

Lissowska, Maria

## Article

# Welfare against growth gains in post-transition countries: What are the consequences for stability?

Economics: The Open-Access, Open-Assessment E-Journal

## Provided in Cooperation with:

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Lissowska, Maria (2014) : Welfare against growth gains in post-transition countries: What are the consequences for stability?, Economics: The Open-Access, Open-Assessment E-Journal, ISSN 1864-6042, Kiel Institute for the World Economy (IfW), Kiel, Vol. 8, Iss. 2014-13, pp. 1-37,  
<https://doi.org/10.5018/economics-ejournal.ja.2014-13>

This Version is available at:

<https://hdl.handle.net/10419/95675>

## Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

## Terms of use:

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



<http://creativecommons.org/licenses/by/3.0/>

# Welfare against Growth Gains in Post-Transition Countries. What are the Consequences for Stability?

*Maria Lissowska*

## Abstract

This paper discusses the underpinnings of the financial crisis of the last decade in post-transition countries. It explores the endogenous reasons of this crisis, and in particular a possible link between delayed and unequal growth of household incomes on the one hand and the instability of the growth and depth of recession after the financial crisis on the other. It indicates possible factors underpinning the rapidly growing indebtedness of households, enabling faster, but unsustainable growth in consumption. Furthermore, it claims also that the artificially boosted growth of consumption and a favourable proportion between wages and profits could attract investment (also FDI), possibly searching for short-term gains. It underlines that while the inflow of financial funds was the major reason for unstable growth in this region, endogenous factors also contributed.

Published in Special Issue [Economic Perspectives Challenging Financialization, Inequality and Crises](#)

**JEL** I38 J48 P51

**Keywords** Welfare; post-transition economies; crisis; stability

## Authors

*Maria Lissowska*, ✉ Warsaw School of Economics, Poland, and European Commission, [lisso@sgh.waw.pl](mailto:lisso@sgh.waw.pl)

*The author is grateful to Dr. Piotr Boguszewski for his valuable technical help and to Mr. John Kehoe for linguistic correction. The opinions expressed in this paper are exclusively those of its author and are not binding in any way on the European Commission.*

**Citation** Maria Lissowska (2014). Welfare against Growth Gains in Post-Transition Countries. What are the Consequences for Stability?. *Economics: The Open-Access, Open-Assessment E-Journal*, Vol. 8, 2014-13. <http://dx.doi.org/10.5018/economics-ejournal.ja.2014-13>

## **1 Introduction**

Post-transition countries were, until the global financial crisis, an example of a “success story” with growth rates by far exceeding that of the countries of the European Union. However, they were later hit hard once the crisis arrived. The standard explanation of the extreme vulnerability of post-transition countries to crisis is their rapid integration into the world economy, through international trade, financial flows and migration of the labour force (together with the remittances they used to send to the mother country). Once the crisis in more developed economies reduced those flows to post-transition economies, their growth vanished (EBRD 2010).

In the present text I will reflect on another, additional, factor deepening the vulnerability of post-transition economies, being of an endogenous type, namely delayed and unequal welfare gains for the population. This line of argument is developed by post-Keynesian economists (Lavoie and Stockhammer 2012; Onaran and Galanis 2013; Cynamon and Fazzari 2013) and also by authors in comparative economics (Tridico 2012). They explain that the structural factors, making wages, and in particular the wages of the poor, lag behind profit growth, while the growth of the economy was based on consumption, contributed to instability worldwide and finally to financial crisis.

I will argue that the delayed and unequal growth of incomes in post-transition countries together with the pressure of consumerism and availability of credit enabled by foreign financing brought about an endogenous process resulting in rapid growth in consumption, but driven by household indebtedness. This growth of consumption was clearly unsustainable. Consumption growth and favourable profit rates further attracted investment, often financed from abroad through FDI or by credit. Growing, but unstable investments also contributed to the vulnerability of growth in those countries. Finally, consumption growth needed imports, in the majority of countries not counter-balanced by exports and thus creating an additional source of vulnerability through current account deficits.

All data used in this paper come from the public Eurostat database (including SILC–Statistics on Income and Living Conditions source), unless indicated otherwise. The data are reported for 1995–2008 (post-transition and pre-crisis period of rapid growth) and 2009–2011 (period of post-crisis recession). The benchmark is the European Union of 15 countries belonging to it before the 2004

enlargement (EU15). The methodology applied is based on indicating logical relationships between the phenomena and then seeking confirmation of those relationships by graphical methods.

## 2 At a Glance – Growth and Decline

The countries of Central and Eastern Europe that have undertaken the transition to the market economy, and further accessed the European Union, constituted a particular case among European countries. As seen in Table 1, until 2008 all post-transition countries enjoyed rapid GDP growth. This brought about fast convergence in GDP per inhabitant, expressed in Purchasing Power Standard units, to the

*Table 1: Growth and Convergence of GDP and Consumption*

| Country        | Cumulated GDP growth 2008/1995 | GDP per inhabitant, in PPS, as percentage of EU15 |        | Consumption per inhabitant, as a percentage of EU15 |        |
|----------------|--------------------------------|---|--------|---|--------|
|                |                                | 1995  | 2008   | 1995  | 2008   |
| EU15           | 1.334                          | 100.00%   | 100.0% | 100.0%  | 100.0% |
| Bulgaria       | 1.543                          | 27.6%   | 39.4%  | 7.6%  | 18.8%  |
| Czech Republic | 1.560                          | 65.9%   | 72.9%  | 21.0%   | 43.6%  |
| Estonia        | 2.227                          | 31.2%   | 62.5%  | 10.5%   | 40.0%  |
| Latvia         | 2.254                          | 27.1%   | 50.9%  | 9.5%  | 40.0%  |
| Lithuania      | 2.395                          | 30.6%   | 55.6%  | 8.6%  | 40.6%  |
| Hungary        | 1.489                          | 44.1%   | 57.8%  | 17.1%   | 34.5%  |
| Poland         | 1.805                          | 37.1%   | 50.9%  | 16.2%   | 35.8%  |
| Romania        | 1.581                          | 28.7% <sup>x/</sup>                               | 42.2%  | 8.6%  | 25.5%  |
| Slovenia       | 1.729                          | 64.1%   | 81.9%  | 45.7%   | 58.8%  |
| Slovakia       | 1.903                          | 41.2%   | 65.3%  | 13.3%   | 41.2%  |

<sup>x/</sup> 1996

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_k&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)

level of the countries of the European Union. Consumption per inhabitant also converged quickly to the level of EU15.<sup>1</sup>

According to general interpretation, this fast growth was due to a boost of entrepreneurship after the transition to the market economy, to the integration with the global economy (and in particular, with the European Union on the eve and after accession), and to substantial flows of Foreign Direct Investment (see discussion in Myant and Drahokoupil 2011: 299–312). However, as Table 2 shows, this fast growth experienced until 2008 terminated in a deep fall in all (except two – Poland and Slovakia) post-transition economies after 2008.

This is not the only puzzle that can be disclosed beneath the “success story” of post-transition countries. As can be seen from Table 3, there was also some discrepancy between the results achieved by post-transition countries in terms of consumption and earnings (wages). While consumption per inhabitant rapidly

*Table 2: Increase/Decrease of GDP 2009–2011*

| Country        | Cumulated change of GDP in % |
|----------------|------------------------------|
| EU 15          | –0.9                         |
| Bulgaria       | –3.5                         |
| Czech Republic | –0.5                         |
| Estonia        | –5.7                         |
| Latvia         | –13.4                        |
| Lithuania      | –8.5                         |
| Hungary        | –4.0                         |
| Poland         | +10.1                        |
| Romania        | –5.8                         |
| Slovenia       | –6.9                         |
| Slovakia       | +2.4                         |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_k&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en)

---

<sup>1</sup> Here and in all the subsequent tables: final consumption of households and non-profit institutions serving households. In the Tables 1 and 3 at current prices, for comparability with earnings in Table 4.

*Table 3: Consumption per Inhabitant vs. Average Earnings in Post-Transition Countries, as a Percentage of the Netherlands*

|          | Annual gross earnings <sup>a/</sup> |       | Consumption per inhabitant |       |
|----------|-------------------------------------|-------|----------------------------|-------|
|          | 2008                                | 2010  | 2008                       | 2010  |
| Bulgaria | 8.4%                                | 9.7%  | 18.9%                      | 18.6% |
| Latvia   | 20.1%                               | 17.9% | 40.2%                      | 33.5% |
| Hungary  | 23.6%                               | 21.2% | 34.8%                      | 31.7% |
| Romania  | n.a.                                | 12.7% | 25.6%                      | 23.0% |
| Slovakia | 21.9%                               | 23.2% | 41.5%                      | 44.1% |

<sup>a/</sup> average gross annual earnings in industry and services of full time employees in enterprises with 10 or more employees

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=earn\\_gr\\_nace2&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=earn_gr_nace2&lang=en)

converged to the EU15 level, the level of wages (average gross annual earnings in industry and services) still lagged behind. As here the data for the EU15 are unavailable (and also for some post-transition countries), the level of wages will be compared to the Netherlands, where the household consumption per inhabitant is only by 1–2% higher than in the EU15.<sup>2</sup>

One could try to explain this apparent inconsistency by the influence of the “black market” (part of incomes not being officially declared) which is known to be higher in post-transition countries than in the Western Europe. However, the available studies suggest that earnings in the unofficial economy are by far lower than those in the “official” one (Praca, 2005), even if additional earnings in some professions (doctors) could be high. To some degree the reason of discrepancy between convergence of consumption and of earnings can be also remittances from the people working abroad. As for social transfers, it stems from Table 4 that they are smaller as reported to GDP compared to the countries of EU15, so could hardly contribute to the improvement in the convergence to EU15 measured by consumption as compared to that measured by earnings. The data quoted above suggest that there could be other structural reasons underpinning the discrepancy

---

<sup>2</sup> Only static comparison is possible, because the data for post-transition countries before 2008 are unavailable.

