Only Croatia seems to have everything in order to join the European Union by 2010. The two new entries, Romania and Bulgaria, are therefore destined to remain the easternmost and most dynamic border of

Bulgaria and Romania, Europe's new borders

NEW ENTRY

by Matteo Ferrazzi, Debora Revoltella

the Union for a few years. Their competitive advantages are lower production costs and greater potential for income growth

Romania and Bulgaria became full members of the European Union on 1st January 2007. The entry of the two Balkan countries has not only completed the fifth enlargement and added another 30 million to the EU population, but is also a particularly significant event for Italy, as Italian firms have particularly close economic ties with both countries. Italy is the main end market for both Romania and Bulgaria, with specialization flows and exports by foreign companies located on site playing an important role.

And, with the EU enlargement process now stalled (Croatia is the only country likely to become a EU member in the course of the next decade, probably by 2010), Romania and Bulgaria are destined to remain the eastern border of the Union for a long time. It is not merely a geographical factor. These countries are destined to stand out for a long time within the EU for their lower production costs and greater potential for income growth: a significant competitive advantage.

Romania and Bulgaria: among the preferred destinations for the internationalization of Italian companies

The CEE (Eastern and Central Europe) countries are increasingly becoming the production arm of the "old" Europe. This is particularly the case in some manufacturing sectors (textiles and leather, wood products, the car industry, plastics and rubber and certain types of mechanical production) that have witnessed a massive shift of some production phases to the East, particularly because of a rapid and consistent influx of foreign direct investment.

Bulgaria and Romania are an integral part of this process. The two Balkan countries have made use of their competitiveness, as well as their prospective membership of the EU and a massive privatization programme, to attract substantial foreign investment over the past few years.

Bulgaria and Romania are among the most dynamic economies in Central and Eastern Europe.

The macroeconomic stabilization undertaken in the early years of this decade has encouraged a huge inflow of foreign direct investment. FDI into Romania and Bulgaria accounted for nearly 30% of foreign investment received by Central and Eastern European countries in 2006 (taking both the new EU members and the Western Balkans into account), against less than 10% in the early years of this decade. Bulgaria in particular is the Central Eastern European country that has managed to attract the most foreign investment in relative terms in recent years. In 2006, the FDI-GDP ratio topped 10% for the fourth consecutive year in Bulgaria, and has averaged 13.7% in the course of the past few years; the ratio was 7% for Romania in the same period. The two countries attracted a sizeable total of 33.2 billion in the period from 2003 to 2006. The bulk of the FDI received goes to the services sector (72% of all FDI in Bulgaria and 55% in Romania during 2005), but the manufacturing sector has traditionally represented a significant part. The traditional processes of outsourcing in labour-intensive segments, especially in the 1990s, have expanded to include relations of various types, such as intensive sub-contracting, toll manufacturing and sales of goods on the local market. Some big companies have also decided to set up their production bases in the two Balkan countries, and occasionally served as magnets for small and medium businesses with foreign capital, suppliers or customers. One of the most striking examples is Miroglio, a venerable Piedmontese company with some well-known brands in the textiles and clothing sector (Mötivi, Elena Mirò and Caractère), which has drawn a number of Italian firms to Bulgaria from the first half of the 1990s. Renault chose Romania to produce the Logan, "the 5,000 euro car" intended for the European market as well, through its acquisition of Dacia, thereby encouraging the growth of a network of car suppliers in Romania too.

However, cost advantages are not all as regards Bulgaria and Romania. In the face of growing competition from countries with

_In Bulgaria and Romania the macroeconomic stabilization undertaken in the early years of this decade has encouraged a huge inflow of foreign direct investment

