report with great delay respectively. Such additional sources of information include: media reports, surveys and reports from private sources, market research and case studies, estimates by industry experts and consultants, including international consulting companies. Even though these vary in their reliability and conclusions, when put together, they are likely to provide supplementary information on the dynamics and extent of services offshoring in Romania.

Description of data and measurement-related problems

Trade data. The main data source we use to investigate the patterns of Romania's trade in services in terms of offshoring is the national BoP. These data record transactions between a resident of Romania and a resident of another country. Both international outsourcing and captive offshoring may be expected to appear in the BoP trade statistics, as unaffiliated trade and affiliated trade respectively.

As there are no readily available statistical indicators for measuring the extent and dynamics of offshoring and its effects on trade, we will rely on *indirect measures*, which serve as proxies. Following a widely applied methodology internationally⁹ we will use two services categories to approximate the potential impact of offshoring on Romania's trade in services, namely: "*computer and information services*" (CIS) and "*other business services*" (OBS).¹⁰

The sum of these two BoP categories is assumed to cover the great variety of services that may potentially be affected by offshoring. Further, this aggregate is considered to contain information on international outsourcing and captive offshoring combined. In the current literature, these two categories are also frequently referred to as *IT services* and *ICT-enabled services* respectively. The latter are also known as *business*

⁹ See, for instance: OECD (2004), Amiti and Wei (2004), van Welsum (2004), WTO (2005), van Welsum and Reif (2005; 2006), Stare and Rubalcaba (2005).

¹⁰ At the current level of aggregation of Romania's BoP data, "*computer and information services*" (CIS) may be identified as such, while "*other business services*" (OBS) represent the sum of the following BoP items: (1) merchanting and other trade-related services; (2) operational leasing services; and (3) other services (i.e. legal, accounting, management consulting, and public relations; advertising, market research, and public opinion polling; research and development; architectural, engineering, and other technical services; agricultural, mining; other business services, including services between related enterprises, n.i.e.).

process (outsourcing) services – BPO.¹¹ We will use this terminology too, as we will use the term “*offshorable services*” to generically refer to the sum of the two categories of services.

While according to our assumption offshored service activities should result in a trade flow in services, not all trade in services is related to offshoring and nor is it possible to distinguish which part of it is (van Welsum and Reif, 2005). However, we may consider the resulting trade as an upper limit for any estimated value of offshored services (WTO, 2005). Consequently, we recognize along with other analysts, that there are major pitfalls in the interpretation of BoP trade data by linking them to different offshoring activities. Nevertheless, BoP data have the advantage to help us highlight the dynamics and relative size of IT services and ICT-enabled services within Romania’s total trade in services, and also allow us the calculation of net exports.

FDI data. FDI plays an important role in services offshoring. In principle, FDI affects it in two ways: through captive offshoring, and when specialized services providers set up foreign affiliates to serve foreign clients (UNCTAD, 2004). But similarly to trade, FDI statistics are not adequately equipped to measure services offshoring, and hence it is not possible to determine what share of FDI is directly related to offshoring (van Welsum and Reif, 2005). Yet, it is possible to get some insights into the dynamics and extent of this process from combining several sources of information, i.e.:

- official FDI statistics based on BoP and data from the National Trade Register, which may convey at least a rough picture of the trends underlying the evolution of FDI inflows in terms of magnitude, dynamics and industrial composition;
- proxies (e.g. the examination of the number and destination of export-oriented projects worldwide, provided by UNCTAD for the 2002-2003 period);
- company-level data and company-related reports.

Given the shortcomings of both trade and FDI statistics for gauging services offshoring, it has to be kept in mind that the interpretation of the results deriving from our analysis is liable to the usual caveats associated with this kind of empirical exercise.

2. Increased Services Offshoring in Romania: Evidence From Trade Data

In this section we aim to address the following questions: Is there a rise in services offshoring in Romania in recent years as featured by the BoP data on trade in services? Do the data support the view that Romania is increasingly arising as a recipient of offshored services?

A short insight into the evolution of Romania’s trade in services during the last decade will help us find the answers to these questions, by shedding light on those newly emerging developments which might be associated with increased offshoring activities and might have direct bearing on the country’s potential as location for offshored services.

¹¹ Business process (outsourcing) services – BPO – may be subdivided further into: front-office services or customer interaction services (typically performed by call centres) and back-office services (performed by shared services centres). The boundaries between IT services and BPO are difficult to draw. Mattoo and Wunsch (2004) provide a useful list of the most common offshored IT and BPO service activities.

2.1 The legacy of the past

The previous economic system left Romania with one of the most depressed services sectors and the longest paths towards a services-oriented market economy, for which it was the least equipped among the former communist countries in the region. In a highly centralized economy, with nonexistent private sector and non-competitive environment, with strong monopolistic positions of state-owned enterprises, lack of entrepreneurship and isolation from international markets, the scope for developing services in general and business services in particular was severely restricted until 1990 (Ghibutiu, 1999). Moreover, services have been relegated to a status of lesser importance in the development process both in terms of theory (ideology) and economic policy. Subsequently, trade in services did not focus the attention of policy decisions. It was regarded as a mere complement to trade in goods (e.g. transports) or a source of foreign exchange earnings (e.g. tourism).

Consequently, when Romania started to move towards market-oriented policies and institutions, a wide range of service categories, particularly business-related services (such as banking and insurance, telecommunications, computer and information services, etc.) were either nonexistent at all or not developed according to Western standards. No wonder that at the beginning of the transformation process Romania ranked among the least services-oriented economies from Central and Eastern Europe (CEE). And it may be argued that in respect of several services categories, development started practically from scratch.

The process of market-building and market-functioning demanded increasing amounts of business services, particularly professional services, including legal services, accounting and auditing, advertising, market research, management consulting, etc. However, in the first years of transition these services could not be provided locally due to lack of expertise and skills, particularly business management skills and marketing know-how, but also owing to shortage of capital and weak telecommunications infrastructure. Hence, they had to be acquired from abroad, either from individual practitioners or specialized firms from Western countries. Foreign investors have acted as pioneers in the domestic market, opening and showing the way for developing several new business service categories and, implicitly, in spurring the emergence of local business services companies. Not only that FDI enlarged the domestic supply of business services and forced local service providers to enhance their own performance through increased competition, but also contributed to improving skills, spreading know-how, enabling global connections and increasing the quality of services (Ghibutiu, 2002).

2.2 The changing patterns of Romania's trade in services

The prospects of EU accession, the consequent adoption of the *acquis communautaire* as well as Romania's gradual integration into the European market have increased pressures to upgrade the supply of services to the level of the EU member states, and to attract FDI into higher value-added services, including export-oriented services.

Table 1 illustrates some of the salient features of Romania's trade in services. The picture which arises from the current BoP data on the country's trade in services is that of

a still low degree of involvement of the domestic services industries in international trade flows. Romania accounts for a mere 0.2 per cent share in total world services exports. The country's low export and import capabilities in services are in sharp contrast with both its size and potential. In value terms, Romania's services exports are about three times smaller than Poland's, and about two times lower than Hungary's or the Czech Republic's (Ghibutiu, 2007).

