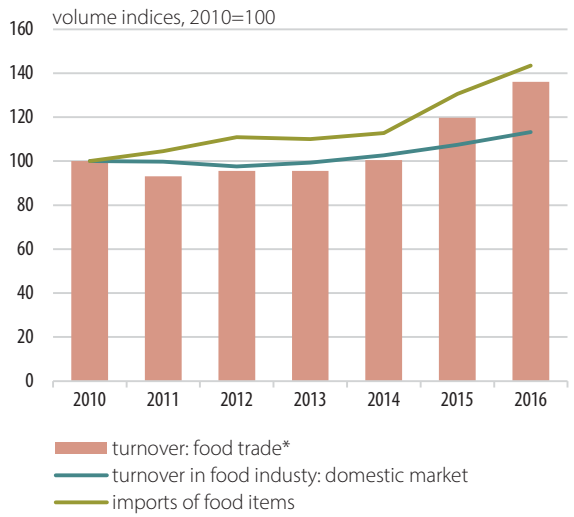
Box 2. Sources of trade deficit in food products

The international trade deficit in food products[1] has widened continuously over the past years to reach EUR 2.8 billion in 2016 and EUR 2.6 billion in the first ten months of 2017, currently accounting for more than one quarter of the total deficit on trade in goods. The recent advance in the domestic consumption of food products, which benefited from both general stimuli (such as income increases) and specific incentives (broadening the scope of the reduced VAT rate to all food items), reflected to a relatively low extent in the activity of food industry, so that the demand surplus was broadly accommodated via imports (Chart A). These developments brought to the fore again the situation in the domestic agri-food sector, which ranks among the least performing sectors among its EU peers (despite Romania's high agricultural potential), as also shown by other competitiveness indicators, i.e. export market share, revealed trade advantage, productivity. Therefore, this box aims to give an account of the sources of competitiveness deficiencies in this sector.

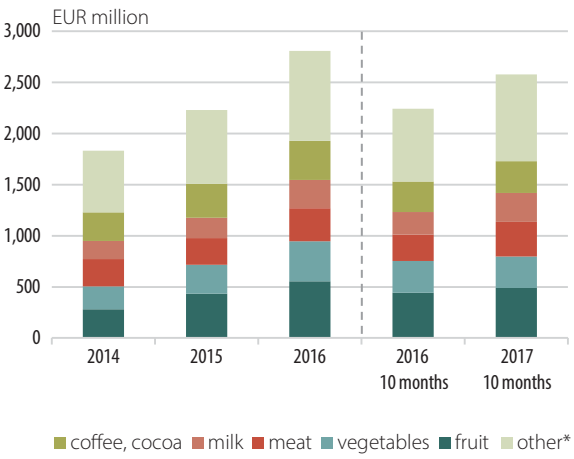
Chart A. Demand and supply of food items



*) including beverages and tobacco products

Source: NIS, Comext, NBR calculations

Chart B. Composition of the food trade deficit



*) bakery products, fish, sweets, etc.

Note: The highlighted categories also include manufactured products.

Source: Comext, NBR calculations

Analysis by product category

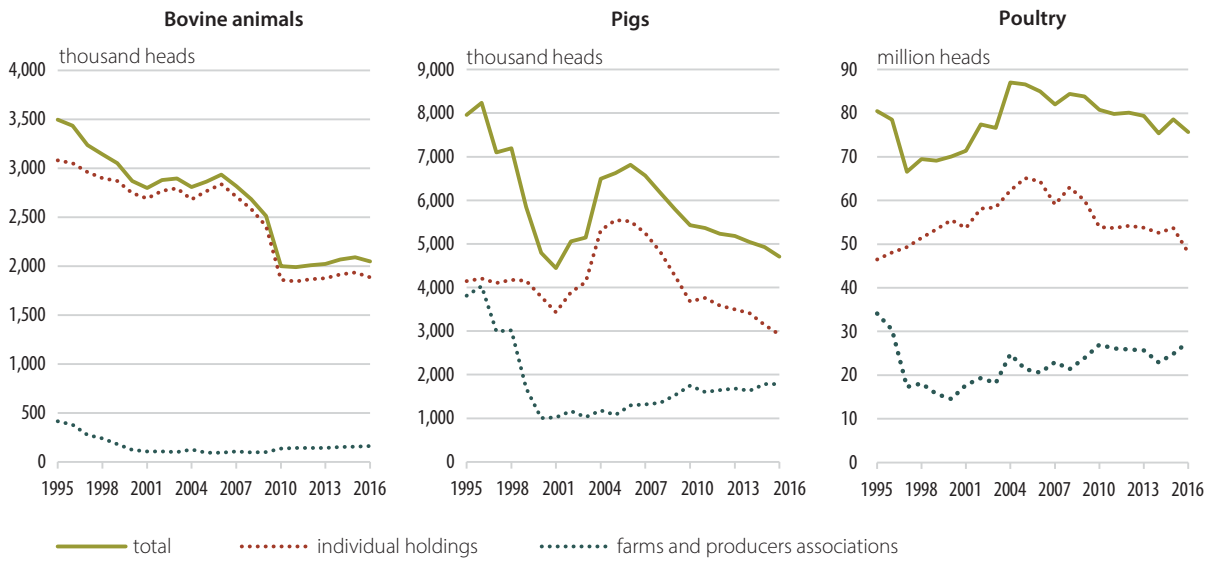
The main imbalances identified refer to four categories of products, i.e. fruit and vegetables, coffee and cocoa, milk and dairy products, and meat and meat products (Chart B). Although there are items (such as tropical fruits, coffee, cocoa) where contributions to the trade deficit may be regarded as normal, on account of weather conditions in Romania, in most cases, shortfalls hide structural competitiveness issues affecting the production chain, particularly the upstream stages.