*Table 4: Expenditure on Social Protection as a Percentage of GDP*

| Country        | 1995 | 2000 | 2008 | 2010 |
|----------------|------|------|------|------|
| EU15           | 20.9 | 19.3 | 19.9 | 22.0 |
| Bulgaria       | n.a. | 12.7 | 11.6 | 14.3 |
| Czech Republic | 16.0 | 18.0 | 17.5 | 19.7 |
| Estonia        | 10.8 | 11.0 | 12.1 | 14.9 |
| Latvia         | 12.7 | 12.5 | 9.0  | 13.6 |
| Lithuania      | n.a. | 12.0 | 12.7 | 14.9 |
| Hungary        | 17.6 | 15.4 | 18.7 | 18.5 |
| Poland         | n.a. | n.a. | 16.1 | 17.0 |
| Romania        | 10.2 | 10.5 | 11.6 | 14.1 |
| Slovenia       | n.a. | 17.9 | 16.6 | 19.5 |
| Slovakia       | 14.4 | 16.0 | 16.1 | 19.5 |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov\\_a\\_exp&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_a_exp&lang=en)

between growth of earnings and of consumption. In the following sections, I will undertake research on those reasons. I will also assess the impact of those structural features of the growth of welfare on the vulnerability of economic growth in these countries.

### **3 Explanations of Crisis in Post-Transition Economies in the Literature**

Different analyses of the crisis that took place in post-transition countries underline that its roots were in vulnerabilities created (or persisting) during the previous phase of fast growth. The fall in growth of post-transition countries after 2008 is attributed to exogenous factors. For example EBRD (2010) points out that sudden declines in output in the fourth quarter of 2008 were mostly impacted by the crisis in advanced countries. While the integration of post-transition countries with the rest of the world (through trade, financial flows, migration and remittances) that followed their transition to a market system boosted their pre-crisis growth, it also created significant vulnerabilities.

The confirmation that the type and speed of growth seen by post-transition countries in the late 1990s and early 2000s contributed to their vulnerability is common in the analyses of crisis. Already the IMF report (IMF 2009: Chapter 1) points to the dependence of this growth on foreign-financed credit, additionally often extended in foreign currencies, and on foreign capital flows as the principal factors of exposure to the sudden stop of funding. The later analysis of Gardo and Martin (2010) identifies additional vulnerabilities present in all or in most post-transition countries in their phase of fast growth: credit/deposit ratios in banks rapidly rising, widening current account deficits, in some countries also limited margin of manoeuvre of the policy due to fixed exchange rates. The trade balance position is also indicated as an important factor of differentiation of the impact of the crisis on Eastern European countries by Becker et al. (2010), besides the growth (but not size) of credit as a crucial driver and also the deepening effect of a fixed exchange rate regime.

There is however another trend in literature pointing to the impact of the changes on the labour markets and in the proportions between labour and capital gains on the mechanism of the global financial crisis.

It is well known from statistics that since the beginning of the 1980s the proportion of wages in the value added was falling worldwide. This trend is explained by a speed up of technological progress since the middle of 1980s requiring flexible adjustments of employment and the deteriorating negotiating position of workers (Ellis and Smith, 2007). The additional factor impacting on the change of proportion between wages and profits was globalization which increased the availability of cheap labour from emerging countries (and impacting by the competitive pressure of imports of cheap goods and by immigration) and thus making capital relatively rare, and sectoral changes towards the sectors with a lower proportion of wages, like finance (Guscina 2006; De Serres et al. 2001). Other research indicates however the strong impact of welfare state retrenchment, of the decreasing power of trade unions and liberal policy and also the growth of the financial sphere on decreasing the weight of wages in value added (Jayadev 2007; ILO 2008; Stockhammer 2012).

As can be seen from Table 5, the trend of the decreasing share of labour in the value added was present in Europe as a whole in the previous decade until the crisis, and re-started in 2011 with austerity policies.



*Table 5: Compensation of Employees as a Percentage of Value Added*

|                | 1995  | 1996  | 1997  | 1998  | 1999  | 2000  | 2001  | 2002  | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  |
|----------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| EU15           |       |       |       |       |       | 56.60 | 56.59 | 56.41 | 56.15 | 55.57 | 55.46 | 55.10 | 54.74 | 55.24 | 56.79 | 56.14 | 55.94 |
| Bulgaria       | 45.45 | 50.00 | 40.00 | 50.00 | 46.15 | 41.38 | 41.18 | 40.54 | 40.00 | 40.91 | 40.00 | 41.07 | 40.91 | 42.11 | 44.16 | 44.44 | 44.44 |
| Czech Republic | 44.48 | 45.61 | 46.49 | 44.57 | 44.22 | 44.33 | 44.29 | 45.26 | 45.59 | 45.81 | 46.25 | 45.91 | 45.80 | 46.45 | 46.47 | 46.31 | 47.37 |
| Estonia        | 58.82 | 59.09 | 53.57 | 53.13 | 51.43 | 50.00 | 50.00 | 49.02 | 49.12 | 50.79 | 50.68 | 50.57 | 52.38 | 56.48 | 59.55 | 54.84 | 52.85 |
| Latvia         | 53.85 | 50.00 | 50.00 | 47.83 | 46.15 | 44.44 | 45.00 | 40.91 | 45.83 | 44.83 | 45.71 | 48.84 | 52.63 | 56.25 | 51.92 | 47.06 | 45.45 |
| Lithuania      | 38.46 | 41.18 | 45.45 | 48.00 | 50.00 | 44.44 | 42.40 | 43.28 | 43.24 | 43.98 | 44.79 | 47.51 | 47.73 | 49.50 | 50.00 | 46.15 | 44.57 |
| Hungary        | 54.60 | 53.08 | 51.88 | 51.68 | 50.85 | 52.73 | 52.50 | 52.57 | 54.04 | 53.87 | 54.21 | 53.33 | 54.66 | 54.49 | 54.93 | 51.70 | 53.57 |
| Poland         | 45.83 | 46.43 | 46.88 | 47.22 | 47.22 | 45.09 | 46.15 | 44.39 | 43.08 | 40.93 | 40.53 | 40.57 | 40.74 | 42.66 | 41.53 | 42.20 | 41.18 |
| Romania        | n.a.  | 41.67 | 38.46 | 40.00 | 38.46 | 43.75 | 44.44 | 45.00 | 40.91 | 40.00 | 42.42 | 42.50 | 45.10 | 47.42 | 45.24 | 44.09 | 37.04 |
| Slovenia       | 64.44 | 61.54 | 60.00 | 59.09 | 58.90 | 59.26 | 59.34 | 58.42 | 58.18 | 57.98 | 57.94 | 57.35 | 56.67 | 58.02 | 60.93 | 62.00 | 59.74 |
| Slovakia       | 43.75 | 47.22 | 47.50 | 48.84 | 44.68 | 47.06 | 43.86 | 43.55 | 42.65 | 41.33 | 41.98 | 40.22 | 39.81 | 40.18 | 42.86 | 41.82 | 41.38 |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)

As to the consequences of the rising proportion of capital gains, according to some views it could underpin positive long-term consequences in terms of strong investment and job creation reducing unemployment (De Serres et al. 2001). It is, however, underlined in other studies that the impact of changes of both labour and capital gains on the scale and type of demand is far from obvious (Naastepad 2006).

Tridico (2012) added a new element to the explanation of the decreasing trend of wages in value added. Namely, he argued that the increase of financialisation (measured as a value of market capitalization in stock exchanges reported to GDP) exerted a pressure of business for liberalization, resulting among others in wage reduction and increased flexibility in the labour market.

The consequences of pro-capital economic policy (profits at the expense of wages) were studied along the lines of a post-Keynesian approach by Lavoie and Stockhammer (2012). They claimed that income distribution is important for growth, both due to its impact on demand and on supply (labour productivity effects). They provided a number of arguments for the negative or positive growth effects of the rising or falling proportion of wages. Onaran and Galanis (2013) have shown, using the results of econometric studies and simulations, that in the majority of countries growth is actually wage-led. Thus the positive effects of pro-capital income distribution may be assured only due to debt (sustaining consumption) or export (sustaining total demand). In their view, the contemporary global economy is based on a symbiosis of debt-led countries (such as the US) relying on financial inflows from other countries, being export-led (China). This mode of growth, with conflict between the policy and growth regime, is unstable and unsustainable, also at the global level.

However, in a number of countries (e.g. US) a decreasing share of wages run parallel with the rise of consumption. The paper of Onaran et al. (2011) provides a partial explanation of this phenomenon claiming that it was due to the behaviours of rentiers whose incomes are included as non-wage. As the share of rentiers' income from profits (in the form of dividends paid) was increasing and their propensity to consume was higher than that from profits as a whole, it could explain the high increase of consumption in spite of the change of functional income distribution to the advantage of profits.

