

East/West Integration and its Impact on Workers: The Austrian Example

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THE AUSTRIAN EXAMPLE

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(Note by the Secretariat)

The International Conference on "Regional Integration and Globalisation: Implications for Human Resources" is being organised jointly by the Organisation for Economic Co-operation and Development and the Austrian Government, within the framework of the Organisation's Employment/Unemployment Study.

The attached paper, prepared by Karl Pichelmann of the Institute for Advanced Studies, and Ewald Walterskirchen of the Austrian Institute of Economic Research, is intended to inform discussion for the topic: Regional Integration and its Impacts on Jobs and Workers.

The views expressed in the paper are those of the authors.

Executive Summary

The opening-up of Eastern Europe has been a great challenge for Austria. The tendencies towards internationalisation and structural change observed in the past have been speeded up. However, the sudden need for rapid adjustment seemed too fast for some industries (cement, steel etc.). On the labour market the trend towards a dual labour market accelerated.

East/West integration has been characterised by higher trade and capital flows. Austrian companies were able to exploit the potential of geographical proximity. Exports to East-Central Europe more than doubled within four years, the trade balance vis-a-vis these countries improved substantially, and direct investment flourished. There are now about 10.000 joint ventures of Austrian firms in Eastern Europe, which offer new opportunities for the staff of these firms to develop abilities and competence abroad.

On balance, the increase in net exports stimulated growth and employment. However, job creation and job destruction did not occur in the same places. East/West integration increased the potential for mismatches on the labour market. For about two thirds of Austrian companies the opening-up of Eastern Europe offered good opportunities, for about one third it was a threat. Industries with high labour and energy intensity or low wages per employee (a proxy for low qualification) are facing the biggest threat. In food, chemical and electronic industries opportunities prevail, in building materials, steel and clothing industries the risks are perceived higher than the chances.

Whereas the liberalisation of East/West trade had, on balance, positive effects for human resources, the liberalisation of labour markets was a kind of a "shock". Between 1989 and 1991 foreign workers - mainly from former Yugoslavia, Turkey and Eastern Europe - raised the total labour force by nearly 5%. The consequences of this supply shock were rising unemployment in a boom period and a dampening of domestic employment. Evidently, there is only a certain number of foreign workers that can be integrated within a short period of time without adding to domestic unemployment and political tensions (nationalist movements).

The main business strategies in response to liberalisation of trading and investment opportunities were to take advantage of the new sales market by means of exports and to increase production in Eastern Europe. Two thirds of the surveyed large enterprises do have plants in Eastern Europe, one third of their staff working abroad is working in Eastern Europe. Outplacement of production mainly serves to satisfy the demand of Eastern European countries and to make use of cheap labour. Another important business strategy has been restructuring towards more sophisticated market segments (e.g. in steel and glass industries).

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1. Introduction

1. After an initial phase of close to euphoria following the fall of the iron curtain, the profound economic, social and political consequences of the transition of Central and Eastern European countries to market economies now tend to be assessed in a more and more sober mood. The transition process in the reform countries has proven to be a lot more painful in terms of output losses than most observers initially expected and, while in some countries first signs of recovery have appeared future growth prospects are likely to remain fragile, subject to several downside risks. But also in the West it had to be recognized that the integration of the CEE economies into the world economy will have a substantial - partly harmful - impact on domestic markets for goods and services, as well as for factors of production.

2. In particular, there have been rising concerns in the West about the emergence of new low-cost competitors just around the corner. Indeed, East/West wage differentials are beyond any precedent in the recent European economic history as wage costs may currently be divided by ten after each border crossing to the East. The differences in unit labour costs are much smaller, but still on average there is a relation of 1:2 between East and West. While international competitiveness certainly does not depend solely upon wage costs, there is no doubt that strong pressures for factor price equalisation will inevitably tend to be present, resulting from increasing flows of goods, capital and labour.

3. Despite considerable improvements in overall trade balances with the CEE economies in recent years, a "call for protection" against rapidly rising imports in areas regarded as sensitive seems to have been among the reflex responses in many Western European countries. For example, in the Association Agreement between the EC and Eastern European economies, while certainly a major step into the right direction of liberalisation of trade, there remained a core group of goods for which substantial barriers were not removed and additional safeguard clauses in the form of contingent protection were introduced.

4. Resistance to liberalisation of trade, however, would prove inefficient and unsustainable over the longer term. With given liberalisation in the East, it would hamper economic progress in the transition countries which, in turn, may create high political instability and strong pressures for migration. Thus, accepting the challenge of newly emerging East/West trade patterns and developing coherent positive adjustment strategies in the West seems to be a superior long-run solution as it allows to reap the advantages of specialisation and to seize the additional export opportunities to growing Eastern markets.

5. Against this general background the present paper addresses business reactions to the opening of the East and labour market adjustment necessities from an Austrian perspective. The paper is organised in the following way: At first, the flows of goods, capital and labour after the opening-up of Eastern Europe are reviewed. The next chapter deals with business surveys: It reveals the affectedness of different branches and business strategies to meet the new challenges. The following chapter is looking further ahead, presenting an outlook on possible future macroeconomic and labour market developments.

6. Broadly speaking, it turns out that the type of structural changes experienced in the past will continue in the future. The big difference is, however, that due to the opening of the East these structural challenges occur suddenly at an enormous speed. This is true for the trends towards internationalisation and structural changes from basic, energy-intensive and low-wage industries to more sophisticated industries. On the labour market, in particular, the tendency towards a dual labour market, experienced in the past, has speeded up in the aftermath of East/West integration.

2. Patterns of East/West Integration Dynamics

2.1 Trade Flows

East/West Trade

7. Trade flows between East and West play a dominant role in the transition process, since the liberalisation of foreign trade is one of the main elements introducing market-orientation in the CEE economies. Moreover, trade usually comes prior to investment as it establishes contacts and the information basis for possible future joint ventures.

8. In terms of trade flows, OECD countries have clearly benefitted from East/West integration: OECD exports to East Central Europe (+61 per cent) rose much faster than imports (+34 per cent) from that region. The OECD countries ended up with an export surplus of \$ 4.5 billion vis-a-vis East Central Europe in 1992, within 4 years the trade balance had improved by \$ 5.5 billion. The bulk of higher export surpluses came from trade with Poland and former Czechoslovakia. On the West European side the increase of trade flows was concentrated on three "bordering"(!) countries, namely Germany, Italy and Austria. The observed medium-term improvement in the trade balances of these three bordering countries is in contrast to a long-run hypothesis put forward in a recent study by Holzmann (12). Here it has been argued that trade flows would be distributed asymmetrically: Exports of Eastern countries would be concentrated on neighbouring countries (due to the lack of marketing strategies), while imports would be distributed more evenly (coming also from overseas).