Table 1: Romania's trade in goods and services, in 1995-2007

	1995	2000	2001	2002	2003	2004	2005	2006	Jan.- Aug 2007
Trade in goods (EUR million)									
Exports	6117	11269	12712	14676	15614	18935	22255	25850	18959
Imports	7336	13099	16028	17437	19569	24258	30061	37609	29823
Balance	-1219	-1830	-3316	-2761	-3955	-5323	-7806	-11759	-10864
Trade in services (EUR million)									
Credit	1155	1899	2270	2482	2671	2903	4104	5513	4711
Debit	1407	2167	2398	2473	2609	3116	4448	5507	4561
Net	-252	-268	-128	9	62	-213	-344	6	150
Composition of trade in services (%)									
Credit, of which:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transport	31.5	36.2	40.7	41.1	39.8	43.1	29.0	27.0	24.9
Travel	39.5	20.5	17.8	14.3	14.8	14.0	20.8	18.8	12.2
Other services	29.0	43.3	41.5	44.7	45.4	42.9	50.2	54.2	62.9
Debit, of which:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Transport	33.2	31.5	34.1	35.7	38.2	38.7	35.6	34.7	33.1
Travel	38.3	21.3	20.9	16.9	16.2	13.9	16.9	18.8	15.2
Other services	28.5	47.2	45.0	47.4	45.6	47.4	47.6	46.5	51.7

Source: Calculations based on BoP statistics, National Bank of Romania.

However, quite interesting conclusions may be drawn when analyzing the evolution of Romania's trade in services in the more recent years in terms of dynamics, composition and performance.

Table 2: Average annual growth (CAGR) of Romania's exports and imports of goods and services (in nominal terms), in 1995-2006 (%)

	1995-2006	1995-2000	2000-2006	2004-2006
Goods				
Exports	14.0	13.0	14.8	16.8
Imports	16.0	12.3	19.2	24.5
Services				
Exports	15.3	10.5	19.4	37.8
Imports	13.2	9.0	16.8	32.9
Offshorable services (CIS + OBS)¹				
Exports	33.7	40.2	28.6	63.7
Imports	16.8	18.1	15.6	29.3

Note: ¹ See Section 1 for the specific services categories covered under this heading.

Source: Calculations based on BoP statistics, National Bank of Romania.

Firstly, services exports increased dramatically over the 2004-2006 period, with their average annual growth rate (CAGR) more than doubling compared to that of goods

(38% and 17% respectively). In the same period, services imports grew also notably faster than imports of goods (33% and 25% respectively), but remained below the growth of services exports (Table 2).

Secondly, the rapid expansion of services exports has been driven mainly by the “Other services” component of trade in services. Business services subsumed under this BoP heading increased their share in total services exports from 29% in 1995 to 54% in 2006 (63% in the first 8 months of 2007) (Table 1). This is a remarkable qualitative shift in the composition of Romania’s trade in services and points towards a highly dynamic process of structural adjustment. In the 1990s, the structure of services flows still reflected the inheritance of the past economic regime. Accordingly, it was characterized by the predominance of traditional services – such as transport and related services as well as travel – and the very low share of advanced business services.

Thirdly, the outstanding growth performance of services exports over 2004-2006 combined with the relatively slower expansion of imports have triggered an important positive shift in Romania’s services balance, which seems to be sustainable for the first time since 1990 (Table 3). Unlike the other NMSs, Romania recorded chronic deficits in services trade since 1990, which have largely contributed to the structural deterioration of the country’s balance of payments. However, 2006 appears to be a turning point in this respect, as the modest EUR 6 million net exports reported for the entire year have been followed by a more substantial trade surplus (EUR 150 million) in the first 8 months of 2007 only. Provided that this favourable trend in Romania’s services trade performance will be long-lasting, it will help at least in part alleviate the country’s much tensed current account due to the huge and continuously rising deficits in trade in goods.

Table 3: Romania’s services balance, by main components, in 2004-2007
(in EUR million)

Years		Total services, of which:	Transport	Travel	Other services
	Credit	2903	1252	406	1245
2004	Debit	3116	1206	434	1476
	Net	-213	46	-28	-231
	Credit	4104	1189	852	2062
2005	Debit	4448	1583	750	2116
	Net	-344	-394	102	-54
	Credit	5513	1489	1034	2990
2006	Debit	5507	1913	1035	2559
	Net	6	-424	-1	431
	Credit	4711	1174	574	2963
Jan-Aug 2007	Debit	4561	1510	695	2356
	Net	150	-336	-121	607

Source: Calculations based on BoP statistics, National Bank of Romania.

Finally, another notable change can be observed when looking at the specific contribution of the three main components of services trade to Romania’s services balance. While the “Other services” component has nurtured substantially and constantly the structural deficits in services trade during the last decade (except for the tiny surplus in 2003), the net exports worth EUR 431 million recorded in 2006 under this item represent a very premiere for Romania. Moreover, this trend reversal seems to be a

durable one, as the respective net exports increased to EUR 607 million in the first 8 months of 2007 only (Table 3).

Hence, we may conclude that Romania's trade in services has clearly gained momentum during 2005-2006. Moreover, the remarkable expansion of services flows has been accompanied by favourable developments in terms of their composition and performance, which have to be put on account of the highly dynamic "Other services" component of services trade. Further, it may be assumed that the outstanding export performances in business services included in this component are related to a large extent to enhanced offshoring activities hosted by the Romanian economy.

2.3 Romania's trade in offshorable services

The arguments underpinning the above assumption are arising from the analysis of the evolution and structure of the "Other services" component of Romania's trade in services, which is supposed to include the "offshorable" services categories, namely: "computer and information services" (CIS) and "other business services" (OBS), as defined in Section 1.

What do the BoP data show?

In value terms, the cumulative exports of offshorable services (CIS + OBS) amounted to EUR 1,690 million in 2006, while the corresponding imports stood at EUR 1,375 million (Table 4). Within this aggregates, exports of OBS represented EUR 1,316 million and imports EUR 1,042 million, while the respective CIS flows were notably lower, i.e. EUR 374 million and EUR 333 million respectively. The recorded flows are rather small when compared with the old EU member states and even with some of the NMSs, but the growth of exports is quite impressive.

Table 4: Romania's trade in offshorable services, in 1995-2006

	1995	2000	2001	2002	2003	2004	2005	2006
Offshorable services (CIS + OBS)¹ – EUR million								
Credit	69	374	458	624	688	631	1123	1690
Debit	250	575	606	709	704	822	1134	1375
Net	-181	-201	-148	-85	-16	-191	-11	315
Share in total services trade (%)								
Credit	6.0	19.7	20.2	25.1	25.8	21.7	27.4	30.7
Debit	17.8	26.5	25.3	28.7	27.0	26.4	25.5	25.0

Note: ¹ See Section 1 for the specific services categories covered under this heading.

Source: Calculations based on BoP statistics, National Bank of Romania.

As seen in Table 2, the average annual growth rate (CAGR) of offshorable services exports (CIS + OBS) over the entire 1995-2006 period was considerably higher than for total services exports or goods exports, i.e. 34% as against 15% and 14% respectively. Moreover, the expansion of offshorable services exports accelerated dramatically during the last two years, so that their growth over 2004-2006 peaked at 64%, compared with 38% for total services exports and 17% for goods exports. Romania's offshorable

services imports (CIS + OBS) expanded also dynamically during the analyzed period, but their CAGR was far less spectacular relative to that of exports, i.e. 17% over the whole 1995-2006 period, and 29% over 2004-2006.¹² Yet, when contemplating the strong export growth recorded by the offshorable services categories during the last decade, it is important to note that Romania, like many of the countries experiencing rapid growth of these exports/imports, and often mentioned as low-cost locations for offshored services (such as India, China, Brazil or some East European countries), are growing from a very low level, and some of the rapid growth may be explained by their economic development (van Welsum and Reif, 2005).