Tridico (2012) underlines the impact of the decreasing trend of wages on instability of growth, and also on the occurrence of the financial crisis of the last

decade. Namely, unstable jobs and poor wages in the framework of consumerism (strong in the US, but also present in Europe) encouraged households to borrow.<sup>3</sup> This helped to sustain consumption, but at the price of instability. In support of his argument Tridico quotes not only the growing level of indebtedness of US households, but also the higher inequality of income compared to consumption, made more equal by credit. Unsustainable consumption boosted by credit unavoidably led to financial crisis. As for Europe, the pressure of firms for labour market flexibility led also to a financial burden on governments obliged to provide social support to the unemployed.<sup>4</sup>

The explanation of the growth of consumption to income ratio before the financial crisis in the US (and then of its sharp fall after the crisis) provided by Cynamon and Fazzari (2013) links it to the rising inequality of incomes. The proportion of incomes of the top 5% was rising which would normally imply a fall in consumption to income ratio (due to the lower propensity of the rich to consume). However, due to the availability of credit, it resulted more in a high growth of debt-to-income for the poorer population, enabling them to increase consumption. Cynamon and Fazzari underline the impact of the behavioural features of consumers (their tendency to stick to previous spending patterns and “conspicuous” consumption, mimicking the rich, as postulated by Veblen in his book *The theory of the leisure class. Study of the evolution of institutions*). The rise of household debt was however unsustainable and contributed to the fall in consumption after the crisis, making recovery difficult.

The analyses quoted above (Tridico 2012; Lavoie and Stockhammer 2012; Cynamon and Fazzari 2013) allow us to logically link the changing structure of household incomes with accelerated borrowing and the increasing reliance of households on finance. In this paper I would like to illustrate this link to the example of post-transition countries. This example is particularly relevant due to the speed of growth and acuity of the recession which emerged after the financial crisis. I will argue that endogenous changes consisting in the delayed and unequal

---

<sup>3</sup> It should be noted that a number of other conditions contributed to the rise of household borrowing: Availability of credit thanks to securitisation (Shin 2009), easing of monetary policy (Ahrend 2010), government policy promoting house ownership, looser creditworthiness requirements by banks (Erlingsson et al. 2014).

<sup>4</sup> Tridico (2012) indicates other factors weakening economic growth, namely low real investment and financial speculation to earn higher profits.

growth of earnings contributed, together with the availability of foreign credits, to unsustainable consumption growth fuelled by credit. I will further study the impact of the delayed rewards to employees and the rapid growth of consumption fuelled by credit as the factors contributing to the instability of growth of those countries.

## **4 Data and Methodology**

All data used in this paper come from the public Eurostat database (including SILC–Statistics on Income and Living Conditions source), unless indicated otherwise. This ensures data comparability, to the highest degree possible. The data are reported for 1995–2008 (post-transition and pre-crisis period of rapid growth) and 2009–2011 (period of post-crisis recession). Due to unavailability of data in Eurostat database for many post-transition countries before their accession to the EU the starting date of the first of those periods had to be postponed in some cases to 1996 or 2000. A pre-crisis sub-period of 2001–2008 is distinguished, in particular for the study of household indebtedness. As to the second period, in some cases the most recent data were available for 2010.

The study is limited to the post-transition countries being in 2008 members of the European Union, namely: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia and Slovakia. The benchmark is the European Union of the 15 member countries before the 2004 enlargement (EU15).

It should be pointed out that availability of data for Bulgaria and Romania before 2000 is particularly poor, as is also the case for Poland for some variables. Thus in some cases the sample under comparison is limited to 7 or 8 countries. However, the particularity of growth of those countries, as shown in Section 2, seems worth explaining, even if tentatively.

To test the hypothesis on the impact of different factors on the growth of household indebtedness and then of this growth of indebtedness on sustainability of consumption I will focus on changes of those variables cumulated over longer periods of time (several years) rather than on year by year changes. The reasons for this are that the annual fluctuations of variables were due to country-specific factors that I will not analyse here (such as policy changes, the external situation). Additionally, in the case of some variables (as Gini) there were changes in

methodology of calculation, for the others (household borrowing) the definition covers both consumer and mortgage lending, of different consequences for consumption. Also the delays with which the variables impacted on one another are difficult to ascertain.

I assume also that rather major differences in state or of size of change impacts on behavior of households, not step-wise evolution. Thus I will compare by country the relationship between the level of income inequality at some point in time and the scale of inflow of foreign credits over 2001–2008 on the one hand, with the change of household indebtedness over the same period, on the other. Similarly, the change of indebtedness will be compared with the rate of change of consumption over the same period. This is to see if the differences between the countries in inequality starting from very egalitarian pre-transition society, and the size of changes of indebtedness, in the context of integration with modern global economy, actually impacted on scale and sustainability of growth of consumption. The similar approach of comparing the size of change of unit labour costs from one country to another with the scale of FDI inflow in post-transition countries will be applied.

After postulating logical relationships between the variables (as above) I will seek confirmation of those relationships by graphical methods (two-dimension graphs with countries as points) rather than by formal verification. The choice of working on cumulated data and the small sample size of countries (in principle 10, but often limited to 7 or 8) limited the possibility of applying more formalized methods (regression, or even correlation).

## **5 Features of Welfare Growth in Post-Transition Countries**

A puzzling fact, which sheds light on the limited progress in the convergence of earnings in post-transition countries to the European average is a low and often decreasing proportion of wages (employee compensation) in value added. It was said above that this tendency is worldwide and was present in the countries of the European Union a long time before the financial crisis. However, as Table 5 shows, in post transition countries the proportion of wages was substantially lower during all the post-transition period than in EU15 (with the exception of Slovenia). This table shows also that in all those countries for which data are available the

proportion of compensation of employees decreased from 1995 till 2000, or till 2005 (as was the case in Slovakia). Then the proportion of the compensation of employees increased in all the countries (except Poland) over the period 2000–2008. Till 2000 the population thus received a systematically lower proportion of the fruits of growth and the growth of incomes was delayed compared to the growth of the value added. It means also that the proportion of profits in gross value added in post-transition countries was higher than on average in EU15 and it tended to increase. Low taxation of corporate profits, in particular in the Baltic States, should be underlined also.

A complementary outlook of the pace of growth of productivity and of incomes of employees is provided in Table 6.<sup>5</sup> Until the beginning of the crisis labour productivity grew very fast in post-transition countries, much faster than in EU15. This growth slowed down or turned into decline only with the financial crisis. As to changes in real unit labour costs (defined as the change in compensation of employees not covered by changes in productivity), they were in principle negative in post-transition countries, meaning that the growth of labour costs (even if growth of wages was substantial) only partly covered the growth of labour productivity. This tendency is also in place in the EU15, but in the case of post-transition countries before 2008 it was particularly acute. The exception was the Czech Republic and the Baltic States in the pre-crisis part of the first decade of the XXI century. In the other post-transition countries the growth of the compensation of employees was thus delayed as compared to the results of their work, to the clear advantage of employers. The gap between growth of compensation of employees and growth of labour productivity for some countries (Bulgaria, Romania, Slovakia) was substantially larger than for the EU15 in the period preceding the financial crisis. Besides the consequences for suppressed welfare growth, it created a favourable incentive for investment.

The second feature of incomes in post-transition countries was their increasing inequality. As reported Table 7 based on the database of the World Bank,<sup>6</sup> those societies started from being very egalitarian before transition, with Gini coefficient

---

<sup>5</sup> Data are available only from 1996 on.

<sup>6</sup> Data on income inequality are not available in the Eurostat database for the new Member States before 2000. For this reason the data of the Word Bank are used for the 1990s. They are not strictly

Table 6: Cumulated Change of Labour Productivity and of Labour Costs (Initial Year =1)

|                | 2000/1995                                    | 2008/2000 | 2011/2008 | 2000/1995                            | 2008/2000 | 2008/1995 | 2011/2008 |
|----------------|--|-----------|-----------|--------------------------------------|-----------|-----------|-----------|
|                | Real labour productivity per person employed |           |           | Real unit labour costs <sup>a/</sup> |           |           |           |
| EU15           | 1.067  | 1.069     | 1.006     | n.a.                                 | 0.975     | n.a.      | 1.013     |
| Bulgaria       | 1.098  | 1.336     | 1.046     | 0.902                                | 0.946     | 0.853     | 1.079     |
| Czech Republic | 1.152  | 1.330     | 1.025     | 1.036                                | 1.050     | 1.088     | 1.026     |
| Estonia        | 1.531  | 1.425     | 1.053     | 0.886                                | 1.108     | 0.982     | 0.914     |
| Latvia         | 1.344  | 1.471     | 1.127     | n.a.                                 | 1.154     | n.a.      | 0.809     |
| Lithuania      | 1.328  | 1.633     | 1.112     | n.a.                                 | 1.025     | n.a.      | 0.887     |
| Hungary        | 1.095  | 1.315     | 0.970     | 0.960                                | 0.980     | 0.941     | 0.960     |
| Poland         | 1.326  | 1.281     | 1.083     | n.a.                                 | n.a.      | n.a.      | 0.964     |
| Romania        | n.a.   | 1.869     | 0.973     | n.a.                                 | 0.838     | n.a.      | 0.816     |
| Slovenia       | 1.248  | 1.276     | 0.994     | 0.916                                | 0.974     | 0.892     | 1.047     |
| Slovakia       | 1.230  | 1.449     | 1.041     | 1.044                                | 0.950     | 0.992     | 1.045     |

<sup>a/</sup> change in unit labour costs corresponds to the change of compensation of employees per number of employees not covered by the change of labour productivity plus the change of the share of employees in total employment.

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_aux\\_lp&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_aux_lp&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_aux\\_ulc&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_aux_ulc&lang=en)

barely exceeding 20. Over ten years this index increased in most of them to 30, ten points more. Thus over a relatively short period of time, they attained the level of income differentiation similar to Western Europe, without having its long historical trajectory of social change.