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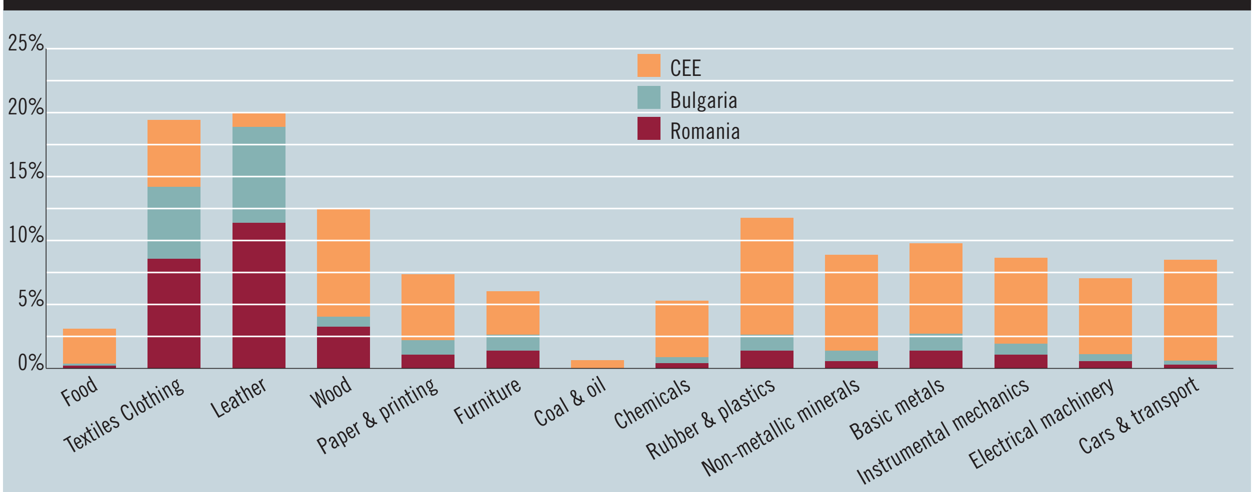
absolutely the lowest labour costs, such as the Southeast Asian countries, the highly labour-intensive phases tend to remain in Bulgaria and Romania because, besides relatively low costs, these two countries are also able to offer a stable and efficient competitive context within the EU market. It is worth noting that, for many companies, especially small and medium ones, geographical proximity is considered an essential element to maintain strong ties with headquarters and serve the European market fast (for example, in sectors in which speed is of the essence, such as "pronto moda", a system for delivering collections of ready-to-wear items that reflect rapidly changing tastes).
In this scenario, a significant part of the trade links between Italian companies and local or foreign companies located in Romania or Bulgaria are oriented towards the textile and leather sectors (**Chart 1**). Italian production specialization in other traditional segments is even stronger in trade with Romania and Bulgaria, an element that is reflected in turn in their sector-wise specialization.

Foreign companies are increasingly focusing on the growth of the local market

While both Bulgaria and Romania have become significant production bases, the rapid growth of income together with the reduction of risks has drawn many companies that focus on serving the local market, particularly in non-manufacturing sectors. The privatization of the financial and telecommunications sectors in particular has played a key role.
Romania and Bulgaria account for 25% of the population (nearly 30 million inhabitants) and 15% of the income of the entire CEE area, taking the 10 EU members as well as the Western Balkans into account. In terms of population alone, Romania is the second-largest CEE market after Poland. While the annual per-capita income of Rumanian and Bulgarian citizens is still under 5,000 (4,500 and 3,270 respectively at the end of 2006), it is rapidly increasing. In fact, Romanian per-capita income has doubled in the course of the past four years and Bulgarian per capita income in the course of the past six years; this is a much faster dynamic than has been observed on average in the other Central and Eastern European countries.
In terms of size and growth, the potential of internal demand is therefore a significant incentive for the presence of foreign companies, especially in retail sales, property and financial services, while the need to renovate local infrastructure has encouraged investments in construction. The growth of communication networks and the energy sector are among the sectors with the

