Institute of Economic Forecasting

2 INWARD PROCESSING TRADE AND IMPLICATIONS FOR THE BALANCE OF PAYMENTS CURRENT ACCOUNT (THE CASE OF ROMANIA)

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Abstract

The study is focusing on the Romanian foreign trade by approaching distinctly its two components, i.e. the final goods under definitive custom regime and the intermediate goods imported under temporary custom regime, which are subject to processing (IPT-Inward Processing Trade), followed by their exports. While the IPT flows entered a slowdown trend, due to gradual diminishing of comparative advantages of Romania, the trade deficits almost doubled as compared to two years ago. The separation of the IPT component from the foreign trade data highlights the importance of the final exports, allowing also for the assessment of related implications on the BoP current account and on the long-term external position of Romania.

Keywords: Foreign Trade, Balance of Payments, Economic Growth

Jel Classification: F13, F15, F43

1. The Foreign Trade Contribution to Economic Growth

The theory of international trade, the past experience of the developed countries and the recent lessons of many emerging countries (mostly from Asia) show a straight link between foreign trade and economic growth. This contribution is seen in terms of effects on the production factors, technological improvements, improved work skills, productivity and increase in competitiveness. Both in the static and dynamic approaches a positive correlation between exports and GDP seems obvious. The specialization in expanding export sectors is considered to create more value added than the specialization in other sectors. The improvement of resources allocation by trade openness has often argued this assertion. A greater exposure to the world market competition is supposed to generate a more rapid economic growth.

The international specialization according to specific comparative advantages is leading to scale economies, otherwise impossible due to the limited domestic demand increase. The foreign exchange receipts from exports are helpful for maintaining external financial balance and for payments on importing the necessary intermediate or capital goods. Other positive externalities of the international trade occur after the technological and know-how transfer, as well as the human capital improvement. Most attempts of formalizing the exports-economic growth causality did not succeed in providing relevant results, different authors admitting that they have been restricted by the lack and non-accuracy of the foreign trade data, mainly in their structural deployment.

At the aggregate level, on the demand side of the GDP, the foreign trade contribution is estimated on the basis of the difference between the volume index (real growth) of exports and imports, representing the external demand. From this point of view, it is clear that the foreign trade contribution to the economic growth is submitted to certain conditions. A negative contribution of the net exports to the GDP growth could mean that the domestic demand increase (driven by the final consumption and/or gross fixed capital formation) has partially been reversed through the external balance deterioration, very often ending in increased deficits in the balance of paments (BoP) current account. In this case, the negative sign of the external demand is removing a slice of the economic growth, more or less consistent, and the foreign trade does not contribute to the GDP growth, but on the contrary. As a consequence, according to the GDP computing methodology a higher real growth of exports than imports represents the essential prerequisite for a positive contribution of the foreign trade to the economic growth. For Romania, at least in recent times and for several years to come this prerequisite has not been and is not going to be completed, due to the negative contribution of the net exports to the GDP growth, associated with increasing current account deficits (see Table 1).

Table 1

GDP growth in Romania and the contribution of the net exports

- % -

Year	2003	2004	2005*	2006*	2007*	2008*
GDP growth	5.2	8.3	5.7	6.0	6.3	6.5
Net export contribution	2.7	2.8	4.8	2.0	1.4	1.3
Current account (% of GDP)	6.0	8.7	8.1	7.0	5.9	5.1

** Forecast*

Source: Romanian National Commission for Forecasting (PEP 2005 Edition).

According to recent estimations, in 2005 Romania's GDP went up by around 5 percent, below the set target. As well as a year earlier, the driving factor of the GDP growth was the final consumption of households, fueled by the non-government credit expansion, mainly to imported consumer goods. The volume index of imports (17.5 percent) doubled the exports' real growth in 2005 (8.5 percent), resulting in a negative contribution of the net exports, which has removed around half of the domestic demand increase, widening at the same time the current account deficit. On the other hand, the domestic demand increase, mainly due to the final consumption rise, showed an unbalanced GDP growth of Romania. It is widely known that a sound economic growth should be led by higher rates of gross fixed capital formation (investment factor), balanced by moderate increases in the final consumption. An optimal situation of the GDP growth would be a positive contribution of the net exports, which is supposed to reduce the development gap, too.