According to Eurostat data in Table 8, for the subsequent period (mid-2000s), inequality, as measured by Gini coefficient, was already systematically higher in new Member States (the overwhelming majority of which are post-transition countries) than in the EU15. However, the degree of inequality tended to stabilize in post-transition countries (or even to decrease in some of them) over the decade,

---

comparable to the ones from Eurostat for 2000s, but they show sufficiently well the evolution of inequality.

Table 7: Evolution of Gini Coefficient in Post-Transition Countries over 1990s

|                | 1989               | 1993               | 1998               |
|----------------|--------------------|--------------------|--------------------|
| Bulgaria       | 23.4               | 24.3 <sup>b/</sup> | 26.4 <sup>d/</sup> |
| Czech Republic | 19.4 <sup>a/</sup> | 26.6               | n.a.               |
| Estonia        | 23.0 <sup>a/</sup> | 39.5               | 37.6               |
| Hungary        | 25.1               | 27.9               | 24.9               |
| Latvia         | 22.5 <sup>a/</sup> | 27.0               | 33.5               |
| Lithuania      | 22.5 <sup>a/</sup> | 33.6               | 30.2               |
| Poland         | 26.9               | 32.3               | 32.9               |
| Romania        | 23.3               | 28.2 <sup>b/</sup> | 29.4               |
| Slovakia       | 19.5 <sup>a/</sup> | n.a.               | 25.8 <sup>c/</sup> |
| Slovenia       | n.a.               | 29.2 <sup>b/</sup> | 28.4               |

a/ 1988; b/1994 c/1996 d/1997

Source : <http://data.worldbank.org/indicator/SI.POV.GINI>

and in particular after the financial crisis. Inequality was particularly deep in the Baltic States, Bulgaria, Romania and Poland. High income inequality broadened the layer of the population at risk of poverty in many post-transition countries.<sup>7</sup> While this percentage in “old” European Union countries (after social transfers) is at the level of 15–16%, it had reached almost 19% in new Member States in 2005, with particularly high levels in the Baltic States and Poland, and later in Bulgaria and Romania. However, this measure of inequality was highly differentiated from one country to another (with particularly low levels in the Czech Republic and Slovenia) and decreased in a number of countries after 2005, and in particular in the period following the financial crisis.

The actual growth of household incomes was thus limited compared to the speed of economic growth and in particular very unequal. The newly emerging poverty of a big proportion of the population could hardly be compensated for by social transfers, which, as shown above, were weaker in proportion to GDP than in EU15 and, in the majority of post-transition countries, this proportion has decreased in the last decade, at least before the crisis.

---

<sup>7</sup> The threshold of risk of poverty is defined as 60% of the median equivalised income of the country.



*Table 8: Indicators of Inequality and Poverty in 2000s*

|                        | Level of Gini coefficient |      |                    |      |      | Population at risk of poverty after social transfers |      |      |      |      |
|------------------------|---------------------------|------|--------------------|------|------|--|------|------|------|------|
|                        | 2000                      | 2005 | 2008               | 2010 | 2011 | 2000   | 2005 | 2008 | 2010 | 2011 |
| EU15                   | 29.0                      | 29.9 | 30.8               | 30.6 | 30.9 | 15.0   | 15.7 | 16.4 | 16.3 | 16.7 |
| New Member States (12) | n.a.                      | 33.2 | 31.3               | 30.3 | 30.5 | n.a.   | 18.9 | 17.3 | 16.9 | n.a. |
| Bulgaria               | 25.0                      | 25.0 | 35.9 <sup>a/</sup> | 33.2 | 35.0 | 14.0   | 14.0 | 21.4 | 20.7 | 22.2 |
| Czech Republic         | n.a.                      | 26.0 | 24.7               | 24.9 | 25.2 | n.a.   | 10.4 | 9.0  | 9.0  | 9.8  |
| Estonia                | 36.0                      | 34.1 | 30.9               | 31.3 | 31.9 | 18.0   | 18.3 | 19.5 | 15.8 | 17.5 |
| Latvia                 | 34.0                      | 36.1 | 37.7               | 36.1 | 35.4 | 16.0   | 19.2 | 25.6 | 21.3 | 19.1 |
| Lithuania              | 31.0                      | 36.3 | 34.0               | 36.9 | 33.0 | 17.0   | 20.5 | 20.0 | 20.2 | 19.2 |
| Hungary                | 26.0                      | 27.6 | 25.2               | 24.1 | 26.8 | 11.0   | 13.5 | 12.4 | 12.3 | 13.8 |
| Poland                 | 30.0                      | 35.6 | 32.0               | 31.1 | 31.1 | 16.0   | 20.5 | 16.9 | 17.6 | 17.7 |
| Romania                | 29.0                      | 31.0 | 36.0               | 33.3 | 33.2 | 17.0   | n.a. | 23.4 | 21.1 | 22.2 |
| Slovenia               | 22.0                      | 23.8 | 23.4               | 23.8 | 23.8 | 11.0   | 12.2 | 12.3 | 12.7 | 13.6 |
| Slovakia               | n.a.                      | 26.2 | 23.7               | 25.9 | 25.7 | n.a.   | 13.3 | 10.9 | 12.0 | 13.0 |

<sup>a/</sup>break in time series in 2006

Source:

<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tessi010&plugin=1>

[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc\\_di12&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_di12&lang=en)

## 6 The Direct Consequences of Delayed and Unequal Growth of Incomes

As welfare expectations were very high on the eve of transition, the limited growth of incomes, and in particular of the poorer population, could cause frustration. Another factor for frustration could have been the availability of consumer goods, contrasting with acute shortages of supply before transition. Frustration was due not only to expectations which were not met, but also to actual poverty, as revealed by the high percentage of populations in precarious situations.

Also the structure of needs changed. One reason for that was withdrawal of the State from granting numerous services, in particular housing. Thus young couples had to look for private investment in apartments.

The actual or perceived lack of satisfaction of needs of both poorer and of some more wealthy groups of the population coincided with the abundance of liquidity on global financial markets looking for opportunities to lend. This liquidity flew to post-transition countries in search of opportunities to invest, be it by direct investment or by lending.

In the years 1995–2008, before the financial crisis, the inflow of foreign credits to the post-transition countries reported in Table 9 amounted to 4% or more of the GDP (with exception of the Czech Republic and Poland). It was even higher and also more differentiated in the period 2001–2008, directly preceding the crisis. While only part of those credits was channeled to households, it

*Table 9: Inflow of Foreign Credits as Percentage of GDP*

| Country        | 1995–2008 |                    |  | 2001–2008 |                    |  | Average 2009–2011 |
|----------------|-----------|--------------------|--|-----------|--------------------|--|-------------------|
|                | Average   | Standard deviation | Coefficient of variation <sup>a/</sup> | Average   | Standard deviation | Coefficient of variation <sup>a/</sup> |                   |
| Bulgaria       | 5%        | 6%                 | 108%                                   | 7%        | 5%                 | 76%                                    | –2%               |
| Czech Republic | 3%        | 3%                 | 114%                                   | 2%        | 2%                 | 90%                                    | 0%                |
| Estonia        | 9%        | 7%                 | 75%                                    | 12%       | 8%                 | 62%                                    | –6%               |
| Latvia         | 15%       | 10%                | 67%                                    | 21%       | 11%                | 51%                                    | –3%               |
| Lithuania      | 6%        | 4%                 | 72%                                    | 8%        | 5%                 | 70%                                    | –6%               |
| Hungary        | 4%        | 6%                 | 134%                                   | 5%        | 4%                 | 76%                                    | 1%                |
| Poland         | 2%        | 2%                 | 131%                                   | 2%        | 2%                 | 156%                                   | 2%                |
| Romania        | 4%        | 3%                 | 75%                                    | 6%        | 3%                 | 46%                                    | 3%                |
| Slovenia       | 7%        | 7%                 | 102%                                   | 11%       | 7%                 | 70%                                    | –7%               |
| Slovakia       | 4%        | 6%                 | 162%                                   | 3%        | 5%                 | 161%                                   | 5%                |

a/ Coefficient of variation is defined here and in subsequent tables as standard deviation over average

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop\\_q\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop_q_c&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)

obviously changed their opportunities to satisfy needs previously suppressed due to delayed growth of incomes, poverty or shortage of housing. It should be mentioned also that the lending practices of this period (both with respect to consumer credit and to mortgage credit) were aggressive and cared little about the creditworthiness of borrowers. It should be said also that the citizens of post-transition countries lacked sufficient financial knowledge to be fully aware of their actual capacity to repay.

There is some statistical evidence that income inequality impacts on the propensity to borrow. The evidence for US is summarized in (Cynamon and Fazzari, 2013) quoted above. Research has also confirmed that in Eurozone countries households with lower incomes tend to be more indebted in consumer credit and suffer much higher credit service burdens compared to richer households (Gomez-Salvador et al. 2011). It seems that poorer households tend to fill the gap between their income and their needs (or consumption wants) by credit. In the case of post-transition countries this gap could be particularly wide because of rapidly rising income differences (and the incidence of unemployment), expectations of welfare gains boosted by transition and aggressive marketing of consumer goods. It is obvious that transition to a market economy implied big cultural changes and could lead to an excessive propensity to consume and irresponsible borrowing.