Table 1

	Trade balance, 1988 (Millions of USD)		Trade balance, 1992 (Millions of USD)		Trade balance, increase (in % of GDP) (Shares in %)		Total trade, 1988 (Millions of USD)		Total trade, 1992 (Millions of USD)		Total trade, 1988 (Shares in %)		Total trade, 1992 (Shares in %)		Total trade, increase (Millions of USD)		Total trade, growth in %	
Austria	26	847	820	0.44	15.0	2,922	6,263	6.7	9.7	3,342	16.2	114.4						
Belgium-Luxembourg	-95	346	441	0.19	8.1	996	1,965	2.3	3.1	969	4.7	97.3						
Denmark	-110	120	230	0.16	4.2	541	1,283	1.2	2.0	743	3.6	137.3						
Finland	-209	103	312	0.28	5.7	641	995	1.5	1.5	354	1.7	55.3						
France	-407	645	1,053	0.08	19.3	2,503	4,521	5.7	7.0	2,018	9.8	80.6						
Western Germany	651				0.0	10,983		25.1			0.0							
Eastern Germany	771				0.0	13,534		30.9			0.0							
Germany	1,422	853	-569	-0.03	-10.4	24,518	29,182	56.0	45.3	4,665	22.7	19.0						
Greece	-219	-46	173	0.22	3.2	444	931	1.0	1.4	488	2.4	109.9						
Iceland	-5	-12	-7	-0.10	-0.1	55	15	0.1	0.0	-39	-0.2	-72.2						
Ireland	-55	-49	6	0.01	0.1	163	196	0.4	0.3	32	0.2	19.7						
Italy	-953	268	1,221	0.10	22.3	3,448	6,778	7.9	10.5	3,330	16.2	96.6						
Netherlands	-94	353	447	0.14	8.2	1,356	2,933	3.1	4.6	1,577	7.7	116.3						
Norway	-94	168	261	0.23	4.8	360	581	0.8	0.9	221	1.1	61.3						
Portugal	-21	-31	-10	-0.01	-0.2	73	88	0.2	0.1	15	0.1	20.7						
Spain	-198	-186	12	0.00	0.2	523	986	1.2	1.5	463	2.2	88.4						
Sweden	-60	135	195	0.08	3.6	1,173	1,659	2.7	2.6	486	2.4	41.4						
Switzerland	424	637	213	0.09	3.9	1,180	1,401	2.7	2.2	222	1.1	18.8						
Turkey	-171	-337	-166	-0.15	-3.0	655	1,359	1.5	2.1	704	3.4	107.5						
United Kingdom	-238	599	837	0.08	15.3	2,267	3,265	5.2	5.1	998	4.8	44.0						
OECD Europe	-1,056	4,413	5,469	0.07	100.0	43,817	64,403	100.0	100.0	20,586	100.0	47.0						

Source: Austrian Chamber of Commerce, World Trade Data Base

Austria's performance in East/West trade

9. Austria takes a prominent part in Europe's East/West trade. After Germany and Italy, Austria holds the third highest share (9.7 per cent of OECD-Europe's East/West trade). Austria has on balance, as well as OECD-Europe, clearly benefitted from East/West integration. Her exports to East Central Europe rose by 141 per cent between 1988 and 1992, imports increased by 87 per cent. Thus, the trade balance vis-a-vis East Central Europe has substantially improved.

10. After an initial phase of rapidly rising exports, however, imports began to increase strongly. An increasing number of manufacturing industries came under pressure from low-cost suppliers. The representatives of those branches got alarmed by the observation that wage costs in East Central Europe were no more than one tenth of those prevailing in Austria. Partly, this was attributed by them to "exchange rate dumping". Furthermore low environmental standards and low energy and transportation costs ("environmental dumping") were blamed for increasing competitive pressures. With the gradual introduction of free trade for industrial products - following the EC and EFTA agreements with many Eastern European countries - protection claims for sensible products increased. While most economists were in favour of liberalisation, many politicians tended to protect the strongly affected industries.

11. The performance of different sectors in bilateral trade with three CEE countries (Czechoslovakia, Hungary, Poland) was analysed in a recent study by Aiginger et al. (2). Maybe due to data limitations, it was not possible to explain bilateral trade by factor endowments as suggested by trade theory. The only consistently significant determinant was skill intensity. The changes in RCA-values (1988-92), however, implied that Austria's competitive position improved in capital-intensive goods and deteriorated in labour-intensive goods. This is in line with the observation that in the transition period relative endowments have changed in CEE countries. Today capital is very scarce and labour is abundant.

2.2 Foreign Direct Investment

12. Foreign investment in Eastern Europe is usually called "joint venture". This notion was developed under communist regimes when foreign investors could hold only a minority in state-owned firms. This restriction has now been abolished in all Eastern countries. Foreign direct investment is an essential strategy to guarantee the competitive position of a country or an enterprise in the long run, mainly by lowering production costs. However, negative medium-term effects on domestic output and employment cannot be excluded.

13. Foreign direct investment is the major instrument for bridging the productivity gap between the West and the East by Western technology, modern management methods and access to Western distribution networks. However, total foreign investment in Eastern Europe has remained far behind expectations. The main reasons have been the stagnation of local markets and political or legal uncertainties.

14. In Austria, the opening-up of Eastern Europe gave new impetus to active strategies of internationalisation. Austrian entrepreneurs were able to take their investment opportunities in the East. More than one quarter of Austria's foreign investment was directed towards the East (1990/92). Now, Austria has a large share in the number of joint ventures in East Central Europe (about one fifth), she is the most important investor except Germany. Today nearly 10,000 firms in Eastern Europe (mainly smaller ones) are partially equipped with Austrian capital. The bulk of them in Hungary and the Czech and Slovak Republics. (Stankovsky (20)).

15. As trade usually comes before investment, Austria had a specific advantage in Eastern Europe. Due to geographical proximity and historical ties, the share of Eastern Europe in exports has been the highest among Western European countries (with the exception of Finland). Relatively high exports imply quite a good knowledge of markets and personal contacts to firms in East Central Europe. Due to this knowledge of markets investors have been able to judge better opportunities and risks. Furthermore, Austrian enterprises are typically small or medium-sized firms which are highly scarce in Eastern Europe.

2.3 Labour Market Adjustments

2.3.1 *Flows of Migrant Labour: Some Basic Considerations*

16. In recent years issues of international migration have been pushed to the forefront of economic policy agenda in many European countries. After stagnating during the first half of the Eighties, migrant flows into Western Europe have increased substantially in the second part of the decade. Even Southern European countries like Italy, Spain and Portugal, which used to be traditionally sending countries of migrant workers, have now become net immigration countries. Additionally, serious concerns have been raised that the already apparent rise in migration pressures from developing countries may be strongly accerbated by the emergence of new sending countries in Eastern Europe.

17. Obviously, it seems almost impossible to estimate the potential migratory flows from Eastern Europe with any satisfactory degree of precision given the large number of contingencies involved. However, under the presumption of reasonably stable conditions of living, truly large-scale migration may be regarded as rather unlikely. Based on observed migration behaviour in Europe and Mexico in the past, Layard et al. (15) have suggested that desired East/West migration over a period of 15 years might well be of the order of 1 million a year, roughly 0.3 per cent of the population of Western Europe; however, in case of severe political instability, major ethnic conflicts or famine, the numbers could clearly be much higher.

18. The increased flow of immigration into Western Europe has met with growing efforts to limit the number of immigrants by establishing more effective entry controls and limiting the number of available work permits for foreigners. These policies seem to have been mainly motivated by increasing

Table 2

Determinants of Investment in Eastern Europe

Ranking		Score ¹⁾
1	Political stability	115
2	Important market	71
3	Financial stability	47
4	Skilled workers	40
5	Profit opportunities	35
6	Geographical situation	33
7	Cost competitiveness	28
8	Currency convertibility	15
9	Infrastructure	10
10	Legislation	6
11	Potential export basis	5
12	Favourable tax system	2

¹⁾ International Survey carried out in Summer 1993

Table 3

Foreign Direct Investment in Eastern Europe

	Foreign Direct Investment			Number of Joint Ventures		
	Stocks at the End of 1992			Total	Austria	Austrian share of total as %
	Total	Austria	Austrian share of total as %			
	\$ Mill.	\$ Mill.				
East Central Europe	8,320	860	10.3	38,705	7,328	18.9
CSFR	1,820	140	7.7	11,825	2,908	24.6
Czech Republic	1,589	77	4.9	9,000	2,000	22.2
Slovak Republic	231	63	27.2	2,825	908	32.1
Hungary	4,850	600	12.4	16,780	4,000	23.8
Poland	1,650	120	7.3	10,100	420	4.2
Slovenia	830	215	26.0	1,650	340	20.6
South-East Europe	1,518	-	-	24,460	929	3.8
Former USSR	5,500	-	-	13,250	420	3.2
Eastern Europe	15,338	(1,075)	(7.0)	76,415	8,677	11.4

difficulties regarding the social and cultural integration of migrants in the receiving countries; but the mounting migration pressures have also raised serious concerns about the effects of immigration on the earnings and employment opportunities of the destination countries' resident population.