Due to the extraordinary export growth performances, the combined share of the two offshorable services categories in the country's total services exports increased from 6% in 1995, to 31% in 2006 (Table 4). The share of CIS went up from 0.2% to 7%, while the respective share of OBS from 6% to 24%. Comparatively, the shares of CIS and OBS in world services exports stood at 4% and 24% respectively in 2003 (WTO, 2005).

Finally, noteworthy changes occurred as regards the contribution of the two offshorable services categories to Romania's services trade performance during 1995-2006. At the aggregated level, these services have fuelled permanently Romania's chronic services deficits until 2006, when they generated for the first time net exports of EUR 315 million (Table 4). These have contributed significantly, i.e. in a proportion of 73%, to the first major surplus recorded by the "Other services" item of the Romanian BoP after 1990 (Table 3). It follows, that the favourable trend reversal in terms of services balance mentioned above is largely attributable to net exports generated by the country's offshorable services categories.

Offshorable *versus* offshored services

From the above analysis it may be concluded that the newly emerging trends in Romania's trade in services are mainly driven by the offshorable business services categories covered under the "Other services" heading of the BoP. While the findings of our investigation support the assumption that offshored services activities have generated more trade flows, not all trade in these two services categories is related to offshoring and nor is it possible to distinguish which part of it is. However, as mentioned above, the resulting trade may be seen as an upper limit for the estimated value of offshored services. Further, both international outsourcing and captive offshoring are presumed to appear in the BoP trade statistics, as unaffiliated trade and affiliated trade respectively. But the current BoP statistics do not permit to divide cross-border transactions between affiliated and non-affiliated firms, as Romania did not implement yet the foreign affiliates' trade in services statistics (FATS).

While the BoP trade data as such do not allow us to find out how much of Romania's offshorable services exports has been really generated by the offshoring phenomenon, we

¹² A recent international comparison based on BoP trade statistics confirms Romania's ranking among the countries with the highest growth of exports and imports of CIS and OBS during the last decade, which may well reflect the country's emergence as offshoring location. It shows that in terms of average annual growth (CAGR) of cumulative exports of CIS and OBS during 1995-2004, Romania ranked 6th worldwide with over 30%, being exceeded only by Latvia, Croatia, Ireland, Argentina and Estonia. As regards the respective imports growth, Romania ranked 17th with almost 15% (van Welsum and Reif, 2006).

may find some relevant hints when looking into the Eurostat enterprise-level statistics related to the business services sector. Data analyzed by a recent Eurostat publication (2007a) focusing on business services exports – derived from a voluntary survey carried out in 2005 (reference year 2004) among 15 EU-27 countries – reveal that in Romania 52% of the exporting companies in the business services sector declared “outsourcing driven demand” (i.e. international outsourcing) as a reason for their exports, and 10% identified their affiliation to a TNC as a reason for exporting (i.e. captive offshoring).

Table 5: Offshorable services¹ exports in selected NMSs and the EU-15, 1995-2006
(in EUR million and %)

Year		EU-15	CZ	PL	HU	SK	RO	BG
Value – EUR million								
1995	Services, of which:	400510	5138	8161	3977	1817	1142	1354
	Offshorable, of which:	88904	1368	975	...	...	69	...
	CIS	6154	4	9	...	...	2	...
	OBS	82750	1364	966	...	488	67	...
2000	Services, of which:	677714	7403	11304	6604	2487	1902	2355
	Offshorable, of which:	187084	1583	1463	1498	560	375	70
	CIS	24209	103	66	132	56	48	6
	OBS	162875	1480	1397	1367	504	327	64
2005	Services, of which:	890666	8663	13077	10313	3542	4104	3483
	Offshorable, of which:	279538	1528	2298	2939	714	1123	225
	CIS	46683	148	159	311	94	268	26
	OBS	232855	1380	2139	2628	620	855	199
2006	Services, of which:	...	9373	16324	10677	4306	5513	3991
	Offshorable, of which:	...	1785	3356	3138	859	1690	451
	CIS	...	303	328	374	134	374	41
	OBS	...	1482	3028	2764	725	1316	410
Share in total services – %								
1995	Offshorable	22.2	26.6	11.9	...	...	6.0	...
	CIS	1.5	0.1	0.1	...	...	0.2	...
	OBS	20.7	26.5	11.8	...	26.9	5.9	...
2000	Offshorable	27.6	21.4	12.9	22.7	22.5	19.7	3.0
	CIS	3.6	1.4	0.6	2.0	2.3	2.5	0.3
	OBS	24.0	20.0	12.4	20.7	20.3	17.2	2.7
2005	Offshorable	31.4	17.6	17.6	28.5	20.2	27.4	6.5
	CIS	5.2	1.7	1.2	3.0	2.7	6.5	0.8
	OBS	26.1	15.9	16.4	25.5	17.5	20.8	5.7
2006	Offshorable	...	19.0	20.6	29.4	19.9	30.7	11.3
	CIS	...	3.2	2.0	3.5	3.1	6.8	1.0
	OBS	...	15.8	18.5	25.9	16.8	23.9	10.3

Notes: ¹ See Section I for methodology and the specific services categories covered under the headings below; ² CZ= the Czech Republic, PL = Poland, Hu = Hungary, SK = Slovakia, RO = Romania, BG = Bulgaria.

Source: Calculations based on Eurostat (2007b) data.

When linking the Eurostat data with the BoP data, we may conclude that already in 2004 an important part of Romania’s business services exports was associated with the process of offshoring. Undoubtedly, this process has generated even more exports since 2005, when exports of offshorable services started to experience outstanding growth rates.

Romania's performance in relation to other NMSs

Table 5 provides a comparative analysis on the evolution of offshorable services exports over the 1995-2006 period in Romania and other five NMSs (namely, the Czech Republic, Poland, Hungary, Slovakia and Bulgaria), as well as the EU-15, based on Eurostat data. The figures show that in value terms, Romania is still lagging behind Poland, Hungary and the Czech Republic, but the country is catching up due to much higher dynamics relative to the latter over 2005-2006. It is noteworthy, that in respect of the combined share of the two offshorable services categories in total services exports, Romania is ahead of all analyzed NMSs. With 31% in 2006, the respective share is similar to that recorded by the EU-15 in 2005. Further, Romania's CIS share (7%) was the highest among the selected NMSs in 2005 and 2006, and surpassed even that of the EU-15 in 2005.

