

## ROMANIA'S TRENDS IN LOHN SYSTEM EVOLUTION

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### ***Abstract***

*In the current economic conditions of the financial crisis, companies must identify and use all the opportunities that the market offers for reducing the financial flows influence on the performance of their current activities. One of these possibilities is lohn operation, which combines the import of raw materials and the export of finished products and manpower, ensuring the use of production capacities and the increase of labor employment.*

*The paper addresses both theoretical aspects as well practical ones, analyzing the evolution and lohn's impact on the Romanian market.*

**Key-words:** *lohn, instructing, executing, active lohn, passive lohn*

**JEL Classification:** O<sub>1</sub>, O<sub>10</sub>

### **Introduction**

In contemporary international trade, combined economic activities have witnessed a significant extension: the re-export process, switch operations, swaps operations, etc., which justifies their incorporation in foreign trade techniques.

There are numerous causes for these businesses' international economic expansion:

- in some cases, it has to do with the production capacity capitalization for some partners, while in others it is brand-related;
- gaps between different countries in terms of quality of the commercial and marketing techniques and mechanisms, which bring significant benefits to firms in countries where they figure as big trading powers (lohn);
- obtaining an important commercial profit and increasing foreign currency reserve;
- surpassing discriminatory trade barriers, achieving flexibility in the more rigid business techniques, such as counterparting, re-export, etc.;
- in other cases, the main reason lies in the requirement to mitigate the rigid nature of the clearing agreements and other bilateral arrangements (switch).

Due to the fact that usually these businesses do not engage commercial material substance, but generally, production investments in some partner countries, they contribute heavily to the prosperity of participating nations and companies.

### **Lohn term evolution**

Although statistics are incomplete in this area (as a consequence of the confidential nature of certain businesses that work under the lohn system), companies from countries like Belgium, Netherlands, Austria, France, Germany, England and others have achieved large profits from such combined commercial operations, in the last three or four decades.

In Romania, the lohn technique can be traced back in the '70s, at the handcraft cooperatives where it was used in order to absorb the labour force available in this sector (especially in textiles). The clothing products are among the items that are manufactured on a large scale in Romania, under the lohn system.

The term "lohn system", is derived from the German word "lohn", which means "salary". In the European Union, lohn system is known as the "outward processing data – OPT" (i.e. passive processing operations), while in the US, as production subcontracting (i.e. "shared production") that refers more or less to the same system.

According to the Legal Dictionary, lohn implies a contract whereby a manufacturer (performer) is obliged to execute an order product for the costumer (contractor), in exchange for some remuneration and some technical documentation provided by the contractor.

The operation of pre-processing in lohn, also called "order production", has developed especially for West-East and North-South relationships through relocation by western companies of the intensive industrial labour production to countries in Central and Eastern Europe, or to developing regions.

Lohn – sale of labour or re-export, pre-processing – consists of the processing of raw materials, intermediate goods or finished products, belonging to one party (the importer) by the other party (the exporter). Contractors working under lohn are companies that provide inputs, buildings, machinery, utilities and labor, but no brand products; they have weaknesses in management and marketing activities, especially in international affairs.

Lohn processing operations employ relationships and collaboration in production and techniques development, so they can be considered as international economic cooperation actions, especially in the formula known as "on-demand production", as well as "trade monopoly" or "export of manpower".

To some extent, lohn is a source of promoting re-exports because the importer usually sells the respective products primarily on foreign markets. Contractors under lohn own prestigious brands, well-placed in the world market, which tend to expand their businesses by fully exploiting the advantages arising from the strong position they have in this market.

Depending on the purpose of the transaction (export or import) *lohn* is either active (labour export) or passive (labour import). Active *lohn* requires the importer of finished products to provide the necessary raw materials and other supplies for the exporter and after that, the finished products are manufactured and re-exported to the importer. In passive *lohn*, the importer of finished products exports raw materials and other supplies to the exporter who processes them into finished products, after which the importer re-imports them. *Lohn* payment is generally determined by a compensatory amount in currency. In most countries, raw materials, spare parts and accessories enjoy preferential customs treatment if they are under a *lohn* contract. Economic affairs through *lohn* contracting may be determined by different reasons, which generally represent advantages for the business partners.

In terms of contractor (exporter) benefits, we mention:

- the performer uses the surplus production capacity on account of external market conditions specific to this operation – exporting labour, utilities, and to an extent, depreciation of machinery, buildings, etc.;
- maintain production at an acceptable level or even at a higher level, even without the necessary raw materials and supplies needed to meet the quality of current market requirements and by acquiring them from the contractor;
- has the opportunity to modernize a number of activities in the field of product design and manufacturing technology, receiving along with the contractor's order a series of models, designs, and often technical assistance – i.e. real manufacturing “know how”;
- maintaining a relatively high degree of labour employment while the impact of knowledge acquired from external partners reflects favourably on its quality;
- execution of products under *lohn* contract is a testament to the competitiveness of the enterprise in terms of production, which for skilled managers may be a prerequisite for transitioning to production of own brand products (underproduction, coproduction).