1. SHARE OF ITALIAN TRADE WITH THE CEE COUNTRIES AND ROMANIA AND BULGARIA'S PART



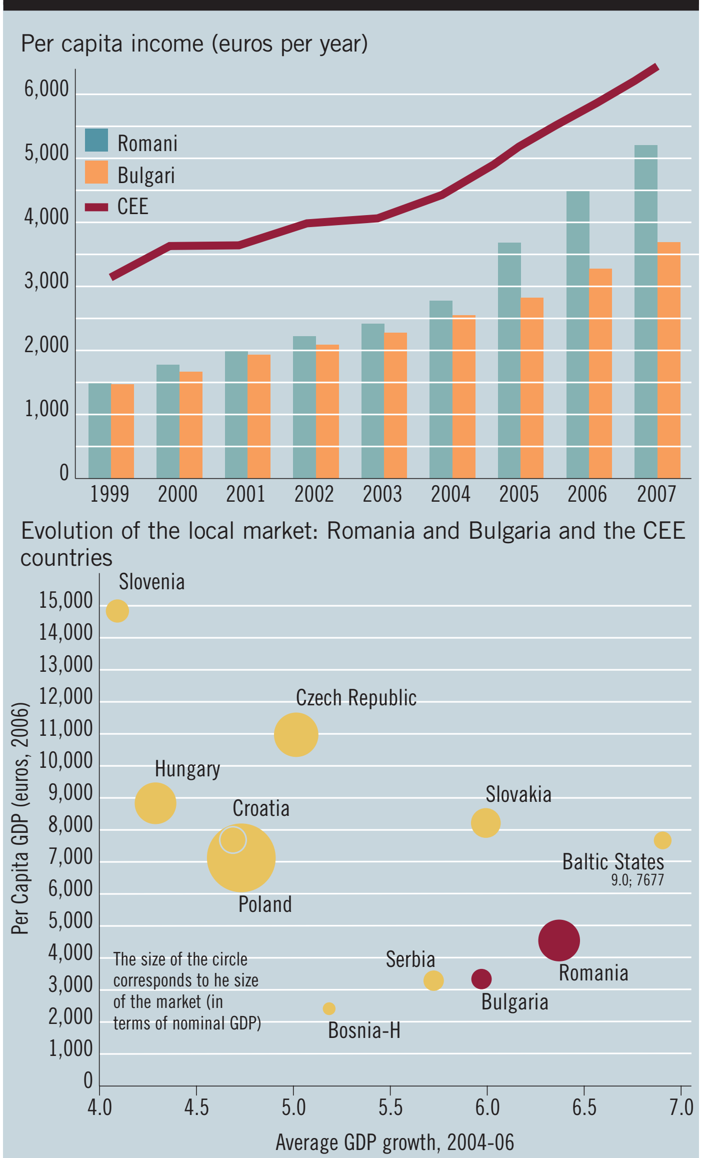
Source: UniCredit New Europe Research Network on Global Insight Data

highest potential in the near future.
Many Italian investors view the two Balkan countries as the ideal place to "reproduce", a few years later, the experience they have acquired on the Italian market in the past decades. This is the case, for example, of some medium-size Italian firms operating in Bulgaria in the utilities sector, having focused on growth abroad as a result of decreasing room for manoeuvre in Italy. In addition, while Western markets are already considered "saturated" in many sectors, businesspeople can still find room to develop their activities in Bulgaria and Romania. It is not unusual for foreign companies to also actively seek new opportunities in sectors not directly connected to their traditional lines of business in their domestic markets.

Romania and Bulgaria's competitiveness and the challenges of the future

As mentioned earlier, the Central European countries (mainly the countries that joined the EU in May 2004) have already

2. EVOLUTION OF PER CAPITA INCOME *(IN EUROS PER YEAR)*



Source: Central banks, UniCredit New Europe Research Network; * 2007: Forecast

_The growth of communication networks and the energy sector are among the sectors with the highest potential in the near future

experienced a rapid and profound transformation of their production structure in the course of the past decade, migrating from a purely traditional production model towards sectors with greater added value. It must therefore be seen whether Romania and Bulgaria are capable of following the same route or whether, on the other hand, these two countries are destined to remain a low-cost production base for the "old" Europe. With the presence of other emerging countries that are increasingly taking on a leading role in the arena of international trade (in Asia and North Africa but in Europe too, as in the case of Moldavia and Ukraine), Romania and Bulgaria are also being pushed towards production with greater added value.
In absolute terms, Romania and Bulgaria are destined to increasingly lose their competitive advantages on the labour cost front. Salaries (the equivalent in euros) have increased in the course of the past four-year period by 18% and 8% respectively per year in the two Balkan countries (they have therefore doubled in Romania and increased by 40% annually in Bulgaria from 2002 to today). A consideration of nominal salary levels alone in these two countries shows that other production destinations can boast greater advantages on cost factors. It therefore seems clear that such advantages can no longer be the driving factor of competitiveness in these countries in the future. Other factors can make a decisive contribution, if associated with low production costs (which must however still be evaluated considering the different levels of productivity): as mentioned earlier, geographical proximity with

3. A REVIEW OF SOME COMPETITIVENESS INDICATORS (DECILES)[1]

decile	Global Competitiveness Index	Ease of Doing Business	Inward FDI potential Index	Corrupton Perception Index	Human Development Index
source	World Economic Forum	World Bank	UNCTAD	Trasparency Internartional	UNDP
Top 3	Switzerland	Singapore	United States	New Zealand*	Norway
	Finland	New Zealand	U.K.	Finland	Iceland
	Sweden	United States	Canada	Iceland	Australia
Germany	1	2	1	1	2
Italy	4	5	2	3	1
Poland	4	5	4	4	3
Hungary	4	4	3	3	2
Czech Rep	3	3	3	3	2
Slovakia	3	3	4	4	3
Slovenia	**3**	**4**	**3**	**2**	**2**
Romania	**6**	**3**	**6**	**6**	**4**
Bulgaria	6	4	5	4	4
Croatia	5	8	4	5	3
Turkey	5	6	5	4	6
Bosnia-H	8	6	n.a.	6	4
Serbia	7	4	n.a.	6	n.a.
Russia	5	6	2	8	4
Ukraine	7	8	4	7	5