The research carried out on Polish households in principle focuses on changes of their borrowing behavior during transition. It tends however to confirm the existence of pressure of needs on borrowing. The fact of over indebtedness is frequent for the households on lowest incomes and with bigger sizes of household. They take consumer credit to satisfy their current (not home ownership) needs. It may be basic consumption needs (food and clothing), financing of fixed costs (like rent), or else financing previous debts. The richest and the youngest households however tend to take mortgages under pressure of housing needs. Thus both higher income differentiation and lagging income growth may underpin household decisions to borrow (Bialowolski 2012). This borrowing would have different causes for poorer and richer layers of the population: to satisfy basic needs in the case of poor households, and to invest in housing (in particular, when it was insufficient or of insufficient quality before transition) by richer ones.

*Table 10: Indebtedness of Households – Debt as a Percentage of Disposable Income*

| Country                  | 2001                | 2008  | 2011  | Change<br>2001–2008 in<br>percentage points |
|--------------------------|---------------------|-------|-------|---|
| Euro area (17 countries) | 75.09               | 95.06 | 98.97 | 19.97                                       |
| Czech Republic           | 14.22               | 49.65 | 56.14 | 35.43                                       |
| Estonia                  | 18.85               | 91.91 | 88.26 | 73.06                                       |
| Latvia                   | 9.69                | 70.79 | 65.88 | 61.10                                       |
| Lithuania                | 2.71                | 44.89 | 40.08 | 42.18                                       |
| Hungary                  | 12.65               | 62.24 | 63.40 | 49.59                                       |
| Poland                   | 11.79               | 48.03 | 57.82 | 36.24                                       |
| Slovenia                 | 23.30 <sup>a/</sup> | 41.95 | 46.76 | 18.65                                       |
| Slovakia                 | 9.25                | 35.37 | 42.50 | 26.12                                       |

<sup>a/</sup> 2002

Source:

<http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00104> (accessed on 29/04/2013)

The propensity to fund consumption and residential investment by borrowing developed fast. The statistical data (Table 10) reveal rapidly growing levels of household indebtedness (both consumer and mortgage credit) in post-transition countries.

The level of indebtedness of households in post-transition countries was finally not higher than in the Eurozone, but its relation to household income had increased drastically (from 2 to 16 times. This rising debt (representing new credit, or appositive difference of credit awarded and paid back) enabled additional consumption, above the growth in incomes. It seems thus that the rapid increase of borrowing was a substantial factor in the difference between the (lower) convergence of wages in post-transition countries and the (higher) convergence of consumption to the EU. However, it was not the only reason for this difference: some proportion of undeclared income and also of remittances from abroad plaid a role.

Looking for the factors impacting on this growth of indebtedness, I will first illustrate the relationship between the inflow of foreign credits and the increase of

household indebtedness. Figure 1 below suggests that the increase of indebtedness was positively correlated with the size of inflow of foreign credits to a given country.

The next step will be to see if actual rising indebtedness was correlated with inequality and/or with the percentage of population at risk of poverty (Figure 2 and Figure 3).

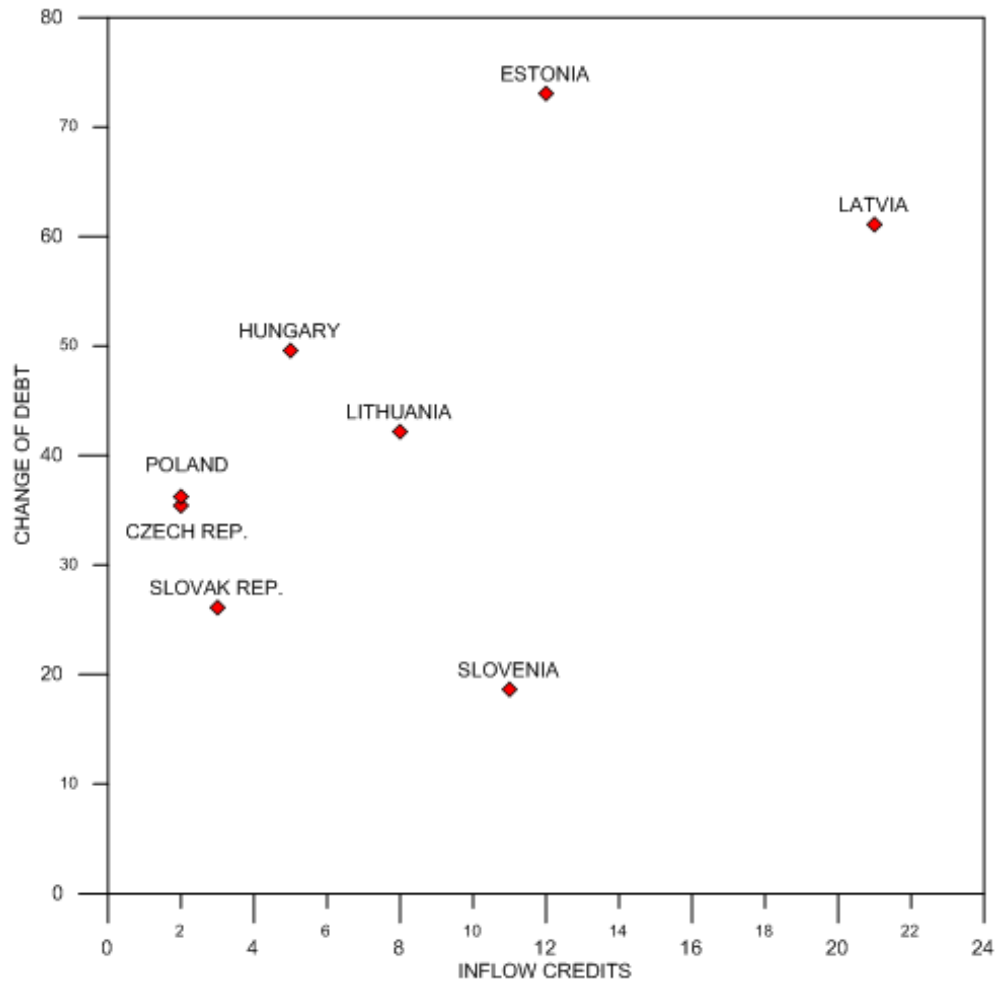
The absence of data on indebtedness for Bulgaria and Romania, where poverty is particularly high should be noted. However, the graphs show that the speed of growth of indebtedness went hand in hand with the previously shown level of inequality and the proportion of the population at risk of poverty in the middle of analysed period. This suggests a link between inequality and poverty and the propensity to borrow.

Furthermore, borrowing, with its fluctuations due to the changing availability of funds and due to the changing strictness of lending practices between the pre-crisis and post-crisis period was a factor contributing to volatility of consumption growth in some Central and Eastern European countries as presented in Table 11. Undeniably, fluctuations of the rate of GDP growth contributed to this volatility, but also the sudden appearance of credit availability could enable consumption leaps above what was available from household incomes. Later, reliance on borrowing and need to repay debt (also mortgage credit) exposed household consumption to decline once financial flows were reduced and credit became less available.

Besides Bulgaria and Romania, where the data on household indebtedness are unavailable, the scale of consumption growth (highest in the Baltic States) correlates with the speed in the growth of household indebtedness. Faster indebtedness was growing, higher was consumption growth. Also, the countries experiencing the fastest consumption growth before the crisis (in part fuelled by credit) suffered the highest drops of consumption later. This is illustrated in Figures 4 and 5 (on pages 24 and 25).

It seems that while for the pre-crisis period the higher growth of indebtedness speeded up the growth of consumption, higher indebtedness before the crisis tended to provoke higher falls in consumption after the crisis. Thus the fast growth of household indebtedness contributed to the unsustainability of growth of consumption among post-transition countries. It made recovery more difficult, similarly to the US, as pointed out by Cynamon and Fazzari (2013).

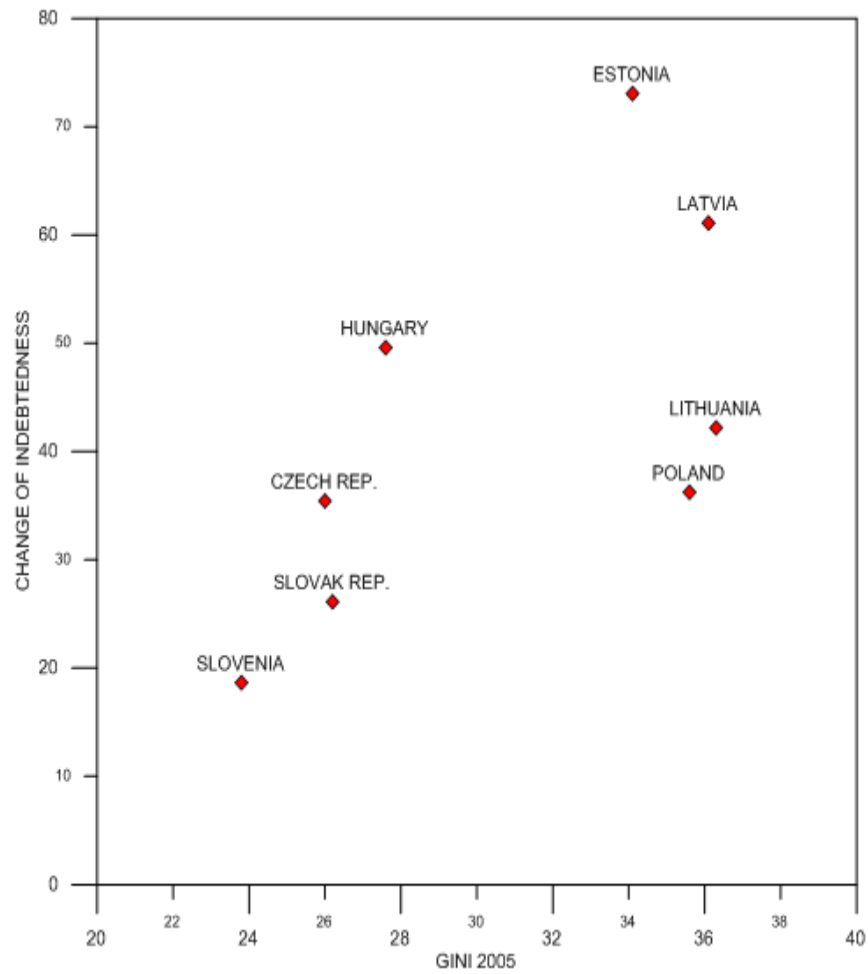
*Figure 1: Relationship between the Inflow of Foreign Credits and Rise of Household Indebtedness*



On X axis: average inflow of foreign credits to GDP in 2001–2008.