Specifically, in the case of fruit and vegetables (which make up for one third of the trade deficit generated by food items), it is surprising to notice the prevailing contribution of traditional local produce, such as apples, grapes, tomatoes, potatoes. Leaving aside the influence of the seasonal factor, the production of these crops stagnated or even went down in the past 10-20 years. This was first of all associated with the absence of yield gains and then with the overall decline in croplands, including the greenhouse

[1] The analysis in this box refers to food items, excluding livestock, cereals and oleaginous plants.

surfaces. For instance, no matter how surprising it would be from the standpoint of local potential and tradition, apples are among the main sources of fruit trade deficit, given that, in 2016, Romania held over 10 percent of the total apple tree area in the EU, but accounted for merely 3.6 percent of the total apple production. The difference between the local yields and the EU average yields is even more pronounced for tomatoes, as Romania holds 9.1 percent of the tomato cultivated area and makes up for only 2.4 percent of the total tomato production. In fact, the production of fruit and vegetables is generally well below potential, the farmers' poor investment activity having a negative influence on several areas such as the mechanisation of works, the building of irrigation systems, soil fertilisation, construction of greenhouses, land reconversion, the replacement of old orchards and vineyards with new, high-yielding varieties, the insufficient storage facilities, etc. Consequently, retailers often find it more advantageous to purchase from foreign suppliers that are capable of ensuring steady commodity flows within appropriate quantitative and qualitative parameters.

Chart C. Livestock populations



Source: NIS

As for animal products, comprising mainly meat and meat products and milk and dairy products (with contributions to the total deficit of 13 percent and 11 percent respectively), mention should be made of the excessive fragmentation of livestock farms, in addition to the continued decline in livestock (Chart C). This situation affects farmers' investment capacity and, hence, their yields, the sectoral production being additionally affected by the insufficient collection, storage and transport facilities. Thus, the inability to supply produce to the upper links of the production chain in compliance with their quantitative and qualitative requirements is a characteristic of both vegetal and livestock segments.

Cattle breeding is the most exposed to fragmentation, the individual agricultural holdings accounting for 90 percent of the dairy cow population, so that farmers manage to supply milk processors with merely a quarter of the local milk

production (in 2016), a percentage that lies well below the EU average of around 90 percent. As a result, even if the milk for processing comes mostly from local farmers, the specialised industrial companies need supplemental imports (which account for about half of the purchases of milk and dairy products from abroad), a situation that has actually been persisting for years. At the same time, the segment of milk processors is highly concentrated (the top five players holding about half of the market share), with international companies ranking among the most important. These companies operate in several countries, throughout the production chain, and the decisions on what, where and how much to produce rely exclusively on the cost-efficiency criterion.

Thus, the expansion of international networks in Romania refers not only to the retail segment dominated by large retailers, but also to processors to some extent, whereas the phenomenon is still at an early stage at the beginning of the production chain. Although the presence of these undertakings is an opportunity for the domestic agri-food sector, considering the related benefits (stable demand, access to know-how), the highlighted structural deficiencies and, generally, the current poor situation of productive capital (in terms of technology) erode the attractiveness of the local economy for new investment. Hence, the low competitiveness determined many companies (retailers and processors alike) to supply foreign-made products for final consumption purposes, these imports virtually explaining the worsening trade balance on the food segment over the past years, given that the progress in exports, albeit visible, is still very modest.

As for the production of meat and meat products, although the livestock segments that are relevant in terms of the structure of consumption – breeding pigs and poultry – are affected by lower fragmentation (the share of livestock bred in individual holdings going down to around 60 percent), the challenges are broadly similar to those specific to the milk production sector. Therefore, processors choose, in their turn, to purchase raw materials from abroad in order to supplement the locally sourced meat (imports of specialised industrial companies amount to about 40 percent of total meat imports). Even though local products, particularly meat products, are somewhat better represented than dairy products at the retail level, the atomisation of the processing sector – especially on the pork meat segment – contains the capacity of most processors to gain access to modern stores, which has an impact on the related trade deficit.