The traditional models of the correlation between international trade and the economic growth are dealing with the final goods, which, through gains from specialization, are changing the national and international income distribution. The recent introduction of intermediate goods parameters in these models, following the outsourcing expansion (or the processing trade, derived from the international fragmentation of the global supply chain), has allowed for interesting conclusions about the national and international income convergence.

2. The Impact of IPT on the Trade Flows

An appropriate study of the foreign trade should approach distinctly its two components, i.e. the final goods under definitive custom regime and the intermediate goods imported under temporary custom regime, which are subject to processing (IPT-Inward Processing Trade), followed by their exports. If the dimension of the IPT is significant, just like in the case of Romania (around half of the total exports), ignoring its hidden effects on the foreign trade and also on the BoP current account would be a serious error. The predictable decline in the IPT contribution to the foreign exchange receipts of Romania and the limited growth capabilities of other current account components for compensating it are inducing high risks, which could create severe burdens on the external financial sustainability.

	Imports (CIF)		Exports (FOB)
Total (A+B):	€ 32.5 bn *		€ 22.2 bn
	Out of which:		
A. Final:	€ 24.8 bn		€ 11.5 bn
B. IPT**:	€ 7.5 bn		€ 7 bn
IMPORTS FOR IPT		ROMANIA PROCESSING SYSTEM	EXPORTS AFTER IPT

* *Including € 0.2 bn financial leasing.*

** *The imports for IPT of € 7.5 bn is a nominal value (it is not paid), being included also in the value of exports after IPT (€ 10.7 bn). The real (effective) receipts from IPT account for the difference of € 3.2 bn.*

As one may see in the figure above and also in Table 2, the real trade deficit FOB-CIF (Romanian final goods only) in 2005 stayed at € 13.3 bn. The trade deficit of € 10.3 bn according to the official data is apparent, being altered by the receipts from IPT amounting to € 3.2 bn. While the IPT flows entered a slowdown trend, due to the gradual diminution in the comparative advantages of Romania, the trade deficits (real and apparent) almost doubled as compared to two years ago.

Table 2

Final exports and imports and the real trade deficit

- million € -

	1999	2000	2001	2002	2003	2004	2005
Total Exports (FOB)	7977	11273	12722	14675	15614	18935	22255
Final exports	3663	4942	5122	6402	6885	9025	11537
% in total exports	45.9	43.8	40.3	43.6	44.1	47.7	51.8
Total Imports (CIF)	9927	14235	17383	18881	21201	26281	32569
Final Imports	6522	9016	11532	12577	14452	19196	24803
% in total imports	63.0	63.3	66.3	66.6	68.2	73.0	76.2
Trade Deficit (FOB – CIF)							
Total (apparent)	1950	2962	4661	4206	5587	7346	10314
Real (adjusted)	2859	4074	6410	6175	7567	10171	13266

Source: National Institute of Statistics, Bucharest.

By superimposing the two completely different faces of the foreign trade is creating a distorted image of reality, misleading the policy makers. One example, significant in our view, is the wearing apparel sector, which is considered by most economists the main source of the Romanian exports. Not at all true! Looking at the combined figures of Textiles and articles (final exports mixed with IPT exports) in 2004, they totaled € 4.2 bn, holding 19 percent of the total exports and ranking the first among the 21 sections of CN-HS classification (see Table 3). However, sectioning the whole image and looking only to the final exports (apparels directly exported on behalf of the Romanian companies), it results that they reached only € 0.4 bn (3.7 percent of the total final exports). In fact, the greatest part (90.5 percent) of section XI is exported under the IPT regime (€ 3.8 bn, accounting for 35.5 percent of the total IPT exports).