Table 6: RCA in offshorable services for selected NMSs¹, in 1995-2006

Year	Services categories ²	CZ	PL	HU	SK	RO	BG
1995	Offshorable, of which:	1.198	0.536	...	...	0.270	...
	CIS	0.067	0.067	...	...	0.133	...
	OBS	1.280	0.570	...	1.295	0.285	...
2000	Offshorable, of which:	0.775	0.467	0.822	0.815	0.714	0.109
	CIS	0.389	0.167	0.556	0.639	0.705	0.083
	OBS	0.833	0.517	0.863	0.846	0.717	0.113
2005	Offshorable, of which:	0.561	0.561	0.908	0.643	0.873	0.207
	CIS	0.327	0.231	0.577	0.519	1.250	0.154
	OBS	0.609	0.628	0.977	0.670	0.797	0.218
2006	Offshorable, of which:	0.844	0.916	1.307	0.884	1.364	0.502
	CIS	1.032	0.645	1.129	1.000	2.194	0.323
	OBS	0.814	0.954	1.335	0.866	1.232	0.531

Notes: ¹ RCA is calculated in relation to EU-15 for 1995, 2000 and 2005, and the group of selected NMSs for 2006;

² See Section 1 for methodology and the services categories covered under the headings below; ³ CZ = the Czech Republic, PL = Poland, HU = Hungary, SK = Slovakia, RO = Romania, BG = Bulgaria.

Source: Calculations based on Eurostat (2007b) data.

A more clear-cut picture of Romania's position among its competitors in attracting offshored services is conveyed by Table 6. On the basis of the same Eurostat data, it attempts to assess the competitiveness of Romania and five other NMSs in offshorable services in relation to the EU-15 for the years 1995, 2000 and 2005, and the selected NMSs as a group of countries for 2006 (in the absence of EU-15 data for 2006), relying on revealed comparative advantage indices (RCA).¹³ The results indicate a revealed comparative advantage of Romania relative to the EU-15 in the case of CIS in 2005 and a comparative advantage in both types of offshorable services over all selected NMSs in 2006.

¹³ The RCA index has been defined as the ratio between the share of a service X in total services exports of country Y and the share of service X in total services exports of EU-15 and the group of selected NMSs respectively.

From the above analysis it may be concluded that Romania reveals a comparative advantage in offshorable services, especially in the CIS category for the last two years, when exports of offshorable services have experienced prominent growth rates.

3. FDI and Services Offshoring in Romania

FDI plays an important role in services offshoring, although this is difficult to quantify owing to the lack of reliable data. As mentioned above, FDI affects offshoring in two ways: through captive offshoring (by moving services from a parent company to its foreign affiliates), and when specialized services providers set up foreign affiliates to serve foreign clients. In fact, the bulk of all offshoring (over two-thirds) is estimated to take place through captive offshoring, i.e. through FDI (McKinsey&Company, 2005).

Offshoring may be seen as a particular form of FDI in the NMSs. In the FDI literature it is identified as efficiency-seeking (or vertically integrated FDI), as opposed to market-seeking (horizontally integrated FDI). Alternatively, export-oriented subsidiaries are set up by vertically integrated multinational companies in a host country with the aim to lower production costs or to seek, secure and diversify resources (Hunya and Sass, 2005). As services become more open to efficiency-seeking FDI, information-intensive services can be fully subjected to the international division of labour and hence integrated international production (UNCTAD, 2004).

Services-related FDI inflows into Romania have followed broadly the trend of growth in services worldwide and in the CEE region itself, however with a notable delay when compared with the most advanced NMSs. While in the largest FDI recipient countries – Poland, Hungary and the Czech Republic – services had already become dominant in FDI in the late 1990s, in Romania the structural change has been considerably slower, with manufacturing retaining a much higher share of FDI. Several factors are behind Romania's delay relative to the other NMSs in attracting FDI in general and in services in particular. They are related to the specific circumstances of the systemic transformation, including the more severe inheritance of the past regime, the hesitant pace of economic and institutional reforms until the mid-1990s, and the subsequent slow progress in structural adjustment (especially privatization).

Hence, in services and particularly business services FDI played a relatively limited role until the last couple of years, and Romania's involvement in export-oriented FDI projects related to offshored services was rather insignificant. The results of an examination of the number and destination of TNC projects worldwide in export-oriented services during the 2002-2003 period may be used as a proxy to illustrate the country's low degree of attractiveness for offshored services over the respective years. According to this quantitative assessment undertaken by UNCTAD (2004), over 2002-2003 TNC projects related to services offshoring in the CEE region have been concentrated in three countries, namely Hungary (26 projects), the Czech Republic (20 projects) and Poland (15 projects). Romania received only 7 projects. Out of this total, 4 projects concerned *regional headquarters*, 2 projects were related to *IT services* and 1 project concerned *call/contact centre services* (front-office services). Very interestingly, no project related to *shared services centres* (back-office services) went to Romania in the respective period, while Hungary received 7, the Czech Republic 6 and Poland 5.

While there are no comparable data on TNC projects in export-oriented services for the 2004-2006 period, when Romania's offshorable services exports increased significantly, we may get some relevant insights into the dynamics and extent of offshoring-related developments from combining several sources of information, i.e. official FDI statistics and private sources (e.g. company-related media reports).

Evidence from official FDI data

Even a glimpse at the highly dynamic FDI-related developments proves Romania's increasing attractiveness for FDI and may support at least in part the view that captive offshoring gained momentum. The surge in FDI inflows in the last three years reflect an unprecedented intensification of foreign investors' activity, which is sharply contrasting with the trends prevailing in earlier years. The average annual amount of FDI flows into Romania increased over 4 times in 2004-2006, as against the 2001-2003 period. After the turning point in 2004, FDI inflows continued to rise and reached their highest level ever in 2006, with a total amount of EUR 9,082 million, according to national BoP data.

Table 7: FDI indicators in Romania and selected NMSs¹, in 2000-2006

Country	FDI inflows (EUR million)							2006	
	2000	2001	2002	2003	2004	2005	2006	Inward FDI stock (EUR million)	Inward FDI stock/inhabitant (EUR)
CZ	5404	6296	9012	1863	4007	9374	4752	58813	5738
HU	2998	4391	3185	1888	3633	6099	4874	62096	6088
PL	10334	6372	4371	4067	10292	7703	11093	90000	2330
SK	2089	1768	4397	1914	2441	1694	3324	18000	3315
BG	1103	903	980	1851	2736	3103	4104	15723	2088
RO	1147	1294	1212	1946	5183	5213	9082	30891	1387

Note: ¹ CZ = the Czech Republic, Hu = Hungary, PL = Poland, SK = Slovakia, BG = Bulgaria, RO = Romania.
Sources: BoP statistics, National Bank of Romania; WIIW (2007, p.476-479); authors' calculations.

In terms of total inward FDI stock or inward stock per inhabitant, the gap between Romania and the three best performing NMSs continues to be still very pronounced, as seen in Table 7. Yet the remarkable growth rates of FDI inflows during the 2004-2006 period suggest a notable increase of Romania's attractiveness for TNCs' locational decisions, and we may assume that at least partially the increased FDI amounts are attributable to offshoring activities unfolding between Romania and companies from the EU and the rest of the world. The sheer fact that almost 75% of Romania's inward FDI stock is accounted for by investors originating from the EU-15 is indicative of the high level of corporate integration and intense offshoring activities between the country and the old EU member states.

While the above figures alone do not offer any point about the current level of FDI in services, the recent changes in the industrial composition of Romania's inward FDI stock point towards intensified services-related FDI inflows. By the end of 2006, manufacturing still accounted for 51% of the total FDI stock, but the available data

suggest an expansion of TNCs in services industries, and particularly in business-related services, including financial services, insurance and other business services. The share of business-related services in the country's total FDI stock increased to 26.0% by the end of 2006, followed by wholesale trade (6.7%), retail trade (6.3%), transport (6.4%), construction (1.6%) and tourism (1.5%) (National Trade Register, 2006). Even though the data provided by the National Trade Register are highly aggregated and refer to equity capital only, the rising share of business-related services both in terms of company number and equity capital stock in the last years suggests intensified FDI in this field, as seen in Table 8.