The sector's competitiveness – several coordinates

As concerns trading partners, a significant proportion of Romania's food trade deficit is due to its relations with other countries in the group of new EU Member States, i.e. Hungary and Poland[2] (cumulative share of 30 percent in the first 10 months of 2017), these two countries having, in fact, some of the most favourable external positions

2 Trade deficits with Hungary and Poland have been recorded ever since the '90s and have gradually widened also on account of the asymmetrical terms and conditions of trade arrangements signed during that period (the European Union Association Agreement, the Central European Free Trade Agreement – CEFTA), as well as of the lag between the EU accession dates, which gave Western European producers the opportunity to access the domestic market under more favourable conditions, ahead of Romania actually joining the customs union.

on the food segment at EU level. The signal given by the size of the negative balance on trade is also strengthened by other competitiveness indicators, such as the export market share and the revealed trade advantage, an indicator of the extent to which specialisation in a certain product category makes exports prevail over the imports in the same category. Specifically, Romania's competitive position at EU level is modest (across all four categories of goods under review), standing well below those of the emerging economies the trade deficit is associated with (Table A). However, a slight improvement has been noticed at aggregate level over the past years, almost solely on the back of "meat and meat products". This was partly ascribable to the gradual easing, as of 2012, of the sanitary and veterinary restrictions on exports of pork meat starting with 2006, subsequent to the outbreaks of swine fever.

Table A. Competitiveness indicators in food industry, relative positioning versus EU countries

Category of goods	Position	28	27	26	25	24	23	22	21	20	19	18	17	16	15	14	13	12	11	10	9	8	7	6	5	4	3	2	1
Total food items	i1							I	II														I	II	I	II			
	i2					I				II						I+II					I		II						
	i3			I		II															I	II		I+II					
Meat	i1							I								II								I		II	I	II	
	i2										I					II		I+II				I				II			
	i3					I										II								I+II			I+II		
Milk	i1				I	II							I+II										II	I					
	i2		I	II						I		II										I+II							
	i3				I+II				I					II						II	I								
Vegetables	i1											II				I								II	I	I+II			
	i2								I		II								II	I			I+II						
	i3											II					I					II	I	I	II				
Fruit	i1													II					I						I+II	I+II			
	i2								I+II								I+II						I+II						
	i3												II				I					I+II			I+II				

Hungary Poland Romania

i1 – trade balance on each category (% of GDP); i2 – export market share[3]; i3 – revealed trade advantage[4]
I: 2007-2011 period; II: 2012-2016 period

Source: UNCTAD, Eurostat, NBR calculations

Although Romania has an agricultural potential above those of most EU countries, the extent to which it has been turned to good account is still among the smallest. Specifically, the crop yields obtained by local farmers (calculated as a ratio of harvested production to harvested areas/slaughtered livestock) rank among the lowest in the EU, below those of Poland and Hungary. An explanation lies with the very low level of direct investment in the cultivation of fruit and vegetables and in stock breeding as compared, for instance, with the inflows of investment in the farming of cereals and oleaginous plants, which make, in fact, a positive contribution to the external balance. Furthermore, the food industry, while benefiting from increasing capital flows, further has a productivity level well below the EU average (Table B). This is the result of low-tech productive capacities, so that the option for imports or the relocation

3 Ratio of one country's exports to world exports, for a certain category of goods.

4 It shows the difference between the share of a category of goods in export composition (normalised based on a similar share, calculated at global level) and an indicator of imports of that category of goods, calculated in a similar manner.

Table B. Production efficiency in food industry

Indicator	Period	RO	PL	HU	EU-28
Average production of a firm (% of EU-28 average)	2012-2015	**30.5**	101.3	57.9	100
Average number of employees in a firm	2012-2015	**20.4**	28.4	19.9	14.5
Labour productivity (production value/number of employees, % of EU-28 average)	2012-2015	**21.7**	51.6	42.1	100
Changes in labour productivity (production volume/number of hours worked, %)	2008-2011, annual average	**2.5**	3.0	3.1	
	2012-2016, annual average	**3.1**	2.5	1.2	

Source: Eurostat, NBR calculations

of some business activities in other EU countries is likely to prove more profitable in many cases. As such, the expansion of the domestic consumer demand was unusually accompanied by an underutilisation of productive capacities.

To sum up, the worsening balance on trade in food products reflects, to a large extent, structural deficiencies that share a common denominator – the excessive fragmentation of agricultural holdings. In the absence of farmers' associations, it is difficult to envisage a recovery in investment, which is a *sine qua non* condition for improving yields and product quality. Additional obstacles to the large-scale adoption of a competitive business model that would enable the integration in international networks (not only on the domestic front, but also via exports) along the production chain are the shortage of skilled staff and the lack of a medium- and long-term business vision, compounded by the small size of the average manufacturer. Thus, the constant decline in the market share of locally sourced products on the domestic market indicates, apart from the identified structural issues, that local economic agents refer only to their own businesses and find lower-than-market-average increases acceptable, without being concerned with taking full advantage of the existing potential that would enable the consolidation of their relative competitive position.