From the contractor's viewpoint, *lohn* also offers a number of advantages:

- increases the economic activities volume (revenue, profits), without investing in production capacities, since they use the production capacities of the partner
- may achieve a high rate of profits due to various regional differences, such as wage discrepancies, as well as the fact that they are able to exploit the advantages of marketing under their own brands;
- consolidates its market position there by developing and maintaining a high rate of sales on the market, representing lasting positive effects in the competitive struggle.

### **Limits and risks for the Lohn performers**

Lohn is a system of on-demand production, export of manpower and manufacturing production facilities, which as has been shown, gives the performer small financial benefits and a modest financial profit rate, with the “dollar portion” returning to the contractor.

The risk that the contractor will close a Lohn contract, in case of adverse conditions that may occur under respective products market, may produce catastrophic consequences for the performer, who has trained the workforce and prepared the entire manufacturing operation for the production of the ordered products.

Production under a Lohn contract, while under a foreign brand, postpones the promotion and marketing activities for prolonged periods of time. In fact, it keeps the performer anonymous, with adverse consequences on his company’s prestige on the international market. Extension for a very long period of Lohn execution condemns the performer enterprise to commercial stagnation; also, being to a certain extent at the discretion of other firms, performer companies could end up in bankruptcy.

Other risks are related to the delays that may occur in the transportation and supply of raw materials, which may adversely affect the production continuity and regularity, with numerous negative consequences arising from this situation.

The price risk, which can affect the exporter, may be present in the sense that the price of the finished product may become insufficient to cover the input factor costs associated with its production; after signing the contract, the cost factor may increase significantly (labour, energy, water, etc.). Lohn assures to the exporter a lower income in foreign currency, compared to the situation in which he would export finished goods from own production, under own brand and obviously having an adequate management.

### **Limits and risks for the Lohn contractors**

There are cases when the performer of the products under Lohn contract doesn’t meet the product quality requirements and even registers a high percentage of rejects. Obviously, the officer shall ensure the contract for these situations, but the issue becomes tricky when they waste raw materials and valuable semi-manufactured.

As a result of any breach of quality requirements and delivery terms, the officer risks losing some favourable conjunctural moments or even businesses already contracted.

Officers indirectly “take” some risks, arising at the performer, sometimes due to a reduced quality management, some other times, as a result of some social and political disturbances, natural disasters, etc.

Analyzing objectively the comparative advantages of the two parties, we have to mention that processing operations under Lohn contract resolve or reconcile the discrepancies which occur in terms of quality and assortment between the

possibilities of executing the company's internal product and external market requirements, fostering a spirit of cooperation between business partners.

In order to stick to the plain truth, we must emphasize that the officer's benefits are much higher than the performer's, both in the short term and especially in the long term. In fact, analyzing the economic effects, it results that the officer obtains a profit rate ten times higher than the performer, consolidates his global market position, prospers, while the executor of the products under Lohn contracts just survives.

Looking back some years ago, according to a study conducted by an American company, Romania was the largest supplier of garments to the European Union, ahead of Poland. Romania's exports of footwear and clothing owned 35% of the total. Products made in Lohn exports represented 90% of light industry, from those exports, one third were directed to Italy.

Many years Lohn meant for textile factories in Romania a great business opportunity. They didn't have to bother with any problems concerning the design or invention of a strong brand and the sale of any products. Everything came from abroad! They just had to have equipment and manpower as well as to meet the deadlines and quality standards imposed by the large firms from abroad. At present, almost the entire Romanian textile industry is supported by Lohn system orders and in case the Lohn system ever withdrew from our factories, our textile industry situation would be seriously affected. Some of the major international firms which produced in Romania's Lohn system, have already gone to the East, attracted by a labour force cheaper than in our country.

One of the biggest clothing manufacturers in Lohn system which used to produce over 20 million products annually in the factories of our country is the Swedish brand H&M. They "packed their things and left" our factories at mid-2010. The situation is slightly ironic since H&M officials have announced that early next year they are going to enter in mall stores across our country. Still, this time, we will not find on their labels inscribed "Made in Romania". The Romanian fashion designer Romanita Iovan's textile factory also used to work for H&M and it produced brands like: "Romanita", from Caracal. Her factory also used to produce for another prestigious brand named Next. They also left the Romanian market last year. Along with them, Marks&Spencer, C&A, Kiabi, Lindex and the Italian shoes maker Geox, left one by one our country.

Returning to Romania of 2010, things are different, rules have changed the game and here we are without the important customers we used to have once, since they were not willing to pay increased salaries to Romanian workers, which is why they moved elsewhere. The crisis has increased considerably the Romanians' "chances" of going bankrupt, which makes our employers seek for new financing or surviving solutions. Even if the Lohn system doesn't bring a fabulous income, it assures production and keeps people in factories, fact that in Romania of 2010 is considered to be a great success.