On Y axis: change of debt to income in percentage points in 2001–2008.

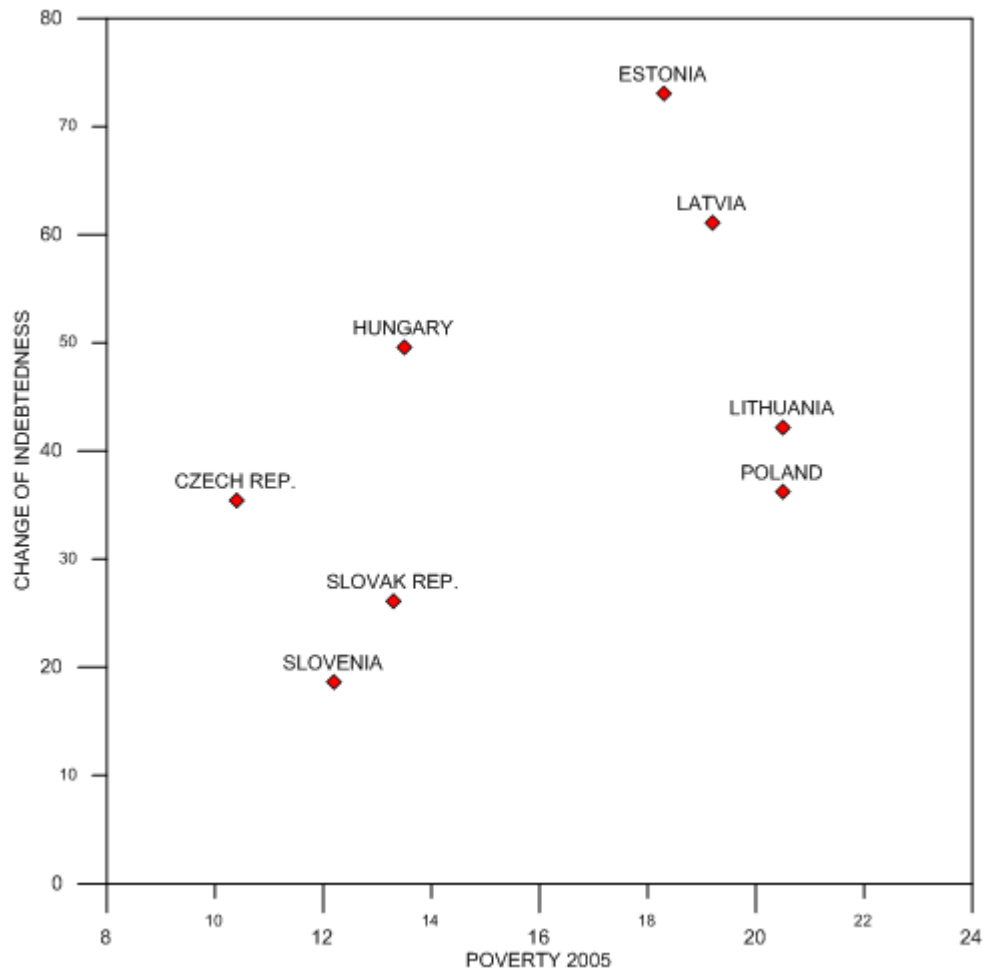
*Figure 2: Relationship between Inequality and the Rise of Household Indebtedness*



On X axis: Gini coefficient in 2005.

On Y axis: Change of debt to income in percentage points in 2001–2008.

*Figure 3: Relationship between Poverty and the Rise of Household Indebtedness*



On X axis: percentage of population at risk of poverty in 2005.

On Y axis: change of debt to income in percentage points in 2001–2008.



*Table 11: Features of Consumption Growth in Post-Transition Countries*

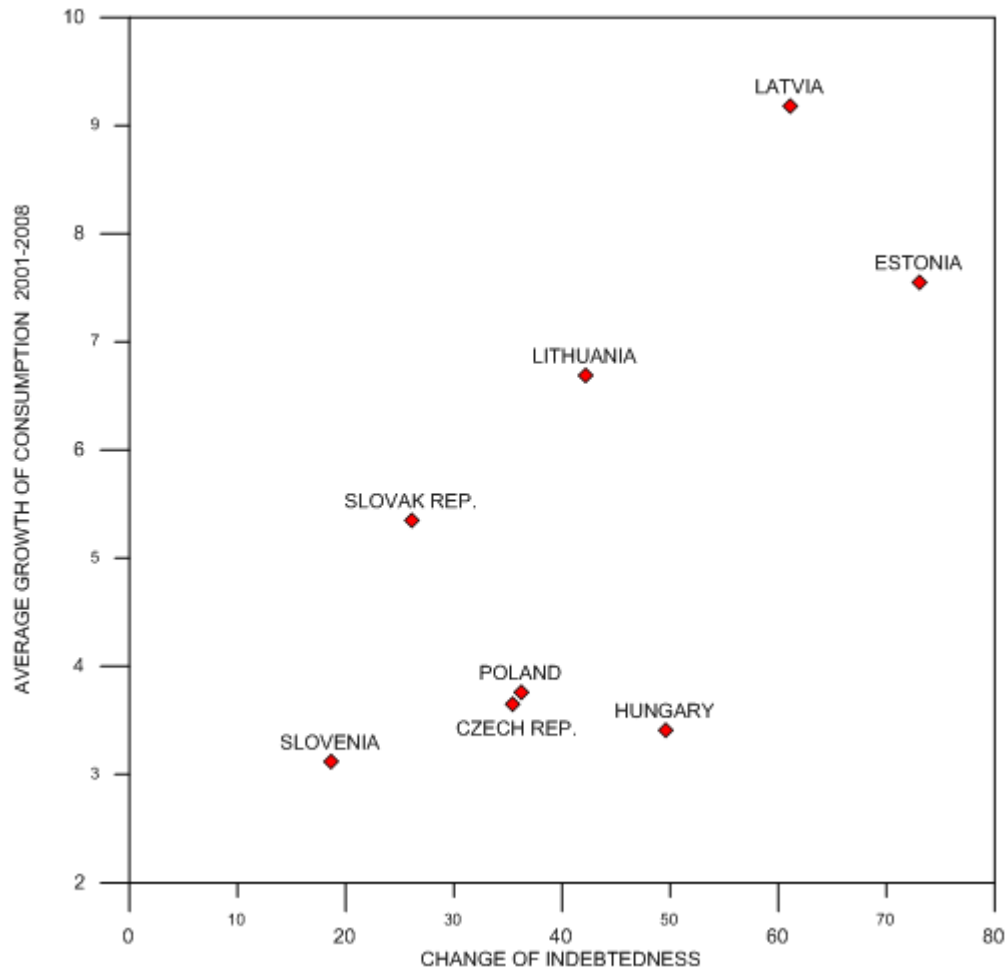
| Country           | 1996–2008                |                           |                             |                                       | 2001–2008                                     | 2009–2011                               |
|-------------------|--------------------------|---------------------------|-----------------------------|---------------------------------------|---|---|
|                   | Consumption              |                           |                             | GDP<br>coefficient<br>of<br>variation | Average<br>growth<br>of<br>consumption<br>(%) | Average growth<br>of consumption<br>(%) |
|                   | Average<br>growth<br>(%) | Standard<br>deviation (%) | Coefficient<br>of variation |                                       |   |   |
| EU15              | 2.1                      | 0.87                      | 0.406                       | 0.441                                 | 1.7   | –0.1                                    |
| Bulgaria          | 4.9                      | 5.06                      | 1.023                       | 1.376                                 | 6.7   | –2.0                                    |
| Czech<br>Republic | 3.1                      | 2.03                      | 0.660                       | 0.659                                 | 3.6   | 0.6                                     |
| Estonia           | 7.6                      | 4.81                      | 0.635                       | 0.624                                 | 7.5   | –4.6                                    |
| Latvia            | 7.7                      | 6.27                      | 0.814                       | 0.561                                 | 9.2   | –5.1                                    |
| Lithuania         | 7.6                      | 2.92                      | 0.386                       | 0.460                                 | 8.7   | –5.4                                    |
| Hungary           | 3.2                      | 3.17                      | 0.997                       | 0.500                                 | 3.4   | –3.0                                    |
| Poland            | 4.6                      | 1.95                      | 0.422                       | 0.378                                 | 3.8   | 2.6                                     |
| Romania           | 7.0                      | 5.81                      | 0.835                       | 1.078                                 | 10.4  | –3.1                                    |
| Slovenia          | 3.2                      | 1.53                      | 0.480                       | 0.261                                 | 3.1   | 0.8                                     |
| Slovakia          | 5.1                      | 2.32                      | 0.458                       | 0.513                                 | 5.3   | –0.3                                    |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_k&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en)