Source: WEF, WB, UNCTAD, Transparency International, UNDP
The GDI (Global Competitiveness Index) developed by the World Economic Forum is the weighed average of some sub-factors such as infrastructure, technological progress, education etc. The World Bank index (Ease of Doing Business) takes into consideration the time and cost of starting a new business, the possibility of asserting one's legal rights, bankruptcy management etc. The "Inward FDI potential" index calculated by UNCTAD is a simple average of some variables such as country risk, the share of service exports as compared to global demand and R&D spending. The Transparency International index, for its part, calculates the level of corruption (or at least the level "perceived" by operators) within the political and bureaucratic set-up. The index of human development is calculated by the United Nations and evaluates the quality of life and the possibilities offered to citizens of different countries.

Europe, membership of the EU and the prospect of using the euro are particularly relevant factors. The use of the euro is currently expected to start around 2011 in Bulgaria (most probably before other EU members such as Hungary, Poland and the Czech Republic) and 2014 in Romania. Bulgaria could become part of the European exchange rate mechanism (ERM II) in the near future.

Romania and Bulgaria provide a good operating environment in general, particularly as regards taxes (the tax on profits is one of the lowest in the EU, with a rate of 16% in Romania and as little as 10% in Bulgaria) and infrastructure. Both countries are also, as mentioned earlier, extremely open to foreign investors, as the high FDI-GDP ratio shows. There is still a significant gap in terms of productivity, which is less than half European levels, but it is rapidly increasing (see **Chart 3**); the gap is due to fairly low R&D levels as compared to GDP.

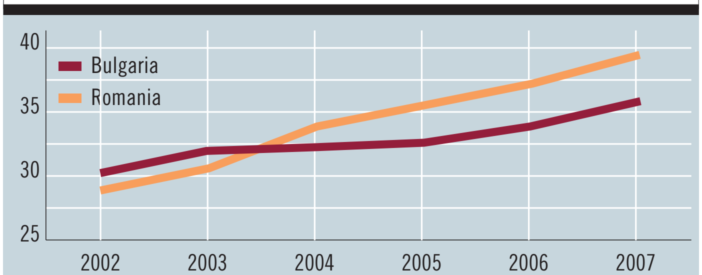
The difference between Romania and Bulgaria and the other CEE countries is also highlighted by some short competitiveness indicators developed by certain international institutions (Table 1): the cost advantages are hence compensated to some extent by a rather difficult operating context compared to other CEE countries. The two Balkan countries have however significantly simplified the conditions to do business, as can be seen from their positioning in the third and fourth decile of the World Bank's "Ease of Doing Business" index. The World Bank mentions Romania in particular as being the second-best "reformer country" (out of 175 countries examined in the 2007 report) because of the improvements in simplifying procedures, access to credit and the protection of foreign investors.

The future challenge for Romania and Bulgaria will be that of strengthening global competitiveness, without remaining imprisoned in their position of leadership on the costs front in the European context. They must in fact concentrate their efforts in two main directions: one concerns the emphasis on the quality of the operating context and the evolution of production specialization to bridge the gap in terms of investments in research and development, productivity and education. The other is related to the opening of these economies towards the exterior, which is of vital importance to attract FDI and develop trade and institutional relations with the EU. The two Balkan countries can also leverage the growing local market, pushed by high income growth. The ability to maintain a high level of foreign direct investment even after having completed the bulk of the major privatizations is a key factor.

While Germany has been among the countries most interested in the enlargement of the EU eastwards (which has accelerated the restructuring of German companies and contributed to the opening of new end markets), Romania and Bulgaria's entry into the EU could play a more significant role for Italian firms. In particular, the ties between Italy and Romania, due in part to a common Latin heritage deriving from Emperor Trajan's conquest of Dacia, are destined to remain particularly close. The evolution of the specialization of the two Balkan countries could partially influence the internationalization model of Italian companies in the area, a model that is currently largely characterized by trade flows and subcontracting relations, directing it towards more stable relations that could include not only trade but also other aspects related to the local context (culture, training and institutional relations). And Italian foreign direct investment in the two Balkan countries will be increasingly "market seeking", i.e. oriented towards serving the local market, and decreasingly "resource seeking", not least because of the diminishing cost advantages.

4. ROMANIA AND BULGARIA: EVOLUTION OF PRODUCTIVITY

(EU25=100)



Source: Eurostat