Table 8: FDI in business-related services in Romania, 2001-2007¹

	2001	2002	2003	2004	2005	2006	June 2007
Total number of FIEs ² (thou), of which:	82.4	90.6	97.2	107.4	119.1	131.9	139.9
Business-related services (%)	8.6	11.3	12.9	15.3	16.7	24.5	26.1
Equity capital stock (EUR billion), of which:	7.5	7.2	7.7	10.2	12.9	15.3	16.5
Business-related services (%)	17.0	16.7	15.8	16.7	21.7	26.8	26.5

Notes: ¹ All figures are for the end of the period; ² FIEs = foreign investment enterprises.

Source: National Trade Register (2007).

When analysing the evolution of this aggregated services category, we have to keep in mind that at present Romania is characterized by substantial FDI penetration in infrastructure services (e.g. banking, telecommunications, water, electricity), that are a precondition for attracting services offshoring, but do not represent the offshorable services that we are tracking. For instance, the most important investment included in this broad category in 2006 was the Erste Bank's EUR 2.2 billion in taking over 36.8% of the Romanian Commercial Bank's stock.

While current FDI statistics are not suitable to identify the share of FDI which is directly related to services offshoring, useful hints regarding the dynamic expansion of captive offshoring over the last years may be obtained from some additional information provided by The Romanian Agency for Foreign Investment (ARIS) – the Government agency responsible for monitoring FDI and ensuring consultancy to foreign investors. Out of the total 24 FDI projects assisted and monitored by ARIS during 2006 (with a cumulative investment value of EUR 469.7 million and 6,060 new jobs), 5 projects concerned services offshoring centres set up in Bucharest by Hewlett Packard, Microsoft, General Electric, Infineon and Wipro (ARIS, 2007). These projects represented 21% of the total number of successful projects monitored by ARIS in 2006, and their share in the total investment value and overall job creation was 32% and 45% respectively. This demonstrates the growing number of FDI projects related to services offshoring and their importance in terms of both capital investment and employment creation in Romania. These new developments are all the more relevant as out of the 12 successful FDI projects assisted and monitored by ARIS during 2004 (with a cumulative investment value of EUR 286 million and 9,380 new jobs), as well as the 9 FDI projects monitored in 2005 (EUR 185 million investment and 2,275 new jobs), none represented a services offshoring project.

What do the unofficial data show?

Even a snapshot on media information during the last two years – which remain basically the main source for monitoring the real trends in offshoring activities, similarly to other countries – reveals that there are many other important investment projects that have not been monitored by ARIS, and many global services providers are already present in the Romanian market. Probably the most relevant are those media reports, according to which during the first six months of 2006 only, three major global players set up almost simultaneously their business process operations (BPO) centres in Bucharest, namely Hewlett Packard, Oracle and Microsoft.

Indeed, offshored services centres are growing at an astonishingly rate, particularly since 2005, and Romania seems to establish itself as a prime location for offshored services, especially for clients based in Western Europe and the United States. In 2006 alone six new shared services centres were created in Bucharest, which is a testimony to the country's attractiveness (IDC, 2007). But call centres are also springing up steadily. Their number exceeds currently 250, and is estimated to grow by 20-30 units each year.

Several global players in the BPO market including the top 10 are already present in Romania and more are likely to follow. Most of the TNCs present on the local market started as market-seeking FDI already in the 1990s, and expanded later into efficiency-seeking FDI, including export-oriented projects. In July 2007, BusinessWeek Romania (the local edition of BusinessWeek) published a review of the companies from its TOP 100 InfoTech that are already present in Romania. According to the report, the largest ICT companies in the world, as well as software and business services suppliers from the TOP 100 InfoTech are already well-known foreign investors in Romania. The examples include: Microsoft (9th position in the top), Accenture (16), IBM (21), Oracle (22), Wipro (49) and Adobe Systems (98). But important hardware and telecommunication equipment producers, such as Siemens (34th in the top), Hewlett-Packard (35) and LM Ericsson (55), have also offshored several services functions to Romania (Panturu, 2007).

Professionals within the BPO business expect the local market for offshored services to grow significantly by 2008. Official estimates put the size of offshoring-related FDI at EUR 200-250 by 2010. However, the estimates on the scale of FDI and the number of new jobs created seem to be already exceeded when taking into account the surge of offshoring-related FDI projects or the stepped-up pace on the local recruitment market. It is noteworthy that companies providing IT, BPO and call centre services are the most active employers in the Romanian economy, and the rate of their recruitments on the labour market is faster than in any other traditional industry. The big players have already employed several thousands of persons and announced further recruitments in the order of thousands in the near future, according to recent media reports.

All these unofficial sources are confirming the impressive dynamics of services offshoring in Romania and its growing extent, especially under its captive form. The sustained and constant economic growth, the young pool of talents and the low levels of corporate and income tax have been mentioned among the main reasons behind the decisions of these companies to choose Romania as location. The case of Romania seems to illustrate that success in attracting offshored services has a cumulative dynamic on its own, i.e. success in one set of activities can lead to success in another, once a reputation for providing efficient and reliable services has been developed.

4. Romania's Potential as Location for Offshored Services

Notwithstanding the severe statistical shortcomings and the limits of interpretation, the findings presented in the previous sections suggest that a change in the *status quo* is under way. In other words, Romania is emerging as an increasingly interesting location for companies' international organisation of production. This section looks behind the main factors making Romania an attractive location for offshored services in the European and global context, and attempts to reveal the country's strengths and weaknesses in the light of growing competition it has to face in the highly dynamic global market for services offshoring.

4.1 Factors behind Romania's attractiveness for offshoring decisions

The search for competitiveness is driving offshoring at the company level. As to the choice of the foreign location for offshoring, among the determining factors are labour costs, workforce skills (particularly relating to computers and language), trade costs, the quality of infrastructure and institutions, the tax and investment regime (WTO, 2005). Hence, what makes Romania an attractive target for offshoring?

There is little doubt that labour cost savings are a major factor driving the offshoring decisions by companies globally. Labour cost differentials across different locations worldwide, including at the European level, play a prominent role among the determinants of offshoring. As far as wages and related policies are concerned, there have been long-standing differences between the more developed higher wage countries and the less developed lower wage EU members. With the accession of ten new countries in May 2004, followed by Romania and Bulgaria in January 2007, the discrepancies have further widened.

Table 9: Labour costs¹ in services² in the EU and selected NMSs
(in EUR)

	2000	2001	2002	2003	2004	2005
EU-25	19.16	19.66	20.28	20.10	20.50	20.53
EU-15	21.70	21.94	22.62	23.11	23.64	...
Bulgaria	1.12	1.20	1.24	1.31	1.39	1.52
Czech Republic	4.10	4.94	5.66	5.74	6.21	7.25
Hungary	...	...	...	5.27	5.75	6.30
Poland	4.72	5.57	5.55	4.94	4.94	5.76
Romania	1.42	1.57	1.72	1.67	1.80	2.37
Slovenia	10.07	10.84	10.82	11.83	11.25	11.64
Slovakia	3.12	3.44	3.79	4.05	4.44	5.04

Notes: ¹ Hourly labour costs, annual data estimated on the basis of quadrennial labour cost survey, covering enterprises with 10 or more employees; ² Services (excluding public administration) (NACE: G to K).