Table 3

The share of the main products in the Romanian exports in 2005

- billion € -

	Total	Final exports	IPT exports
Exports	22.2	11.5	10.7
Out of which, sections (CN-HS):			
XI. Textiles and articles	4.2	0.4	3.8
(% in total exports)	19.0	3.7	35.5
XV. Metals and articles	3.3	2.8	0.5
(% in total exports)	15.4	23.8	5.2
V. Mineral products	2.5	2.0	0.5
(% in total exports)	11.1	17.3	4.4

Source: National Institute of Statistics, Bucharest.

We stress that the IPT regime in this case means temporary imports of textile intermediate goods (raw materials and accessories) and, after their processing in Romania, the export of products resulted (wearing apparel). During these transfers, there is no change in ownership, all these goods (intermediate and final) remaining the property (intellectual included) of the foreign companies which ordered the IPT arrangements and, consequently, there cannot be named “Romanian products”.

Indeed, the real image of the Romanian apparel exports is revealed by the share of 3.7 percent in the final exports and not by that of 19 percent as it appeared in the total exports (IPT included). Moreover, the value of € 3.8 bn related to the wearing apparel exports under the IPT regime include a nominal value of € 2.6 bn (corresponding to the value of the textile raw materials temporary imported for processing, which is not submitted to any payment). Thus, the real (effective) revenues for the Romanian subcontracting companies are the difference of € 1.2 bn (mainly for the compensation of labor cost). In fact, the entire contribution of the wearing apparel sector to Romania’s foreign currency earnings in 2005 stayed only at € 1.6 bn (final exports + IPT receipts), accounting for 5 percent of total current external receipts. If it is true that the wearing apparel industry remains an important sector of the economy, employing 300 thousand employees (which are working almost exclusively on the account of the foreign companies), obviously this industry has not been the main supplier for the Romanian exports. Eventually, it could become, to the extent to which the field experience and labor skills are associated with a quality/design of the intermediate goods made in Romania at the level of external demand requirements, together with an expensive promotion of own brands on the international markets. On the other hand, as the data are showing, the most important chapters of the Romanian exports are Metals and articles (mainly plates, tubes, but also metal scrap) and Mineral products (mainly gasoline and diesel fuel), which account together for more than 40 percent of the total final goods exports.

The separation of the IPT component from the foreign trade data highlights the importance of the final Romanian exports, allowing also the assessment of related implications for the BoP current account and for the long-term external position of Romania. The higher growth of the final exports than the IPT rate observed in 2005 is supposed to be a positive trend, but this was mainly due to the increase in the raw materials exports (chemical products, mineral products, basic metals), enjoying higher external prices. Being driven by low value added products in a favorable external environment, we have no reason to believe that this impressive recent growth of the final exports is sustainable. Under a less favorable/adverse international environment, we can expect a slower rate of the final exports, widening the trade and current account deficits.

3. The Implications of the IPT for the BoP Current Account

By statistical convention as per the IMF methodology – the BoP Compilation Guide - the value of the materials imported for IPT, even if such transaction does not imply cash or non-cash payments, is included in the imported goods value. This nominal value is transferred also to the value of exports after the IPT (besides the real receipts corresponding to the payment of processing work) and it is added to the exported goods value. If, at least from statistical reasons of measuring all merchandises entering and leaving a country, the transfer of nominal values creates only interpretation problems for the policy makers, the difference between the goods flows and the payments flows could seriously affect the assessment of Romania's real external financial position. Therefore, in order to avoid a current account crisis and to secure a sustainable external debt, knowing the real flows of the BoP is economically vital.