19. A common approach of the immigration-welfare literature models immigration flows as exogenous shifts in the supply of labour to geographically defined labour markets. Under standard neoclassical assumptions, the following propositions regarding the economic consequences of such labour supply shocks in the receiving country can be derived (Greenwood-McDowell (10) and Meier-Wenig (16)):

- The wage rate declines: Immigrant workers enlarge the existing labour force in the receiving country and, therefore, exert downward pressure on real wages. The magnitude of the decline of the wage rate depends upon the elasticities of domestic labour supply and labour demand and may also be affected by the existence of immigration quotas.
- Total employment rises: Lower real wages lead to higher overall employment in the receiving country.
- Native employment declines: Assuming that immigrants are willing to work at lower wages, they will partly displace the native labour force. The displacement effects will tend to be greater the more elastic the domestic labour supply and the less elastic the labour demand.
- Total native labour earnings decline: As a result of the lower wage rate and non-negative displacement effects, the natives' total income from labour declines. However, depending on capital endowments some of the natives will be more than compensated by increased interest income, while other wage earners will suffer because their decline in labour earnings is not offset by an increase in capital income.
- Total returns on capital rise: The increase in the labour force changes the capital-labour ratio inducing a shift in the wage-interest ratio.
- Total output increases: Inflows of labour (and capital) into the country of immigration result in increased economic activity and, therefore, higher total output.
- Earlier immigrants' income may decline: Given that their skills are similar to those of the new immigrants or that they compete for the same jobs, earlier immigrants are likely to experience declining wage rates as a result of inflows of new migrant labour into their local labour market.

20. The basic message from this literature, however, is that immigration, in general, raises native well-being. Clearly, there may be winners and losers and the average income of the whole economy may fall, but the change in total

native income is predicted to be positive. In principle, therefore, compensation mechanisms could be designed that make everybody better-off. Thus, there exists a complete analogy with free trade arguments; indeed, under standard assumptions trade in goods and factors are perfect substitutes, producing the same long-run outcomes. It should be noted, though, that standard economic analysis may fail to take account of the full costs of immigration given that a massive inflow of foreigners may give rise to negative consumption and production externalities or may meet with resistance by the resident population because of differences in social and cultural norms (Freeman (8)). Against this background, the crucial importance of free trade and/or of flows of capital for mitigating the pressures of migration is evident; indeed, access to Western markets and unrestricted flows of foreign direct investment may be regarded as the best response to the threat of mass migration.

2.3.2 Adjustments in the Austrian Labour Markets

Overall Developments Since 1989

21. This section provides a brief overview of labour market developments in Austria since 1989. Against the background of a rapid increase in foreign labour supply in 1990/91 it focusses on the absorption mechanisms of this supply shock in the domestic labour market.

22. After a period of sluggish growth in 1986/87, the Austrian economy entered into a boom phase in 1988. Fuelled by both foreign and domestic demand real GDP growth attained rates of 4 to 4 1/2 per cent in the period between 1988 and 1990 and showed only a modest decline to 3 per cent in 1991. With the usual lag due to pro-cyclical productivity developments, the strong expansion of output was accompanied by a sharp rise in the demand for labour. Growth of total dependent employment was 1.8 per cent in 1989, accelerating to 2.3 per cent both in 1990 and 1991. However, while the rate of registered unemployment had fallen to 5 per cent in 1989, it rose by almost one percentage point in the course of the two subsequent years. Obviously, in a mechanical accounting sense the rapid employment growth in 1990/1991 had been outpaced by an unusually fast expansion of the labour force, mainly due to massive inflows of foreign workers.

23. Several economic and institutional factors may have combined to account for the sharp increase in foreign labour supply at the turn of the decade. The rapid expansion of output and employment gave rise to tighter labour market conditions, confronting firms with increasing difficulties to fill vacant jobs at given wages; indeed, econometric estimates seem to indicate that the Austrian unemployment rate was already close to the NAIRU in 1989 (Pichelmann (19)). Thus, demand-pull elements attracting migrant labour have certainly played some role in the rapid build-up of the foreign labour supply. However, several institutional regulations facilitating immigration and foreign employment, e.g. efforts to integrate the growing number of refugees and asylum-seekers, more generous procedures regarding family unification, and, in particular, the introduction of a new nation-wide quota system seem to have been important contributing factors as well.

24. As a result foreign labour supply in Austria increased sharply by some 110,000 workers in the period 1990/1991 pushing the share of foreign labour in the total labour force from about 6 per cent to more than 9 per cent within two years. It may be interesting to note that, contrary to widespread public perceptions about the major source countries, two thirds of the additional foreign workers originated from the traditional guestworker countries Yugoslavia and Turkey. Immigrants from the CSFR, Hungary and Poland, on the other hand, accounted for only about 10 per cent of the inflow of migrant labour. By 1992, workers coming from the CEE5 (CSFR, Poland, Hungary, Romania and Bulgaria) had reached a share of one sixth in total foreign employment.

Cross Border Regional Integration

25. Austria's Eastern region strongly benefitted from the opening-up of Western Europe. The development of real GDP in Burgenland (near the Hungarian border) e.g. was much more favourable than in the rest of Austria. In particular, positive impulses to employment were given by East/West integration. Employment rose by about 2 per cent per year in the Eastern region, in the border regions even by 2.3 per cent in the period between 1989 and 1992. This increase in employment was higher than on the Austrian average, before liberalisation it was far below. Foreign workers, particularly in construction, tourism and trade, were the decisive factor for this evolution of employment.

26. There appears to be a difference between the development of manufacturing and services. Manufacturing employment in the border regions was reduced by 3.8 per cent from mid 1991 to mid 1992, much faster than on average. Employment in the service sector and in construction, however, substantially increased. This tends to confirm that manufacturing industries in the border regions (mainly low-wage industries) are under strong pressure from Eastern low-wage competitors. Labour cost reductions achieved by commuters from the East may only postpone the necessary structural adjustments.

27. There was a large relative increase in vacancies in the Eastern region, but unemployment was rising at about the same rate as in the rest of Austria, mainly due to the legal and illegal inflow of foreign workers. They were usually commuters who spend most of the earned money in their home country. In the Eastern region, 70 per cent of the employment increase can be attributed to foreign workers. In the border regions, even the total increase of employment was due to foreign workers, native employment even slightly decreased. In terms of growth and employment, the picture is certainly not negative if we take into account that the Eastern region had fallen further backward in the decade before. However, GDP per capita was dampened.

Assessing the Macroeconomic Impact of a Labour Supply Shock

28. The following assessment of the macroeconomic effects of the sketched inflow of foreign workers is based upon simulation analysis of a large-scale macroeconometric model of the Austrian economy. The model has been built at the Institute for Advanced Studies and is in regular use to produce the Institute's

quarterly forecasts for the Austrian economy. The model consists of approximately 400 equations and may well be characterised as a fairly conventional Keynesian macro model incorporating some neoclassical elements, in particular with respect to the determination of potential output and the derivation of factor demand relations. Another important feature of the model is the sluggish adjustment of wages and prices to output gaps and/or to deviations of actual unemployment from its equilibrium level.

29. The scenario for the simulation analysis has been designed as follows. As a starting point a reference model solution was produced for the period between 1990 and 1995 using realised values for 1990 to 1992 and forecast values thereafter. In the simulation exercise foreign labour supply was reduced by 50,000 in 1990 and another 60,000 in 1991. For the convenience of the reader we then simply use the simulation solution of the model as a baseline which is compared with the reference model solution over the entire period of analysis.

30. The results of our simulation exercise clearly demonstrate the transmission mechanisms of a labour supply shock affecting both the demand side and the supply side of the economy. The sharp rise in labour supply puts downward pressure on wages and, despite some moderating impact on price inflation as well, results in a reduction of real wages compared to the baseline. The negative impact upon wages is mitigated to some extent by a reduction in domestic labour supply induced by the deterioration of employment prospects, but this effect turns out to be quantitatively of minor importance. The reduction in wages, however, does not fully translate into a decrease in unit labour costs in the medium run because of induced productivity effects with labour productivity falling below the baseline. The potential output of the economy, however, has unambiguously increased. The demand side effects turn out to be favourable as well. While private consumption remains nearly unaffected, both investment and net exports respond positively to the labour supply shock due to an increase in profitability and improvements in relative competitiveness. In summary, according to our estimates GDP was raised by one quarter of a percentage point in the short run and by about three quarters of a percentage point in the medium run. However, these positive outcomes have to be weighed against a significant increase in unemployment and, last not least, against a reduction in per capita GDP.