Source: Eurostat (2007c).

The notable differences existing in terms of labour cost both between the old EU members and the NMSs, as well as across the latter, are illustrated by Table 9. In 2005, the hourly labour cost for the EU-25 average was 11.5 times higher than that for Romania when considering the services sector alone (and 11 times higher when considering all

economic sectors respectively). Romania has the lowest level of labour cost among the NMSs, comparable only with that of Bulgaria.

Another major advantage of Romania in attracting offshored services activities relates to the availability of well-educated and highly skilled workforce. While in terms of education level there are no notable gaps between Romania and the EU average and the NMSs respectively, important differences can be observed in terms of highly skilled workforce, especially in those domains which are relevant for services offshoring. According to a recent assessment by Economist Intelligence Unit (2006), Romania is leading in Europe as regards the availability of certified IT specialists. With about 64,000 IT specialists, Romania overtakes the United States or Russia in terms of IT specialists per 1,000 inhabitants. Moreover, out of the total 30,000 engineers graduating annually from technical universities, 5,000 are skilled in ICT. According to Brainbench's Global Skills Report (2006), which documents technical and work skill certification worldwide, Romania ranks 5 among the top 10 countries across the world in terms of overall certifications (in 2006). While Romania is behind the United States, India, Russia and Ukraine, it is ahead of the United Kingdom, Canada, Belarus, Philippines and Bulgaria. Except for the United Kingdom and Bulgaria, no other EU member ranks among the top 10. This shows Romania's substantial advantages both over the old EU members and the NMSs.

An additional advantage for Romania arises out of the combination of relatively low wages, low corporate taxes and the use of subsidies.

As far as the fiscal regime is concerned, a wave of tax reductions was made by the majority of NMSs before joining the EU. According to a KPMG's corporate tax rates survey cited by UNCTAD (2004), not one of the NMSs ranked, as of January 2004, in the top 11 in terms of corporate tax rates, while six were in the bottom eleven.¹⁴ Since 2005, Romania applies a flat rate of 16% for both corporate and income tax. At present, the country ranks second in Eastern Europe in terms of low level of corporate tax rate, being surpassed only by Serbia, with 14% (e.g. Estonia applies 26%, Lithuania 29%, Latvia 25%, Russia 24%, Ukraine 25%, and Slovakia 19%). In terms of income tax, however, the Romanian 16% flat rate is over the level currently applied by other East European countries, such as Ukraine and Russia (13%), Serbia (14%) and the Czech Republic (15%) (Stefan, 2007).

Evidently, a simple comparison of corporate tax rates is not sufficient for assessing the relative tax burdens imposed on comparison (as the profits to which the tax rates are applied, i.e. "the tax base" also needs to be taken into account). Nevertheless, the relatively low corporate tax rate in Romania is adding to the attractiveness of the country both in the European and global context. At the EU level, services offshoring and international investment respectively are believed to be driven not as much by differences in corporate tax rates between member states, but mainly by other factors, such as unit labour costs or agglomeration economies (geographical location advantages, market size, human capital, the general business environment) (European Commission, 2006). Anyway, the low level of corporate tax has been an important factor behind the decisions of Hewlett-Packard, Oracle and Microsoft, for instance, to choose Romania as location for their offshored services centres, at least according to their official statements.

¹⁴ Among the top eleven ranked Germany (with 38.3%), Italy (37.3%) and Spain (35.0%), while Ireland was the only old EU member state ranking in the bottom eleven (with 12.5%).

Further, under the EU Structural Funds, Romania can expect (in the framework of the objectives defined by the EU regional policy) total transfers amounting to EUR 29.2 billion over the 2007-2013 period from the common budget of the EU, out of which EUR 17.2 billion represent Structural and Cohesion Funds (the rest of EUR 12 billion is related to the Common Agricultural Policy). These funds are intended mainly for such purposes as building basic infrastructure (including transportation), human resource development, competitiveness and enterprise development, rural development and improving environment. While the EU Structural Funds are not specifically directed to FDI, they may have an indirect effect on it, through enhancing FDI attractiveness and improving the investment climate in Romania.

The above combination of factors – further supported by improved business climate and free access to the rest of the EU market – makes Romania an attractive location for efficiency-seeking FDI, both from other EU countries and from non-EU members.

While cost reduction and availability of highly skilled workforce are leading factors among the location-related determinants of offshoring decisions, an additional key consideration is the quality of the telecommunications and IT infrastructure. The availability and access to a cost-effective and reliable telecom and IT infrastructure are critical to attracting all types of IT and ICT-enabled offshored services. Given the high weight of telecom costs in total costs in low-income locations in the case of call centres, for instance, and due to the specific quality requirements that apply to voice transmissions, access to fibre-optic links is crucial for a country that seeks to attract call centres or shared services centres (UNCTAD, 2004). The dynamic developments unfolding in this field in Romania in the last couple of years (particularly in respect of fix and mobile telephony penetration, broadband access, Internet and IT) are important prerequisites for encouraging and supporting increased offshoring activities from the EU, as well as other parts of the world. Nevertheless, in terms of ICTs Romania still has to catch up not only with the old EU member states, but also with the new ones.

Apart from the above mentioned factors, there are many other key considerations which bear upon the decision of TNCs to prefer Romania as location for offshored services, particularly from a European perspective. Geographical proximity to EU-15 markets, language skills and linguistic traditions, historical ties and cultural affinity – are unanimously stressed by analysts when discussing the advantages of the NMSs over other popular low-wage locations in Asia or other parts of the world in terms of offshoring decisions taken by European companies.

Further reasons for EU-15 companies to prefer Romania to the detriment of other low-wage locations worldwide relate to easier coordination of offshoring procedures due the same time zone, harmonised standards and other regulations, easier alignment of prices in a single currency (Euro) (Stare and Rubalcaba, 2005). And last but not least, the agglomeration effect of already present FDI acts as location advantages (Hunya and Sass, 2005).

4.2 The challenges facing Romania

While cost-related as well as non-cost factors are lying behind Romania's intrinsic advantages and potential as a favourite target for services offshoring, there is no doubt that its growing attractiveness is associated with the process of EU enlargement.

Romania's accession into the EU has triggered a process of gradual structural transformation of the country, which has laid down the foundations for institutional, political and macroeconomic stability while making possible the liberalization of international trade and investment flows (European Commission, 2006).

Viewed strictly from the offshoring perspective, the implications of EU membership are manifold and contradictory. Full membership in the EU means that the country needed to adopt the full body of EU law, the *acquis communautaire*. Certainly, the implementation of EU law has contributed to improving significantly the business environment and the attractiveness of Romania. It ensured a stable and predictable political climate that made investment more secure. On the other hand, the application of EU law (e.g. concerning labour standards or environmental protection) will bring about an increase in the cost of doing business. As Romania catches up to its Western neighbours, its cost advantage is starting to erode. Hence, the benefits of EU accession are likely to reduce cost advantages leading companies to look even further east to Russia, Ukraine and the other former Soviet countries.