According to NBR data, the BoP current account at end-2005 (see Table 4) ran a deficit of € 6.9 bn, increasing by 35.1 percent year-by-year. The sharp deterioration of the current account has been driven by the trade balance widening, despite growing current transfers (due mainly to workers' remittances). Under these circumstances, for 2005 a current account deficit ratio of around 9% of GDP is likely, Romania outstripping for the third successive year the maximal target of 6% recommended by IMF.

Table 4

The BoP current account (apparent) and adjusted (real) in 2005

- billion € -

	Official data of NBR			Adjustment following the real flows of receipts and payments			Alternative with receipts from IPT excluded		
	Assets	Liabilities	Balance	Assets	Liabilities	Balance	Assets	Liabilities	Balance
Current Account (A+B+C)	31.6	38.5	-6.9	24.1	31.0	-6.9	20.9	31.0	-10.1
A. Goods and services	26.2	34.4	-8.2	18.7	26.9	-8.2	15.5	26.9	-11.4
a) Goods	22.2	30.0	-7.8	14.7*	22.9**	-8.2	11.5	22.9**	-11.4
b) Services	4.0	4.4	-0.4	4.0	4.0***	0.0	4.0	4.0***	0.0
B. Income	1.3	3.6	-2.3	1.3	3.6	-2.3	1.3	3.6	-2.3
C. Current transfers	4.1	0.5	3.6	4.1	0.5	3.6	4.1	0.5	3.6

** Real receipts, arising from final exports and from revenues related to IPT.*
*** Real payments for final imports (FOB prices, dividing CIF imports by the coefficient 1.0834).*
**** Real payments for services, merchandise transport estimated based on the CIF/FOB ratio.*
Source: NBR data and own estimations.

Even if the current account deficit has remained unchanged after our adjustment following the real flows of receipts and payments, the lower real external receipts (€ 24.1 bn against € 31.6 bn) is significantly deteriorating the indicators considered for the assessment of Romania's external financial soundness. For example, the real ratio of *medium and long-term external debt service* stayed at 25.4 percent in 2005, as against 18.2 percent as stated by the NBR. The economy openness (the ratio of the final exports to the GDP) stayed in fact at 15 percent as against 30 percent, and the coverage of the final imports by final exports at only 46.3 percent, as compared to 68.3 percent that would result from the official data. The ratio of the medium and long-term external debt to the exports of goods and services in 2005 reached 130 percent, as against 93 percent as it results from the NBR data. On the other hand, excluding the nominal value of the imports for IPT, the import cover of the forex reserves stayed at more than 8 month as against 6.4 months stated by the NBR, which is supposed to show an improved external position of Romania, if it would not raise the issue of exceeding the interval between 3 and 5 months recommended by the IMF for this indicator.

On the long-term horizon, having in view the diminishing inflows of FDI (even if more current transfers granted by EU are expected), the financing of the current account deficit could not happen as it has been so far (mostly through autonomous capital flows), which is leading to increased compensatory flows and, consequently, to the external debt rise. In fact, as the main effect of the current account balance deterioration the external debt of Romania on the medium and long-term witnessed a sharp increase, from € 18.3 bn at the end of 2004 to € 24.4 bn at the end of 2005, i.e. more than € 6 bn during a single year!

Romania's economy faces the dilemma of fast growth and worsening external balance versus slow growth and improving external balance. It is clear that Romania has to maintain high growth rates, at least for reasons related to the EU accession in 2007 and the derived convergence process (included for EMU). On the other hand, the EU accession does not guarantee by itself Romania's economy resilience to the supplementary competition pressures. There is no doubt that the productive capacity of Romania is still unable of competing with the imports, mainly due to the unsuccessful restructuring of the economy. Even in a long-term developing scenario it is difficult not to assume a worsening of the external unbalance. Therefore, essentially for the policy makers in mitigating Romania's external vulnerabilities is to maintain the trade and current accounts deficits within sustainable limits, mainly through adequate support of the final exports and the increase in their competitiveness.

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