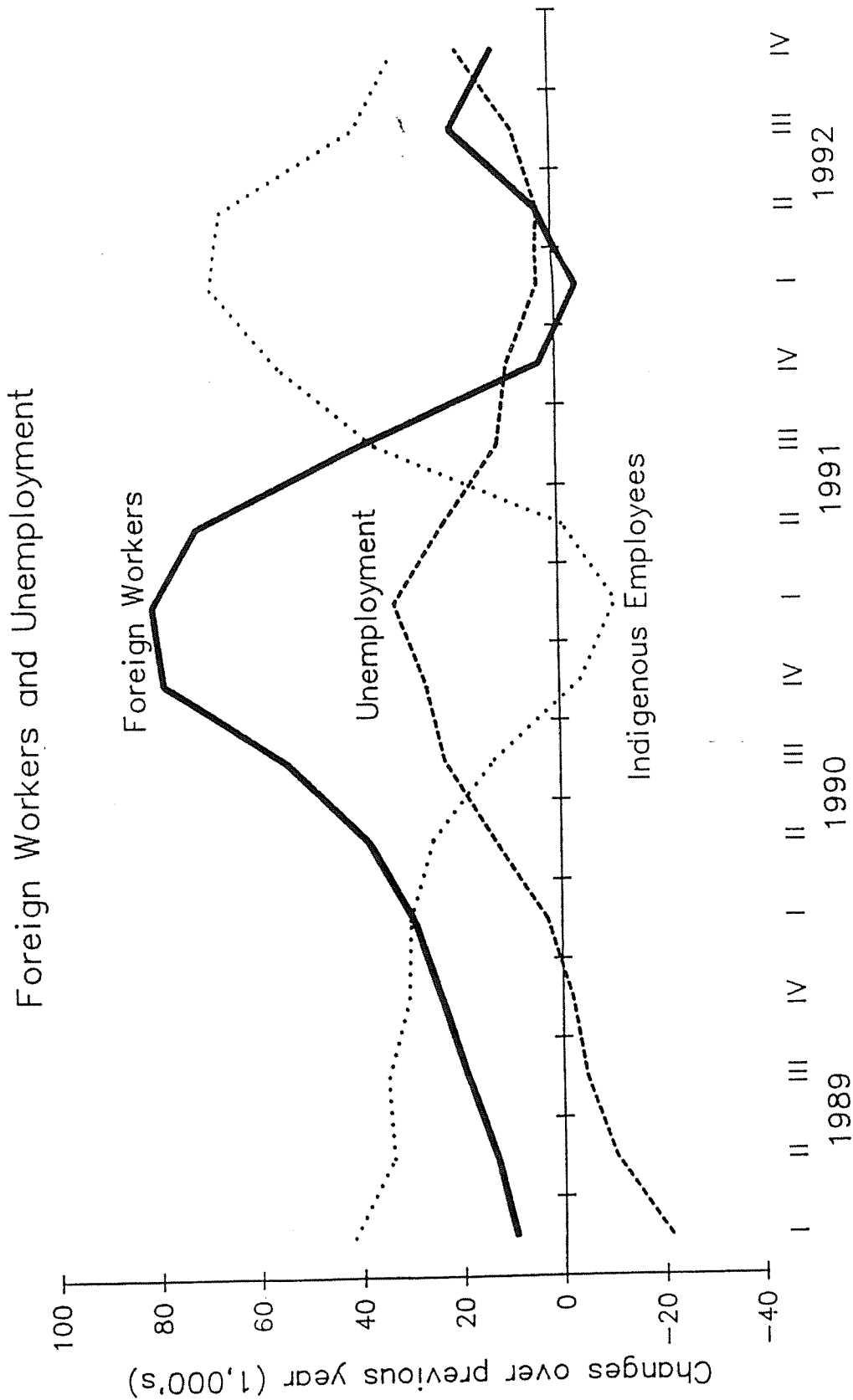
Table 4

Macroeconomic Implications of the Labour Supply Shock 1990/91

	Deviation from the Baseline	
	Short-Run	Medium-Run
	in per cent	
Gross Wages per Employee	- 0.7	- 3.7
Unit Labour Costs	- 0.7	- 2.7
Labour Productivity	-	- 0.7
Capital Productivity	+ 0.2	+ 0.6
GDP + 0.2	+ 0.8	
GDP per Capita	- 0.8	- 1.3
	in 1,000s	
Domestic Labour Supply	- 5	- 15
Employment	+ 5	+ 49
Unemployment	+ 39	+ 45

31. In the interpretation of the results of this simulation exercise it should be kept in mind, however, that the highly aggregated approach of the analysis comes short of identifying the sectoral and occupational distribution of foreign employment in Austria. In fact, foreign workers tend to be heavily concentrated in manufacturing and service jobs of average and low qualification; in 1992, for example, foreign workers accounted for more than one quarter of total employment in agriculture, textiles, leather, hotels/restaurants and cleaning, and for about one fifth in construction (Biff1 (4)). Thus, the main labour market costs of immigration - through reduced earnings and employment opportunities - may have fallen to a large extent on specific groups of workers whose skills compete with those of immigrants (for some microeconomic evidence on displacement effects see below). These effects of immigration on the distribution of income may be part of an explanation for the wide-spread resistance of the resident population against rapid increases of foreign labour. In our view, any sustainable immigration policy must therefore be complemented by a reasonable redistribution of the overall gains from immigration.

Chart 1



Recent Developments

32. The rapid growth in foreign labour supply petered out in late 1991, mainly because the Austrian authorities put a brake on the further inflow of foreign workers, but also in line with a gradual weakening of economic activity in response to a slump in exports. Austria had benefitted from the surge in German imports following unification and from additional export opportunities in Central and Eastern Europe, but her outlier position in the European business cycle gradually came to an end. GDP growth slowed to 1.5 per cent in 1992 and in early 1993 the economy moved into recession. Weak activity abroad, notably in Austria's main trading partner Germany, and a largely exchange-rate-induced worsening of international competitiveness have been the main factors behind the fall in demand and output. As a result, for the first time in more than a decade real GDP has declined in 1993.

33. Employment so far has stayed on a higher level than suggested by the fall activity showing only a small net decline, thereby implying more or less stagnant aggregate labour productivity. On a sectoral level, however, net job losses in manufacturing amounted to some 45,000 with relative employment losses being particularly pronounced in the textiles, clothing and leather industries; in absolute figures, the metal industry was most badly hit. Obviously, at the present stage it seems close to impossible to neatly disentangle the cyclical and the structural component behind these job losses. However, casual evidence suggests that newly emerging competitors and/or the relocalisation of production activities may be partly responsible for employment losses in specific manufacturing industries. Despite a rather moderate decline in overall employment, recent job losses caused unemployment to rise by about one percentage point, reaching a new record level by Austrian standards because of the already high pre-recession level.

Patterns of Labour Reallocation

34. The newly emerging trade patterns will almost certainly exercise strong pressures for structural adjustments in domestic labour markets. These pressures do not only arise from trade links, but also from foreign direct investments which result in the relocalisation of production from high-wage to low-wage economies. However, the reallocation of labour from shrinking to growing activities could be regarded a normal feature of labour market dynamics in any economy actively coping with structural change. In fact, even small net employment changes in the course of a year are usually accompanied by large gross job flows as jobs are created in expanding or newly born firms and, simultaneously, jobs are lost in contracting or dying firms.

