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The effect of FDI and foreign trade on wages in the Central and Eastern European Countries in the post-transition era: A sectoral analysis for the manufacturing industry

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Abstract

The aim of this paper is to estimate the effect of FDI and trade openness on average sectoral wages in the manufacturing industry in the CEECs in the post-transition era. We utilize a cross-country sector-specific econometric analysis based on one-digit level panel data for manufacturing industry in the Czech Republic, Hungary, Poland, Slovakia, and Slovenia for the period of 2000–2004. The results suggest that in the short run, productivity has a weak effect on wages, unemployment a strong one, FDI a positive one that is driven mostly by the capital intensive and skilled sectors, and international trade none. In capital-intensive sectors the effect of productivity seems stronger than in labor intensive ones, and the effect of unemployment seems stronger in unskilled sectors then in skilled ones. In the medium-run, the effects of productivity remain modest and that of unemployment stronger. Interestingly, the effect of FDI turns negative. Exports have a negative effect on wages and imports a positive one. However this negative effect can also be an indicator of inverse causality, and should be interpreted cautiously.

JEL classification: F16; F21; J31

Keywords: Openness; European integration; Wage bargaining; CEECs

1. Introduction

This paper aims at exploring how wages in the manufacturing industry in the Central and Eastern European Countries (CEECs) is affected by the integration to the Western European economic area through foreign direct investment (FDI) and trade in the post-transition era. Most studies expect Eastern enlargement to bring about the catching-up of the new member states in terms of GDP per capita in the foreseeable future, though the time horizons as well as country specific expectations of such predictions differ (Landesmann, 2003; Hunya and Geishecker, 2005; Breuss, 2001). However this process has differential effects on different social groups. A decade of transition has brought about dramatic changes in the structure of employment and wages in the CEECs (Havlik and Landesmann, 2005).

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The labor market effects of European enlargement have been discussed disproportionately from a western point of view, focusing on the negative effects of outsourcing and FDI outflow to the East on unemployment and wages in EU15, particularly regarding the unskilled labor (e.g. Anderton and Brenton, 1999; Falk and Wolfmayr, 2005; Geishecker, 2005). The European Comission's Employment in Europe reports in 2004 and 2005 draw an optimistic picture for the West as well as the East, while adressing the possibility of unskilled and older workers losing in both regions (European Commission 2004, 2005). Nevertheless, the idea that trade and capital mobility play an unambigously positive role for the CEECs is dominating economic policy, and the losses are expected to disappear as the skill levels adjust and upgrade. This "enlargement optimism" is based on the argument that European integration driven by FDI and trade will lead to a transfer of modern technology and consequently growth that will eventually trickle down to workers.

Empirical studies about the consequences of FDI for labor in the CEECs point at significant job creation effects in the foreign owned firms after the initial restructuring phase; however in the meantime domestically owned manufacturing companies reduced the number of employed (Hunya and Geishecker, 2005; Mickiewicz et al., 2000). Hunya and Geishecker (2005) point at both negative and positive indirect employment effects of foreign penetration on domestic firms: on the one hand foreign investors replaced traditional domestic suppliers by imports or domestic firms disappeared or downsized due to intensified competition of larger and technologically more advanced subsidiaries of Multinational Enterprises (MNEs). On the other hand cost reduction efforts led to a search for cheaper local supplies or encouraged foreign suppliers to produce in the host country, creating a tendency of increasing local content in foreign subsidiaries. However Mencinger (2003) argues that MNEs contributed more to imports than exports and the spillovers from single foreign firms to the sector do not seem to be sufficiently strong.

Regarding the effects of FDI on wages, Egger and Stehrer (2001) find that the wage bill (wages times employment) of both skilled and unskilled workers significantly decrease in response to an increase in the share of MNEs, but they comment on this finding as an indicator of higher labor productivity effects induced by MNEs compared to the wage effects, which are also assumed to be positive. Stehrer and Woerz (2005) report evidence of a downward pressure of FDI on wage growth for a cross-country analysis for OECD and non-OECD Eastern European and Asian countries; however the authors interpret this finding as the converse of the observation that industries with relatively lower wages (and slower wage growth) are more attractive for FDI. Regarding this last point Hunya and Geishecker (2005) also suggest that the nature of FDI in manufacturing in the CEECs will remain to be low-wage seeking, vertical, and export-oriented.

With respect to industrial relations in the foreign-owned firms Galgoczi (2003) reports that MNEs in general have well maintained industrial relations (as a rule at larger organizations) in Hungary, but some MNEs match their wage and welfare policies solely to the local conditions; even some big firms are union free; and cases of threatening of the trade union president have been observed. Thus the record of multinationals is not uniform.

The effect of trade is also a mixed bag. Egger and Stehrer (2001) show that both intermediate goods exports and imports exhibit a positive impact on the unskilled workers' wage bill in absolute terms as well as relative to the skilled workers in the CEECs. However the final goods exports have a negative significant effect on the absolute and relative wage bill of the unskilled workers, and this effect is greater than the positive effect of intermediate exports.[1] Stehrer and Woerz (2005) for a larger pool of countries find no significant effect of exports, but a negative effect of imports on wages.

The aim of this paper is to present an empirical estimation of the effect of FDI and trade with Europe on average sectoral wages in the manufacturing industry in the CEECs. We aim at answering the following questions: Do FDI and international trade with EU15[2] increase wages in the CEECs after controlling for industrial properties, productivity and labor market conditions? Do these effects vary with respect to the capital and skill intensity of the sectors? We utilize a cross-country sector-specific econometric analysis based on one-digit level panel data (14 sectors) for manufacturing industry, supplied by the Vienna Institute of International Studies (WIIW). Our analysis covers only manufacturing industry due to the availability of data. The countries included are the relatively more developed new members of EU in CEE (the Czech Republic, Hungary, Poland, Slovakia and Slovenia), and the period of analysis is 2000–2004, both

[1] Since their focus is the relative wage bill, they do not discuss the effects on the absolute wage bills, but they report the detailed estimation results, where we can observe these effects.

[2] We focus on trade of the CEECs with the EU15, since that reflects a certain pattern of international division of labor and specialization in trade between the center and the periphery. Trade with EU15 reflects roughly 50–75% of the foreign trade volume of the CEECs. However we also test for the effect of total exports and imports including the trade with the rest of the world to check for robustness.