That these trends are already at work is confirmed by the most recent survey conducted by the US consultancy company A.T.Kearney (2007a), according to which Romania's competitiveness in the global services offshoring market has diminished, as reflected by the decline in its ranking within the Global Services Location Index (GSLI), from 24 in 2005, to 33 in 2007.¹⁵ A closer look at A.T.Kearney's GSLI country ranking reveals that the main factors behind Romania's downward move in 2007 are the relatively higher costs and lower availability of people.¹⁶

It is interesting to note that while some time ago Romania's main disadvantage to other countries, particularly the NMSs, has been related mainly to its economic stability, now the shortage of human resources is creating concern. To this adds the clear downward trend in Romania's attractiveness in terms of relative cost advantages, due mainly to accelerating wages and currency appreciation. At the same time, the results of A.T.Kearney's most recent evaluation reveals that Romania lags far behind the other NMSs in terms of overall competitiveness in the European and global offshoring market, despite its notably larger population base (except Poland). Further, as most countries covered by the GSLI index, including the NMSs, have increased their performance in 2007 compared to 2005, it follows that growth alone is not sufficient to maintain competitiveness both regionally and globally. And nor are the relative cost advantages any more enough to keep pace with increased competition, especially as these are steadily eroding, and talent and policy environment are now considered to increasingly define the competitive landscape (A.T.Kearney, 2007b).

¹⁵ The GSLI calculated for 2007 evaluates 50 countries as potential locations for the most common remote services, including IT services and support, contact centres and back-office support. Each country's overall score is comprised of a weighted combination of relative scores on over 40 individual metrics, which are grouped into three categories: financial attractiveness (labour and other costs); people skills and availability (labour force availability, education and language skills); and business environment (country environment, infrastructure). See: A.T. Kearney (2006; 2007a).

¹⁶ Within the three components of the index, Romania ranks 19th at financial attractiveness, being surpassed only by Bulgaria in the CEE region. It ranks 45th at people skills and availability (despite high ranks for education and language skills, it has a relatively small BPO industry and low labour force availability). In terms of business environment, it ranks 30th, i.e. last position in CEE (due to low scores for the economic and political environment, infrastructure and intellectual property protection) (A.T.Kearney, 2007b).

An additional indication that Romania has started to face difficulties in respect of availability of talent pool is provided by the Brainbench (2006) assessment mentioned above, according to which Romania experienced a drop of 18% in terms of overall IT skills certifications between 2005 and 2006, and hence plunged from rank 4 to rank 5 among the top 10 countries across the world (unlike Belarus, India and Ukraine, for instance, which recorded increases by 49%, 47% and 14% respectively).

The emerging labour shortage and the increasing pressures on the local labour market are relatively new trends in Romania, and are fuelling fears that as the Romanian economy expands dynamically, pressures on wages will continue to grow until the moment they will trigger the risk of diminishing the country's current competitive advantages arising from its low labour costs. That these fears are justified, is demonstrated by estimates according to which average annual wages in the Romanian software and IT services sector (which are about three times higher than the average for the whole economy) experienced the highest increases in 2005 and 2006, of 31% and 35% respectively, due to growing imbalances on the local market for specialized IT work force (ITC, 2006). Besides, figures released by Eurostat show clearly that Romania is at the forefront of labour cost increases among the EU member states.¹⁷

In spite of all these newly emerging challenges facing Romania, the outlook for maintaining a favourable position as location for offshored services both in the European region and worldwide seems quite promising. The following arguments may support this assertion.

Firstly, Romania boasts one of the fastest developing software and IT services industry in Europe. Its software development sector has generated a number of internationally known companies and products. Albeit fragmented, Romania's IT industry is well developed and is growing ahead of the rest of the economy. It attracts foreign investors and is experiencing a wave of acquisitions of local companies by foreign investors. In 2005, the volume of acquisition deals in the IT industry reached USD 250 million (Radkevitch, 2006). Romania attracts foreign clients due to the high level of technical and language skills of its IT workers, as well as availability of a relatively vast and affordable IT labour pool. The country is considered to be especially strong in three areas: R&D outsourcing, security and embedded software development, and mechanical engineering outsourcing. Evolutionary transformations, such as continual growth, FDI inflows and acquisitions, as well as a reduction in the level of the industry's fragmentation are expected to boost the offshoring business.

Secondly, there are signs that European companies are now considering more seriously services offshoring compared with earlier years. According to a recent survey carried out by McKinsey&Company (2006), demand for offshoring among Western European companies rose by half during 2004-2006 with Eastern Europe emerging as a

¹⁷ While total hourly labour costs (i.e. wages and non-wage costs) in the EU-27 rose at an annual rate of 3.7% in nominal terms in the first quarter of 2007, compared with the same quarter of 2006, Romania recorded with 25.0% the second highest increase in terms of total hourly labour costs among the EU member states, being exceeded only by Latvia (32.6%). Romania was followed by: Lithuania (22.2%), Estonia (21.1%), Bulgaria (15.9%), and at a large distance by Hungary (9.0%), the Czech Republic (8.4%) and Slovakia (5.9%). It is also noteworthy, that after the relatively constant labour cost increases (of around 17% on an annual basis) during the first three quarters of 2006, Romania recorded a sharp upward trend since the last quarter of 2006 (with a 29.9% rise), exceeding by far all other NMSs (Eurostat, 2007d).

favourite destination.¹⁸ This is an important change compared with previous years, when European companies have been in general less prone to offshore services in comparison with their counterparts from the United States (except for the United Kingdom, which has followed the most closely behind the United States). Low wages comparable to India's, a relatively low risk profile for key factors such as reliable infrastructure, as well as geographical and cultural proximity to Western Europe are cited among the primary advantages of Eastern Europe. It is also noteworthy, that the region is estimated to remain economically competitive for at least 15 years. This is in line with the A.T.Kearney (2007b) assessment, according to which even though wages started to rise, these countries will remain attractive as offshoring destinations in the foreseeable future.

Thirdly, Central Europe has already established itself as a prime location for offshored services, particularly for clients based in Western Europe and the United States. But the costs associated with conducting business in this region are rising and the capital cities of Budapest, Prague and Warsaw are approaching a state of congestion. Hence, Western European companies are expected to move their operations towards the south and east of the continent. Romania is well-placed to attract a substantial portion of new offshoring business located to Central Europe. The country has the largest labour force among the NMSs after Poland. The level of education rivals that of any country in the region while wages, although increasing rapidly, remain well below those found in Central Europe. Besides, Romania is already home to a significant amount of outsourced and offshored business, with a large number of well-established companies as well as plethora of freelancers and small businesses engaged in custom application development for foreign clients. Although the emerging constraints in the IT labour market mean that Romania is not suitable for establishing very large offshore development centres, the country is an ideal location for R&D and other high added-value activities (IDC, 2007).

And last but not least, there is a large untapped potential for services offshoring in Romania, which should not be overlooked. While the process focused so far on Bucharest, there are also many other cities in the country which are potential candidates for becoming offshoring centres. Mid-size cities such as Iasi, Cluj, Timisoara could turn into hubs for IT services and BPO, due particularly to their cultural environment (universities) and their large talent pools, but also owing to the fact that the labour cost advantages they may offer are more likely to remain attractive in the coming years, especially as in Bucharest the wages for experienced workers are rising fast.

Turning the regional potentialities into reality will depend, however, on both the understanding by policy-makers of the importance of services offshoring for the Romanian economy and their capability to devise proper policies and mechanisms for harnessing the benefits this process may bring in the long run.