35. The empirical evidence assembled in the Interim Report on the OECD Employment/Unemployment Study (18) illustrates clearly that in the past decade labour markets in advanced industrialised economies have been characterised by quite high rates of job turnover. Broadly speaking, in all countries reviewed (Canada, Germany, Italy, UK and US) annual job turnover (defined as the sum of job creation and job destruction at the establishment level) amounted to around 20 per cent of average aggregate employment.

36. Thus, while the pace of net employment growth has clearly been much faster in the US, Western European labour markets do not seem to have differed very much from North America's with respect to the relative amount of gross job flows. This observation also holds true for the Austrian labour market. Empirical evidence derived from a representative sample of Austrian firms operating in the market sector of the economy (Social Security Employment Data Panel, SSEDP) suggests that in the period between 1989 and 1991 annual job turnover rates were in the range of 12 to 13 per cent (IAS 13)). As these figures refer only to continuously existing establishments (birth and death of firms is not included), the relative size of gross job flows in Austria seems to be roughly in line with job turnover in other countries.

37. In the period under consideration, annual job losses in Austria in continuing firms were in the range of 4 1/2 to 6 1/2 per cent. That is to say, even during a cyclical boom accompanied by rapid growth of aggregate employment an estimated 100,000 jobs have disappeared per year. Obviously, this figure has to be treated with some caution given unavoidable definitional problems and data limitations, but it is indicative of the reallocation dynamics in the Austrian job market which is sometimes said to be characterised, inter alia, by rather immobile labour.

38. It is important to note at this point, however, that the pace of structural change in the production structure of the economy should not be overestimated from these figures on aggregate job turnover. This qualification arises from the fact that the majority of job creation and job destruction took place within industries and not between industries. At a sectoral level (classification into 26 industries) only about one third of total job turnover was due to the reallocation of jobs between industries.

39. In the period from 1989 to 1991, the size of the two components of job turnover has varied to a considerable extent across industries; this may not only reflect differing demand conditions, but also e.g. different production technologies, differences in average size of firms and so on. In the ranking of industry-specific job turnover rates tourism, i.e. hotels and restaurants, came out first, followed by construction, trade and personal services. In manufacturing, job turnover rates corresponded broadly to the average. A further disaggregation of the manufacturing sector seems to indicate that, again, more than half of the total job reallocation in the sector took place within specific industries; above average job loss rates were recorded in the chemical industry and in some consumer goods industries. While caution should be exercised in the interpretation of these disaggregated results given the sample size limitations, it may be interesting to note that the ranking of industry-specific job turnover rates is strikingly similar to that obtained for other countries (OECD (17)).

40. Job turnover necessarily implies labour turnover, but not vice versa. Therefore, job turnover rates are an indication for somehow the minimum amount of labour turnover to be processed in the market. Empirical evidence from the SSEDP indicates that in the Austrian labour market labour turnover (measured on a daily basis) exceeded job turnover by a factor of about four to five. Over the period from 1989 to 1991 average monthly separation rates - whether

voluntary or involuntary - in the market sector of the economy amounted to slightly below 4 per cent of the workforce. Thus, broadly converted to aggregate figures and adjusting for lower turnover in the non-market sector, more than 1 million employment contracts were - at least temporarily - terminated each year.

41. In general, job turnover and labour mobility are indicative for quick adaption to structural change; however, against the background of a parallel rise in both employment and unemployment registered in that period, serious concerns have been raised that labour market turnover may to a large extent have reflected displacement and substitution between different categories of workers, in particular induced by the inflow of cheap foreign labour.

42. While the available micro evidence from the SSEDP on this question is still rather sketchy and clearly incomplete, the following broad picture seems to emerge from an analysis of employment patterns in continuously existing firms (IAS 13): In expanding firms, the employment share of newly employed foreign workers rose quite sharply to nearly 6 per cent, partly at the direct expense of earlier immigrants whose employment fell in absolute terms. In firms exhibiting roughly unchanged employment over the period between 1989 and 1991, "new" immigrants gradually built up a share of 2.5 per cent in the total workforce of these firms, with the corresponding fall in employment of other workers being slightly more pronounced for natives than for earlier immigrants. Around 12 per cent of the total workforce were employed in shrinking firms characterised by falling employment of natives and rising employment of foreigners, concentrated in particular in textiles, food processing, chemicals and personal services.

43. Regarding average wages a simple rule of thumb seems to be applicable. While earlier immigrants received, on average, about 80 per cent of the wages of native workers, average wages of newly employed foreign workers were another 20 percentage points lower. Average wage increases of native workers and earlier immigrants, however, have been negatively correlated with employment growth across firms. Thus, combining the shifts in employment structures with an analysis of wage dynamics does indeed suggest that the registered losses in employment shares have been concentrated upon low-paid natives and earlier immigrants.

44. The outlined restructuring of employment patterns and the associated reallocation of labour does not necessarily involve an inevitable increase in unemployment during a period of net aggregate employment growth. However, given the large size of the flows involved as indicated above, a considerable extent of frictions in this process should come as no surprise. Again, evidence from the SSEDP may serve as an illustrative example as it allows to follow for some time the employment careers of workers who separated from their firms. For example, in a cohort of workers terminating employment in June 1989 or 1990, around 20 per cent of the separating workers moved into unemployment and did not regain employment within six months; when the separation occurred from a shrinking firm, which may serve as a weak indicator for a lay-off rather than a quit, this risk approximately doubled. Among the observed personal characteristics age turned out to be a major risk-enhancing factor with very low re-employment probabilities of older workers (IAS 13)).

Table 5

Employment Patterns at Firm Level
(Yearly Averages)

All Firms

	Employment (1989 = 100)			Shares in %		
	Natives	Foreign Workers "Old"	Foreign Workers "New"	Natives	Foreign Workers "Old"	Foreign Workers "New"
1989	100.0	100.0	100.0	96.1	3.0	0.9
1990	100.8	83.8	341.5	94.5	2.5	3.0
1991	100.0	71.6	497.8	93.6	2.1	4.3

Expanding Firms

	Employment (1989 = 100)			Shares in %		
	Natives	Foreign Workers "Old"	Foreign Workers "New"	Natives	Foreign Workers "Old"	Foreign Workers "New"
1989	100.0	100.0	100.0	95.4	3.5	1.1
1990	113.2	87.2	466.7	93.0	2.7	4.3
1991	123.8	78.6	691.2	92.0	2.2	5.8

Firms With No Change of Employment

	Employment (1989 = 100)			Shares in %		
	Natives	Foreign Workers "Old"	Foreign Workers "New"	Natives	Foreign Workers "Old"	Foreign Workers "New"
1989	100.0	100.0	100.0	97.2	2.3	0.5
1990	97.1	90.3	300.0	96.3	2.1	1.5
1991	97.0	80.7	480.6	95.7	1.9	2.4

Contracting Firms

	Employment (1989 = 100)			Shares in %		
	Natives	Foreign Workers "Old"	Foreign Workers "New"	Natives	Foreign Workers "Old"	Foreign Workers "New"
1989	100.0	100.0	100.0	95.1	3.6	1.3
1990	89.1	72.3	214.9	94.0	2.9	3.1
1991	70.2	51.5	274.5	92.5	2.6	4.9

Source: SSED, IAS (1993).

45. In general, though, turnover in the Austrian unemployment pool is relatively rapid in international comparison, partly due to the high share of seasonal unemployment. The importance of efficient matching processes in the labour market is clearly illustrated by the fact that, in 1992, inflows into unemployment were close to 600,000, or roughly 18 per cent of the labour force; but with outflows from unemployment in approximately the same order of magnitude, the rate of unemployment remained nearly constant. However, if the observed transition patterns in the Mid-Eighties were of any guidance, only about one third of the registered spells may have reflected a move between different jobs; the other spells of unemployment have probably been characterised by temporary-layoffs and transitions to and from inactivity in roughly equivalent proportions (Fischer-Pichelmann (7)).