For some time now local manufacturers of clothing and footwear have decided to try their luck on the Romanian market with their own brands. However,

only few of them reach the public eye. Some of the most well-known examples of local brands are: Tina R, Musette, Braiconf or Jolidon.

Secuiana, one of the leading textile manufacturers in the local market, have momentarily frozen their expansion plan in Ukraine and Moldova, and they have also limited to open only two stores Adam's, instead of eight planned for this year, according to Laszlo Dobra, the company's manager, in an interview with Wall Street Journal. The present economic climate has reduced the lohn pieces production to 60%, now representing only 25% of Secuiana's turnover, says Laszlo Dobra. Thus, the share of turnover resulted from *Adam's* brand marketing has annually increased, reaching 75% in 2009. At the same time, businesses displayed after the first six month of 2010 reported a decline of 30%, as an effect of the financial crisis as well as of the lost of important lohn costumers due to high price tallies. In 2010, Secuiana will be able to live on thanks to the production under lohn contract for the few foreign partners who haven't left as well as to the domestic sales of Adam's products range.

The idea of those investing in their own brands is to try to capture the middle-income customers, that is, those who are not satisfied with cheap products, but do not earn enough to invest in expensive foreign brands. "The emergence and consolidation of Romanian brands that offer competitive products more expensive than the current "Chinese" ones, still cheaper than the foreign brands, will gradually guide consumers to quality products", says Maria Grapini. But first, buyers should get used to local brands. This is becoming more and more difficult given the fact that the Romanian market is becoming more attractive to the Western producers.

If we take a look at statistics, a few years ago 700.000 employees worked in the textile sector, while at the end of 2009 their number was roughly 350.000. Compared to the corresponding period of the previous year, imports of textiles had the biggest drop, from 1.5 billion euro. In the last three years, there is a steady decline in textile exports. Statistics show that domestic industry employers do not consume more than 15% of annual production, whereas China, Turkey, India, Bangladesh and Tunisia are the main clothing suppliers for the local market.

If the famous clothing brands have left our factories, Romanians still have a few aces up in their sleeves in the footwear industry. Famous international brands such as Louis Vuitton, Gucci, Prada, D&G, Miss Sixty, Furla, Max Mara, Tosca Blu still produce their shoes and bags in our factories. The nice part is that some of them have outlets, that is, small stores where they sell their products at "producer" prices which are much lower than those in mall stores. However, the contracts with major fashion houses don't allow all factories to benefit from these shops. Foreign orders for shoes registered the smallest decrease over the first eight months of 2009, that is, four percent, according to FEPAIUS data (Light Industry Employer's Federation), indicating exports of 637 million euro.

Let's start with the luxury: Louis Vuitton has two factories in Sibiu, one in Cisnadia and another one in Avrig. They produce their shoes and bags. These

factories belong to the fashion houses. In Sibiu we also find Prada. Here they produce the Italian brand leather line, namely, handbags and belts.

As regards the shoes collections, they are produced in the very capital of our country, or, better said in a factory located on the outskirts of the city. Moreover, Prada shoes are also produced in Craiova and Brasov.

In fact, there is a long list of famous brand shoes that are present in Bucharest's production units: from Prada and Dolce&Gabbana to Tod's, Max Mara and even Rossignol. The luxury brand Dolce&Gabbana is also produced in Arad, whereas Max Mara has a shoes production line in Sibiu.

Not less important when it comes to fashion is Cluj, a city where they produce the brand Gucci along with Miss Sixty and Fornarina. In Jimbolia, a locality from Timis region, they produce Otter's collection and in Beius, from Bihor region, they manufacture the products of Veronella house.

Some of these factories own outlets and sell a part of what they produce for export, while others don't. It all depends on the contract with the international brand. "Only certain factories sell a part of the shoes they produce and have specially equipped outlets in the proximity of their factories. Prices vary from manufacturer to manufacturer, but obviously they are much cheaper than those from ordinary shops. However, there are factories that can't sell anything since the customer doesn't allow them", explained for incont.ro Cornelia Oarga, Footwear Manufacturers Association representative Safra Factor.

### **Conclusions**

Once the largest producer in lohn system in Europe, in today's Romania there remained only a part of the clothing brands that flooded our market in the 80's and 90's. Why did they go? Some have found cheaper labor force in countries such as Bangladesh, Pakistan, China or Vietnam, others were not satisfied with the technology level used by the Romanian tailors to produce their clothes, while the rest of them were defeated by crisis. Contrary to all predictions, the lohn system doesn't die, but it turns into something else: the biggest clothing producers sublet orders to the small ones. However, lohn is not a long-term solution; the real winners are those able to invest in their own brands.

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