¹⁸ Like other East European countries, Romania has been so far a rather insignificant player in the global market for offshored IT and ICT-enabled services. According to McKinsey&Company (2006), Romania together with the Czech Republic, Hungary, Poland, Russia and Ukraine, accounted for a tiny fraction (i.e. USD 0.9 billion) of the global market for offshored services (including IT and BPO, both captive and outsourced), estimated at USD 30 billion in 2003. In the same year, India accounted for USD 12.2 billion, Ireland for USD 8.6 billion, and China for USD 3.4 billion.

5. Concluding Remarks and Some Policy Considerations

We recognize that an accurate picture on services offshoring in Romania, as a host country, is practically impossible to obtain on the basis of available trade and FDI statistics, even if complemented by additional data from various private sources. Nevertheless, we found clear evidence for highly dynamic offshoring activities unfolding currently in the Romanian economy and at least some of their effects on the country's trade in services.

The outstanding growth rates recorded by exports in offshorable services, the positive shift under way in the patterns of services flows, as well as the improvements in terms of trade performance, are the most striking changes occurred in Romania's services trade during the last couple of years. The results of the empirical investigation support our assumption that these favourable developments are closely related to enhanced offshoring activities hosted by the Romanian economy. Concurrently, our findings confirm the large amount of anecdotal evidence on Romania's increasing attractiveness as location for offshoring decisions by companies worldwide.

Piecing together the scattered evidence, we arrived to the conclusion that the process of services offshoring has gained momentum in Romania compared to the early 2000s, under both its forms, namely: (1) offshoring done internally, through the establishment of foreign subsidiaries (captive offshoring); and (2) through outsourcing a service to a third-party services provider (international outsourcing). Further, the available evidence highlights an accelerated pace of offshoring in all main offshorable services categories, i.e. IT services, shared services centres (back-office services), call/contact centre services (front-office services), and regional headquarter services. This leads us to the conclusion that Romania is arising as a strong candidate for all types of offshoring.

While the Romanian economy has a long tradition in hosting international outsourcing activities, the obvious intensification of captive offshoring in the last two years is a new phenomenon. It is associated with the dynamic FDI-related developments triggered by the growing presence of TNCs, and particularly in the services sector. Several global players in the BPO market, including the top 10, are already present in Romania and more are likely to follow. The arrival of the big international players will bring about tighter competition, as well as diversified, higher quality services. The market for offshored services – and especially BPO – is expected to grow significantly by 2008, according to professionals within the business, Romanian and foreign alike. This expectation is strongly sustained as far as offshoring may be considered a particular form of FDI – i.e. efficiency-seeking FDI – and the scope for hosting more offshoring-related (or efficiency-seeking FDI) is quite broad in Romania, especially as the country is lagging considerably behind the most advanced NMSs in respect of attracted FDI amounts.

Though Romania seems to be a preferred location for services offshoring in the regional context, i.e. for EU-15-based companies, the evidence suggests that the process is also largely driven by companies from other regions of the world owing to the country's potential. However, there is no doubt that the growing attractiveness of Romania is closely related to its EU accession on January 1, 2007. The process of EU enlargement provided an outstanding opportunity to EU-15-based companies to take advantage of better production cost conditions by internalizing the labour cost advantages offered by Romania. Firms in EU-15 choose to fragment their production processes and

offshore some parts to the country, either by setting up affiliates or by sourcing inputs from local producers. Ample availability of skilled labour, relatively low labour costs, geographical proximity, cultural and linguistic ties and full EU membership have contributed to making Romania particularly attractive.

The opportunities for Romania to attract employment, trade and income-creating activities are significant, although it is practically impossible to evaluate precisely how significant. The forces driving offshoring are powerful and the resulting economic benefits are a classic illustration of gains from trade and specialization. For Romania as a host country, the main benefits of services offshoring seem to include so far: an increase of services exports and of economic activity through the operations of TNCs' subsidiaries, creation of additional jobs and higher wages, transfer of soft technology (under the form of knowledge and upgrading of skills), increased competition and higher quality services. On the downside, increased offshoring might lead, particularly in the long run, to growing services imports and income transfers of TNCs to their home countries, bearing additionally upon the already huge current account deficits of the country. But from a broader perspective, the benefits deriving from offshoring seem to outweigh the implied losses, at least for the moment. Two arguments arising from our paper might support this view. Firstly, offshoring-related FDI generated more trade, particularly in new types of services and advanced services respectively. Secondly, the steady increase in offshorable services exports has helped to reverse the earlier trend of the Romanian services balance to record chronic deficits.

While there are many reasons for the process of services offshoring to grow and spread in Romania, there are also several challenges to be faced. For benefits to be derived from offshoring, as part of the trend towards increasing globalisation of services activities, consolidation of the domestic services sector is an essential precondition to be met. While the bias against services-led economic development faded away to a certain extent during the last decade, the Romanian authorities are still slow in grasping the crucial importance of services for the country's future development in general and the opportunities associated with services offshoring in particular. Therefore, it is highly time for the Government to become fully aware of the new opportunities opened up by the increasing globalisation of services and to play a more active role in ensuring the adequate technological, economic and institutional framework for cross-border services trade and FDI to expand. This is all so more important, as competition on the global offshoring market is continuously growing, and just maintaining the current competitive capabilities is no longer sufficient to attract and retain the world's fast-growing offshored business services. As evidenced by the rapidly changing country rankings within the recent attractiveness assessments, even successful exporters cannot stand still: they have to invest in new skills to move up the value chain as wages rise and cheaper competitors emerge.

Consequently, in order to mitigate the already visible risks of eroding its comparative advantage associated with the relatively low costs of labour in the mid and long term, Romania will need to continually upgrade its labour force through increased investments in education, particularly tertiary education, which is of utmost importance in view of creating the talent pool required by offshoring. Finding the right solutions for tackling skill shortage, which has become increasingly evident in recent years in the Romanian economy, is an urgent task. Further progress in upgrading the ICT infrastructure is also a

major prerequisite for keeping Romania's current comparative advantages, especially as the country is lagging behind the other NMSs in this respect. Concurrently, proper governmental support is needed for securing a favourable business environment for local services providers to grow and expand, especially as they will start themselves to enter the global market for offshored services.

As services offshoring implies also an important regional dimension, it is important to avoid the risk of offshoring to be concentrated in the capital city alone. Adequate initiatives by the Government at the regional level might encourage the spread of offshoring activities across different regions of the country, by developing several mid-size cities into hubs for IT services and BPO. To raise the business birth-rate, to forge strong partnerships between regional universities and business, develop the skills needed at the regional level and to improve the local infrastructure should be among the priorities of policy measures.

Finally, the findings of the paper bring us to the following question: Should Romania try and build competitiveness in trade in IT and ICT-enabled services? Our answer is a definitely yes. However, the export of services as such should not be seen as the final goal. Such exports are conducive to economic development in a broader sense, because they generate not only international trade, FDI flows and new jobs, but are also supporting the competitiveness of the economy as a whole. Due to growing services-intensity of all economic activities, the competitiveness of companies in open economies is determined increasingly by access to low-cost and high-quality business services. As business services are key inputs in all economic activities, and are also major agents for the diffusion of new ICTs and skills throughout the economy, they are decisive for upgrading all productive activities. And last but not least, business services exports can improve the international image of Romania and support, implicitly, the country's exports of goods.

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