3. Business Surveys

3.1 *Affectedness of Different Sectors and Branches*

46. While trade flows and joint ventures reveal the reactions of entrepreneurs in recent years, business surveys can point somewhat ahead, assessing the medium-term affectedness of different industries and their strategies to meet the new challenges.

47. The Austrian Institute of Economic Research (WIFO) carried out a business survey (1) on the effects of East/West integration. 847 enterprises with 258,000 employees were included in this survey, about 90 per cent answered the questionnaire. An outstanding result of this survey was that there is high pressure of restructuring, but the majority of enterprises is optimistic to overcome the difficulties: For 62.6 per cent of all enterprises the opportunities prevail, for 37.4 per cent the risks are higher than the chances.

48. The survey shows how different branches are affected by the opening-up of Eastern Europe. Highly positive is the assessment in chemical, electronic and paper industries. On the other hand, risks are stressed in the building materials sector (sawmills, minerals, pottery). Generally, the judgement is more positive in medium-sized enterprises and rather balanced in big enterprises. Moreover, those firms which had made a step towards the East before were much more optimistic.

49. Another business survey was carried out by Glatz (9), based on 42 large Austrian manufacturing companies representing 115,000 employees. This survey, carried out later than the WIFO-survey, was generally somewhat less optimistic than the first one (particularly concerning plant closures): One half of the surveyed Austrian firms considered the opening-up of Eastern Europe as an opportunity, one quarter as a big threat. The industries suffering the most from East European competition were - according to both surveys - producers of building materials, traditional consumer goods (shoes, furniture) and agricultural machines.

50. A similar business survey (6) was carried out in Switzerland. Export opportunities for Swiss firms turned out to be greatest in chemicals (far ahead), followed by engineering and synthetics - and in the long run also for

Table 6

Opportunities and Risks of East/West Integration

	Chances	Risks
	As %	
Mining	54.5	45.5
Iron and steel	37.5	62.5
Non-ferrous metals	58.3	41.7
Stones and ceramics	40.6	59.4
Glass and glass products	50.0	50.0
Chemicals	72.9	27.1
Paper	80.0	20.0
Paper products	67.9	32.1
Saw mills	20.7	79.3
Wood products	52.9	47.1
Food, beverages and tobacco	68.9	31.1
Leather products	57.1	42.9
Textiles	51.0	49.0
Clothing	46.2	53.8
Foundries	25.0	75.0
Engineering	71.3	28.7
Vehicles	72.7	27.3
Metal products	68.4	31.6
Electrical machinery	83.8	16.2

Source: Wifo-Business Survey for Austria

53. The second Austrian business survey was, however, much more pessimistic on plant closures. According to this survey, one third of manufacturers are expecting plant closures in Austria. The difference may be due to the concentration in this survey on large enterprises with many sites. Most seriously affected will be wood, clothing, shoes and vehicles industries.

54. A major strategy to meet the new challenges is increased production in Eastern Europe. Two thirds of the surveyed large enterprises do have plants in Eastern Europe, one third of their staff working abroad is working in Eastern Europe. Production in Eastern Europe mainly serves to satisfy the demand of Eastern European countries and to supply goods or components to Austria.

55. In the WIFO survey the reasons for production in Eastern Europe were explored. Nearly all firms (88 per cent) argued with lower wage costs (particularly for cheaper component supplies to Austria). Other important factors were

- vicinity to sales markets satisfying demand in Eastern Europe (37 per cent): For chemical and food industries this was nearly as important as the wage argument;
- lower energy costs (24 per cent): e.g. for the suppliers of building materials and basic industries;
- lower environmental costs (21 per cent) - particularly for paper, steel and metal industries;
- lower transport costs (18 per cent) - crucial for building materials.

4. Looking ahead: Macroeconomic scenarios

4.1 Macroeconomic Scenarios and New Trade Patterns

56. A large part of international research on the transition process of Eastern European countries to market economies has been devoted to the economic and political reforms in the transition countries. Considerably less emphasis has been placed on analyses of the likely patterns of future East/West trade and its implications for structural change in the West. Obviously, given the historical uniqueness of the process under consideration any outlook on the new international division of labour, which is likely to emerge in the future, is clouded with many uncertainties and, therefore, has to remain necessarily quite speculative in nature.

57. However, based on relative factor endowment considerations at a fairly general level, several qualitative predictions regarding structural adjustment necessities seem to be largely uncontroversial. Highly industrialised countries will have to concentrate more strongly on new products and production technologies that cannot be quickly imitated by low-wage producers; this

implies that they will have to rely more heavily on human capital intensive goods and services (with early specialisation and continuous learning processes) as well as on marketing strategies and distribution systems.

58. The biggest threat will probably be faced by labour intensive industries in the West, particularly those with low wages per employee (as a proxy for unskilled labour). The relocation of labour intensive production to countries with lower unit costs will be imperative, but the speed of this process may depend on the degree of political and economic stability in the transition countries. On the other hand, substantial export opportunities to Eastern Europe, in particular with respect to skill intensive goods and services, will undoubtedly open up for Western producers, which should allow to offset the increase in imports. Thus, in the long run both regions are likely to capture welfare gains from integration - to an extent largely dependent on the take-off in the East.

59. One of the main differences between the two worlds - the West and East countries - is the large gap in productivity and hence in real wages. The reasons for the productivity gap are broadly speaking:

- backward technology, which requires investment to change;
- defective organisation, neglecting distribution systems and repair services, which calls for a new generation of managers;
- inadequate motivation and discipline of the workers, to be restored by a climate of democracy.

60. There are essentially two scenarios for the long-run development of the Eastern countries of Europe:

- a pink scenario - we might call it the South-East-Asia scenario,
- and a black scenario - we might call it the mezzogiorno scenario.

61. The pink scenario is characterised by the following features: If, in the long run, there is a scarcity of skilled labour in the West or if unit labour costs are expected to remain low in the East, then the manufacturing industries will have an incentive to move production to the East.

62. The firms moving in from the West will bring in better management and organisation and better technology (partly embodied in equipment) which may be imitated by domestic firms. In the course of a fairly long series of years productivity and real wages may gradually approach the level of the West.

63. The black scenario is dominated by the fact that manufacturing industry in the East may, in the long run, not be able to withstand the quality competition from the West (not even with the protection of a low exchange rate) and it will therefore dismiss more and more employees. With mass unemployment,

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destroyed skills and low domestic demand the East will not be attractive to foreign investors and condemned to stagnation. This would also destroy the chances that Western industries might have under more favourable conditions. Of course, Western countries will benefit the more from East/West integration, the better economic developments in the East will be.

64. There is one factor which is absolutely crucial when it comes to choose between the two scenarios: it is infrastructure. This is really run down in the former socialist countries and its restoration must have political priority. A typical example is computer networks. Infrastructure in the wider sense also includes the distribution system and repair services, the whole network of small and medium-sized firms.

65. But who will pay for infrastructure in the Eastern countries? Here, the need to secure credits on cheap terms is most pressing. A decisive question is therefore the interest policy of the Western countries. Only a low real rate of interest will make it possible to finance the required tasks without heaping up insoluble problems of servicing the debt.

66. Various studies, mainly based on the gravity model approach, have tried to estimate the East/West trade potential and its geographical structure under market conditions arriving at the general conclusion that in the long run East/West trade should amount to a multiple of the trade flows before starting the transition process (see e.g. Collins-Rodrik (5), Wang-Winters (21), Hamilton-Winters (11), Baldwin (3), Holzmann-Petz-Thimann (12), Kramer (14)). Despite the somewhat unclear theoretical foundation of the gravity model approach, these estimates are indicative of the potential size of future trade reorientation. It should also be noted, however, that the results from these models do not seem to be very robust with respect to various underlying assumptions regarding e.g. the grouping of relevant comparison countries' trade patterns, income growth in Eastern Europe and the speed by which the gap between potential and actual trade flows can be closed. Furthermore, this approach remains salient about the commodity structure of future trade patterns which, obviously, will have a significant impact upon the distribution of market shares. Relative factor endowment considerations, on the other hand, also face substantial difficulties as they tend to be hampered by various factor price distortions which are only gradually being removed.