## **7 Instability as Indirect Consequence of the Features of Consumption Growth**

The growth of consumption fuelled by credit in parallel with the delayed growth of wages had broader consequences for the general vulnerability of the economic growth of post-transition countries. However, this vulnerability depended also on other factors (such as the structure of a given economy, its already established links with the global economy, size and structure of investment, availability of external finance, economic policy, specificities of the decisions of economic agents). Thus the features of consumption growth can be indicated only as one

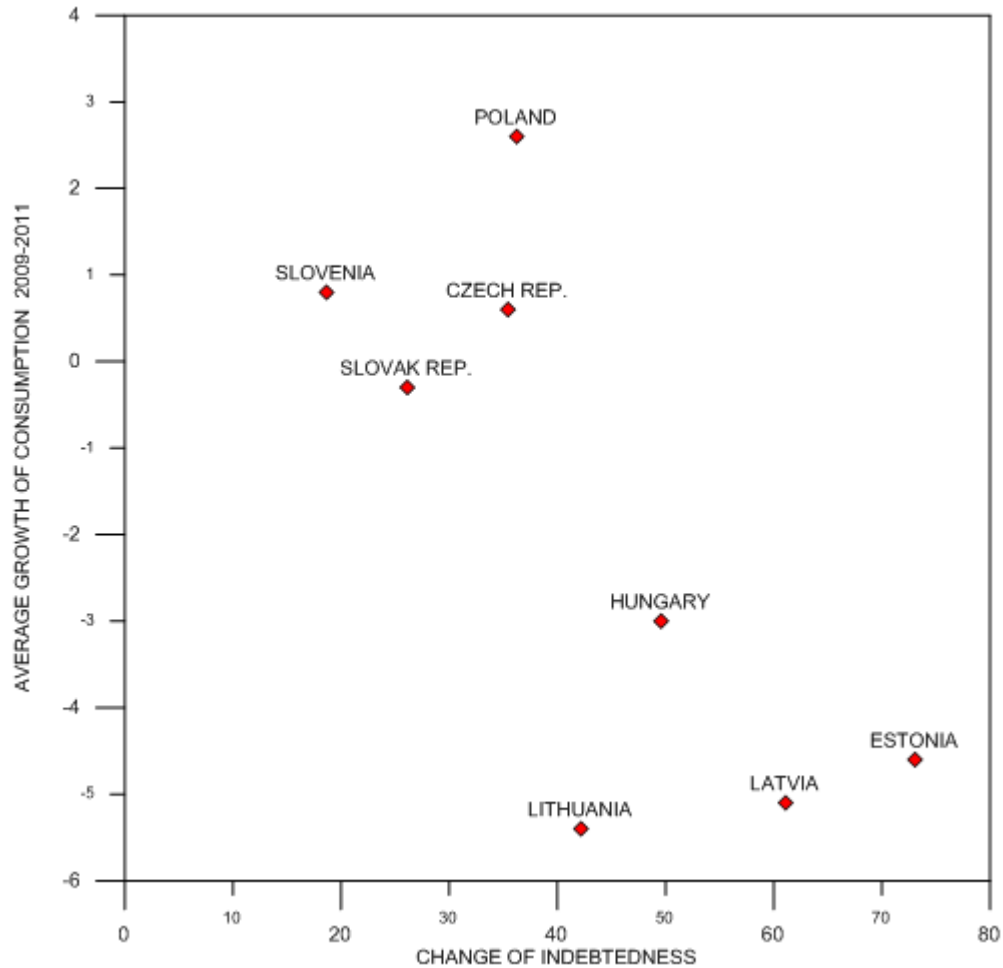
*Figure 4:* Relationship between the Rise of Indebtedness and the Rise of Consumption in the Pre-Crisis Period



On X axis: change of debt to income, 2001–2008.

On Y axis: change of consumption 2001–2008.

*Figure 5: Relationship between Rise of Indebtedness and the Change of Consumption in the Post-Crisis Period*



On X axis: change of debt to income, 2001–2008.

On Y axis: change of consumption 2009–2011.

among the reasons contributing to economic instability. I will focus in this section only on the impact of the features of welfare growth (delayed and unequal gains for the employed) without analyzing other potential factors of the instability of growth of post-transition countries.

Growth of consumption (and also demand for housing) and expectations of further economic growth increased the propensity to invest in post-transition countries. Another factor favourable for investment mentioned above was the exceptionally high growth of labour productivity (in particular as compared to compensation of employees) and the high proportion of remuneration of capital in value added, meaning high opportunities to reap profits. Availability of foreign finance before the crisis was of huge importance also, when investment opportunities were identified. However, while growth of investment (fixed capital formation) was exceptionally high in post-transition countries (Table 12), it was also highly unstable. The table exhibits this instability, both in the terms of pre-crisis fluctuations, and of deep post-crisis decreases. While undeniably GDP

*Table 12: Features of Growth of Fixed Capital Formation*

|                | 1995–2008          |                        |                          | 2009–2011          |
|----------------|--------------------|------------------------|--------------------------|--------------------|
|                | Average growth (%) | Standard deviation (%) | Coefficient of variation | Average growth (%) |
| EU15           | 3.02               | 2.60                   | 0.86                     | –3.8               |
| Bulgaria       | 12.72              | 16.19                  | 1.27                     | –15.2              |
| Czech Republic | 3.62               | 4.86                   | 1.35                     | –4.2               |
| Estonia        | 12.06              | 12.77                  | 1.06                     | –6.7               |
| Latvia         | 15.58              | 17.05                  | 1.09                     | –8.3               |
| Lithuania      | 12.15              | 10.35                  | 0.85                     | –7.1               |
| Hungary        | 4.93               | 3.61                   | 0.73                     | –8.7               |
| Poland         | 7.98               | 9.30                   | 1.17                     | 2.3                |
| Romania        | 9.66               | 8.99                   | 0.93                     | –8.0               |
| Slovenia       | 7.42               | 4.56                   | 0.61                     | –14.1              |
| Slovakia       | 6.18               | 11.46                  | 1.85                     | –0.5               |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_k&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en)

growth, demand generated by investment itself and export opportunities impacted on the propensity to invest, the role of expectation of growth of consumption in inspiring investment cannot be denied.<sup>8</sup>

An important source of financing was foreign direct investment. Table 13 (FDI according to the financial account, as a percentage of GDP and of gross fixed capital formation) prove of great importance of FDI in all post-transition countries (except Slovenia) and also of its relative volatility. As FDI constituted a substantial part of investment as a whole, their volatility had necessarily consequences for the volatility of growth of investment exhibited in Table 12. This impact is visible at the level of coincidence between the volatility of investment as a whole on the one hand and size and volatility of FDI in Bulgaria, Estonia, Latvia, and Slovakia.

*Table 13: Relative Size of FDI (1995–2008)*

|                   | FDI as percentage of GDP<br>1995–2008 |                              |                             | FDI/<br>GDP<br>average<br>2001–<br>2008 | FDI as percentage of gross<br>fixed capital formation 1995–<br>2008 |                              |                             | FDI/<br>GFCF<br>average<br>2001–<br>2008 |
|-------------------|---------------------------------------|------------------------------|-----------------------------|---|---|------------------------------|-----------------------------|--|
|                   | Average<br>(%)                        | Standard<br>deviation<br>(%) | Coefficient<br>of variation |   | Average<br>(%)  | Standard<br>deviation<br>(%) | Coefficient<br>of variation |  |
| Bulgaria          | 9.98%                                 | 8.29%                        | 0.830                       | 14.44%                                  | 44.63%  | 16.45%                       | 0.369                       | 56.51%                                   |
| Czech<br>Republic | 5.78%                                 | 3.02%                        | 0.522                       | 5.95%                                   | 20.86%  | 12.48%                       | 0.598                       | 22.12%                                   |
| Estonia           | 8.37%                                 | 4.27%                        | 0.510                       | 10.11%                                  | 27.66%  | 14.30%                       | 0.517                       | 31.82%                                   |
| Latvia            | 5.30%                                 | 2.10%                        | 0.396                       | 4.56%                                   | 23.39%  | 15.57%                       | 0.666                       | 15.24%                                   |
| Lithuania         | 3.85%                                 | 1.88%                        | 0.489                       | 4.04%                                   | 16.92%  | 8.76%                        | 0.518                       | 17.30%                                   |
| Hungary           | 5.39%                                 | 1.89%                        | 0.350                       | 4.86%                                   | 23.94%  | 9.59%                        | 0.401                       | 21.49%                                   |
| Poland            | 3.92%                                 | 1.45%                        | 0.370                       | 3.72%                                   | 19.43%  | 6.71%                        | 0.346                       | 18.93%                                   |
| Romania           | 5.45%                                 | 3.47%                        | 0.636                       | 7.04%                                   | 23.89%  | 17.67%                       | 0.740                       | 29.27%                                   |
| Slovenia          | 1.98%                                 | 1.66%                        | 0.838                       | 2.80%                                   | 7.88%   | 7.91%                        | 1.004                       | 11.01%                                   |
| Slovakia          | 5.53%                                 | 3.99%                        | 0.721                       | 7.53%                                   | 20.77%  | 17.55%                       | 0.845                       | 28.68%                                   |

Source: [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop\\_q\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop_q_c&lang=en)

<sup>8</sup> I will not comment here on the type of growth regime in post-transition countries (was it wage-led or profit-led), which is a much broader subject.

The growth of FDI in post transition countries had obviously different underpinnings from one country to another and also at different periods of time. Early research underlined the importance of serving local markets (Lankes and Venables 1996). Later, when investors were aiming also for efficient exporting, abundant and cheap assets became more important for them. However, particular institutional conditions prevailing in a given country had an impact and also an agglomeration effect (initial mass of investors self-reinforcing the attraction of the followers) (Campos and Kinoshita 2003).