67. Nevertheless, some general conclusions may be drawn from the existing literature:

- The overall development of East/West trade will crucially depend on the development path of Eastern European income levels. Due to their enormous size, the development of the countries of the former Soviet Union will play an important role as potential export markets for Western products.
- Another central factor will be capital flows towards the East, modernising East European production structures and increasing incomes. In case of lacking capital flows CEE-countries might use their low wage level as a comparative advantage and try to enter Western markets in labour-intensive, low-wage branches. The

combination of low labour, energy and environmental costs and extremely low exchange rates (compared with purchasing power parities) may provoke protectionist measures in the West for the rather small range of products concerned.

- A rapid modernisation of the physical capital stock, on the other hand, might enable the CEE-countries to make better use of their relatively rich endowment with a skilled workforce. In that case, Est/West trade flows might increasingly resemble the intra-industrial trade structures of industrial countries. Accordingly, factors like economies of scale and oligopolistic market structures could shape trade patterns much more than relative resource endowments.
- Relatively independent from Western capital flows, some Eastern European countries may become important suppliers of energy, raw materials and agricultural commodities.

4.2 A "Fuzzy Outlook" on Future Labour Market Challenges

68. Despite the large uncertainties surrounding all presently available forecasts about the future size and structure of East/West trade flows, some conjectures about labour market adjustments, which seem inevitable in the medium-run, can be made. Obviously, the gains from trade expansion have been and will continue to be very unequally distributed among workers. Thus, even under balanced trade, a significant number of gross job losses and/or strong pressures on wage differentials and the remuneration of factors have to be expected.

69. The Austrian Institute of Economic Research (WIFO), for example, has arrived at an estimate of medium-run production losses in the magnitude of some 6 per cent of manufacturing output due to increased import penetration from the East and some ousting of Austrian products on third markets. Assuming a below average productivity of the production affected, this output loss translates into the destruction of some 35,000 jobs. As for other sectors of the economy (agriculture, services), the WIFO estimated some more 15,000 workers to be replaced as a result of increased competition from the East. These job losses, however, have to be weighed against the new jobs potential created by additional export opportunities which, according to the WIFO estimates, is likely to even outnumber the disappearing jobs. Thus, the net employment effect of the newly emerging trade patterns with the East should be positive, amounting to approximately 1/2 per cent of the Austrian labour force over a 3 to 5 years time horizon.

70. A much more optimistic assessment of the medium-term impact of the opening of Eastern Europe on the Austrian economy has been provided by the Institute for Advanced Studies. Based on a simulation exercise using the Institute's macroeconometric forecasting model, it is estimated that over the period between 1990 and 1995 the (cumulated) growth stimulus to the Austrian economy may amount to about 2 1/4 per cent of GDP; this, in turn, should translate into a net addition of some 50,000 jobs compared to the baseline solution (Wörgötter (22)).

71. Estimates of the "job-threat" to the Austrian economy, however, seem to have gradually increased over the last six to twelve months. A recent study by Holzmann-Petz-Thimann (12), investigating into differential impacts of future East/West trade upon "Crescent Countries" (i.e. neighbouring CEE-countries), other OECD-Europe, and non-Europe OECD, arrives at the conclusion that countries geographically closer to the reform countries must be expected to be exposed to relatively larger import shocks, with Austria being strongest affected in the group of crescent countries (Finland, Sweden, Denmark, Germany, Austria, Italy and Greece). Calculating a would-be figure of Austrian unemployment if no adjustment were undertaken and no additional export opportunities were exploited, the authors estimate job losses in the magnitude of some 150,000 over a period of 10 years.

72. Based on his survey results on expected sales, plant relocations and establishment closures, Glatz (9) put the number of expected gross job losses at some 145,000 in manufacturing alone. On the other hand, he derives an estimated potential of new jobs in manufacturing in the magnitude of about 100,000; thus, net employment losses in manufacturing industries may amount to some 45,000 jobs, i.e. close to 10 per cent of total employment in this sector.

73. Thus, while the confidence intervals around these point estimates of threatened jobs are rather wide, there can be little doubt that the likely shifts in the patterns of East/West trade, reflecting changes in patterns of comparative advantage, will significantly contribute to job displacement, in particular in low-wage labour-intensive manufacturing industries. Moreover, strong tendencies for downward pressure on real wages, probably accentuated at the bottom end of the wage distribution, are likely to emerge as factor remunerations are affected by relative product price changes according to the Samuelson-Stolper predictions.

74. In terms of standard economic analysis, trade with (low-skill) labour-abundant countries raises the demand for capital while lowering that for (low-skill) labour. The textbook result is a fall in real wages to restore previous employment levels, or alternatively a reduction in employment at a given real wage. Thus, in both a formal and an economic sense, trading with a more labour-abundant country is similar in its effects to a strongly labour-saving technological change. It should also be noted in that respect that pressures on employment may not only show up in direct job losses associated with growing import penetration, but also in form of trade-induced labour productivity growth resulting from the elimination of inefficient firms and intensified efforts to cut costs and invest in new technologies in order to remain internationally competitive.

75. Thus, the opening-up of Central and Eastern Europe may accentuate an already apparent trend in the skill composition of labour demand running against the employment prospects of unskilled workers. While education, training and the continuous upgrading of skills are certainly the main road to go in this respect, a decrease in the relative cost of unskilled labour may prove indispensable as well in order to stimulate sufficient employment creation in the non-tradeables sector to compensate for job losses in tradeables. Thus, the challenge of positive adjustments in the labour market is

not only defined in terms of enhancing job creation and facilitating the reallocation of labour from shrinking into growing activities, but also in terms of maintaining a socially acceptable distribution of incomes generated in the economy.

76. Broadly speaking, the reallocation of labour made redundant will be more difficult, *ceteris paribus*, the greater the "distance" along various dimensions, for example skill requirements (probably related to personal characteristics like e.g. age), wages, geographical area etc., between the disappearing jobs and the new jobs; however, always provided new jobs are created at all. In particular, when specific skills are an important aspect of the employment relation, redundant workers may take some time to find alternative jobs; and if the loss of specific skills and the associated wage premium eventually has to be accepted, specific capital no longer provides a buffer between productivity and the value of employment elsewhere or non-employment, so turnover from new jobs, probably associated with recurrent unemployment, may be rapid. Even with a constant number of total jobs potentially available in the economy, an increase in labour reallocation requirements is, therefore, likely to push up unemployment if not countered by appropriate policy actions.

77. However, in so far increased labour turnover also reflects rising mobility of individuals through the earnings structure, the equity concerns inevitably associated with higher wage differentials may be considered as less serious. Furthermore, shifts in the structure of labour taxation could help in reducing wage costs of unskilled labour while preserving net wages of low-paid workers. In general, given the inherent trade-off between wages and employment on the demand side of the labour market, government tax and transfer programs may indeed offer a much more powerful mechanism than institutionalised pay compression for reducing inequality.

5. Summary and Policy Conclusions

78. The opening-up of Eastern Europe has been a great challenge for Austria. The tendencies towards internationalisation and structural change observed in the past have been speeded up. However, the sudden need for rapid adjustment seemed too fast for some industries (cement, steel etc.). On the labour market the trend towards a dual labour market accelerated.

79. East/West integration has been characterised by higher trade and capital flows. Austrian companies were able to exploit the potential of geographical proximity. Exports to East-Central Europe more than doubled within four years, the trade balance vis-a-vis these countries improved substantially, and direct investment flourished. There are now about 10.000 joint ventures of Austrian firms in Eastern Europe, which offer new opportunities for the staff of these firms to develop abilities and competence abroad.

80. On balance, the increase in net exports stimulated growth and employment. However, job creation and job destruction did not occur in the same places. East/West integration increased the potential for mismatches on the labour market. For about two thirds of Austrian companies the opening-up of

Eastern Europe offered good opportunities, for about one third it was a threat. Industries with high labour and energy intensity or low wages per employee (a proxy for low qualification) are facing the biggest threat. In food, chemical and electronic industries opportunities prevail, in building materials, steel and clothing industries the risks are perceived higher than the chances.

81. Whereas the liberalisation of East/West trade had, on balance, positive effects for human resources, the liberalisation of labour markets was a kind of a "shock". Between 1989 and 1991 foreign workers - mainly from former Yugoslavia, Turkey and Eastern Europe - raised the total labour force by nearly 5%. The consequences of this supply shock were rising unemployment in a boom period and a dampening of domestic employment. Evidently, there is only a certain number of foreign workers that can be integrated within a short period of time without adding to domestic unemployment and political tensions (nationalist movements).

82. The main business strategies in response to liberalisation of trading and investment opportunities were to take advantage of the new sales market by means of exports and to increase production in Eastern Europe. Two thirds of the surveyed large enterprises do have plants in Eastern Europe, one third of their staff working abroad is working in Eastern Europe. Outplacement of production mainly serves to satisfy the demand of Eastern European countries and to make use of cheap labour. Another important business strategy has been restructuring towards more sophisticated market segments (e.g. in steel and glass industries).

83. East/West integration is a source of employment growth and at the same time a source of unemployment. Therefore, it intensifies the need for policies to smoothen the adjustment process. The following policy conclusions are to be made:

- Confront and surmount the challenge of the fundamental economic changes ahead of us in active mood of positive adjustment. This will allow to reap the advantages of the international division of labour and to seize the enormous potential gains from growing markets in Central and Eastern Europe; and it avoids to engage in a race to the bottom.
- Maintaining a stable, sound and credible macroeconomic environment with respect to fiscal and monetary policies is clearly of overwhelming importance; fostered by traditionally very responsible wage and incomes policies.
- However, newly emerging trade patterns will inevitably result in major reallocation requirements regarding production and employment in domestic markets as the pace of job turnover is bound to speed up. These structural adjustment necessities come on top of structural changes which are anyway induced by technological changes and the general trend towards globalisation of economic activities.

- Countries that wish to maintain and improve wages will have to pay much greater attention to human and physical capital investments and the organisation of work.
- Industrial policies and interlinked innovation policies can enhance the job creation potential in the economy; public infrastructure investments are necessary as well; better functioning capital markets could contribute to ease financing pressures with regard to private investment
- High productivity strategies require greater attention to work force skills, making general education and skill training much more important determinants of economic success.
- Aging of the labour force in virtually all of the OECD countries will tend to weaken the responsiveness of the labour force to structural change as the pace of labour reallocation which is somehow normally induced by the inflow of younger generations into the workforce will slow down considerably. Therefore, an unprecedented burden of adjustment will fall on the adult labour force, calling for major efforts in up-skilling and re-training of the employed which, in turn, will increase the importance of enterprise-based training systems and may require a shift in educational resources in favour of adult training.
- The likely change in the skills profile of labour demand may confront policy makers with an unpleasant trade-off between income inequality and employment in an era when market forces will tend to favour the better educated. Thus, comprehensive resource development policies will have to lie at the core of any positive adjustment strategy.
- Change in income distribution and widening of wage differentials seems to be unavoidable; it should be accepted that the wage share in national income is bound to fall in the adjustment period and that the dispersion of wages will increase.
- In the pursuit of a high-productivity high-wage strategy it should be acknowledged, though, that the process of upgrading and upskilling of the workforce probably has its inherent limits. On theoretical grounds, however, this should pose no problem as low-productivity workers should always be able to find employment in the secondary labour market, for example in non-tradeable service sectors, provided wages are fully flexible downwards. This strategy runs the risk of producing significant groups of "working poor"; shifts in the structure of taxation could help in reducing labour cost while preserving net wages.
- A broad range of active labour market policies to facilitate the adjustment process will prove indispensable which, in turn, calls for efficient public employment services.

- The development of early warning indicators would also be useful for identifying priorities in training and re-training policies and for formulating policies to stimulate the regional and occupational mobility of workers or promote regional development initiatives, or to do both.

- Social policies face the task of assisting those who cannot keep on track; income protection policies are necessary, but should be coordinated with labour market integration policies in order not to encourage long-term dependency.

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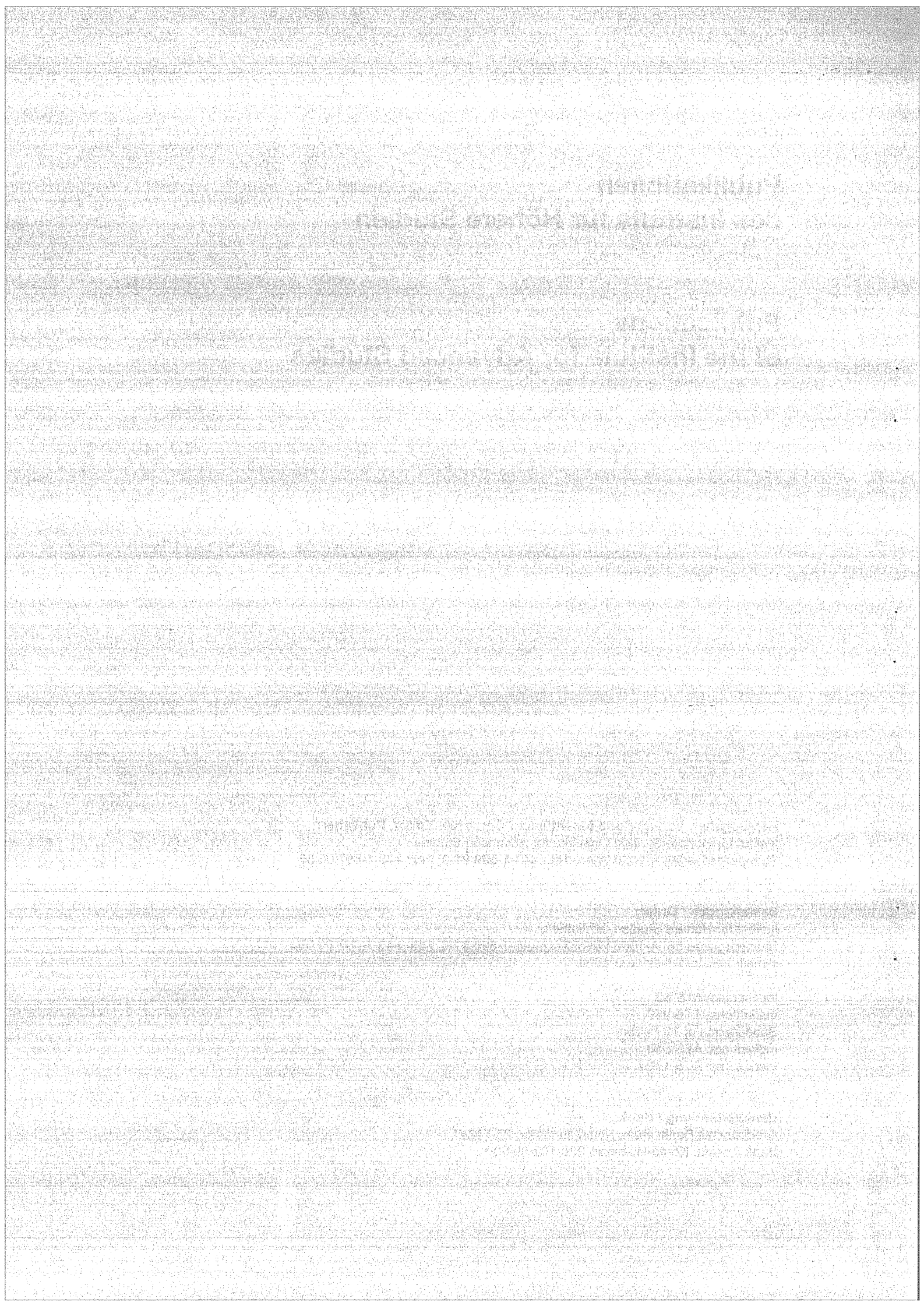
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