Some of those motivations of FDI in post-transition countries could be related to the characteristics of welfare in post-transition countries described above: lowering labour costs contributing to the decrease from an already low proportion of earnings in the value added (and, thus, the possibility to reap higher profits) and good selling prospects due to the fast growth of consumption boosted by debt. However, seeking short term gains would expose FDI to instability.

The countries having the highest average proportion of FDI to GDP during the pre-crisis period were: Bulgaria, Estonia, Latvia, Hungary and Romania. Those countries (except Hungary) are among the ones who experienced rapid growth of consumption. However, some other countries (Lithuania and Poland) also enjoyed rapid consumption growth without attracting such massive contribution of foreign investment to growth.

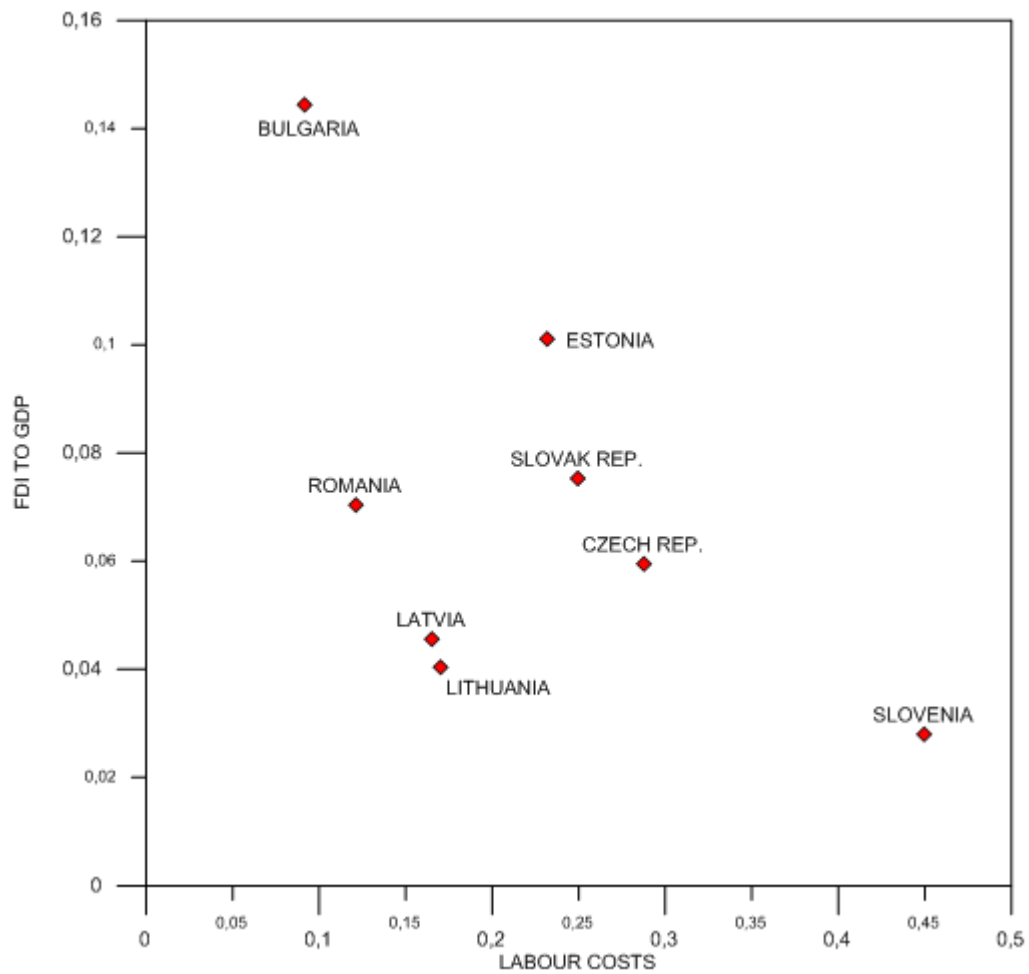
Statistics for hourly labour costs in absolute terms are available only for some post-transition countries and only for the end of the last decade. They provide however some insight into differences of costs of the factor of labour. If we take the Netherlands as benchmark,<sup>9</sup> in 2010 those costs were two times lower in Slovenia than in the Netherlands, 3–4 times lower in the Czech Republic, Estonia and Slovakia, 6 times lower in Latvia, Lithuania and Romania and ten times lower in Bulgaria. Obviously, a part of this difference could come from the difference of structure of output (requiring less skilled, so less well paid, employees), but it cannot be denied that lower actual comparable labour cost played a substantial role in the localization of the FDI in this region.

The visualization of the relationship between the hourly labour costs (relative to the Netherlands) and relation of FDI to GDP for the period 2001–2008 in Figure 6 shows some negative, but not quite clear direction.

---

<sup>9</sup> Data neither for EU as a whole nor for Germany were available.

*Figure 6:* Relationship between Relative Labour Costs and Ratio of FDI to GDP



On X axis: hourly labour costs in 2010 (the Netherlands = 1).

On Y axis: proportion of FDI to GDP in 2001–2008.

Moreover, as was said previously and exhibited in Table 6, labour productivity in post-transition countries was rising for many countries and periods faster than compensation of employees. For the pre-crisis period this difference was, on average, the highest for Romania, Slovakia, Poland and Bulgaria. This factor coincides with intensive inflow of FDI in Bulgaria, Romania and Slovakia, but other factors (probably higher technology level) seem to underpin FDI inflowing to Estonia, and also to the Czech Republic and Hungary, where labour cost advantages were not so substantial.

As the Figure 7 exhibits, there is no clear relationship between the change of real unit labour costs over the period 1995–2000 and the proportion of FDI in GDP over 2001–2008. Thus the factor of relative productivity advantage revealed over the period before investment cannot be perceived as a meaningful factor of FDI flows.

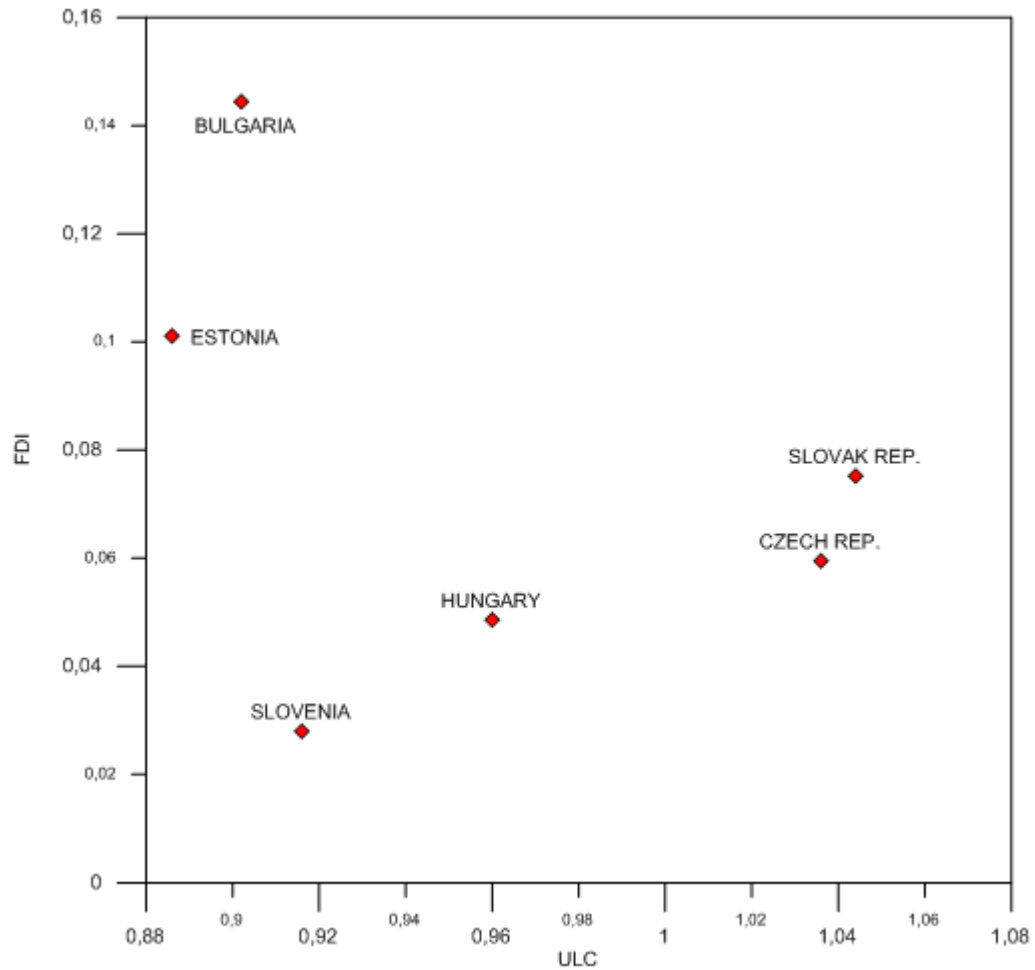
It may be said that it was rather the lower labour costs (and thus the higher possibility of reaping profits) attracting FDI than the growth of productivity exceeding a rise in the remuneration of employees. However, in some countries (such as Estonia – high FDI without particular labour costs advantage) FDI seems impacted by other factors than labour costs advantage.

It is also true that loans from abroad, as shown in Table 9, were another factor enabling the growth of investment (as also that of consumption), in parallel to FDI. This inflow of loans was very substantial (even amounting to 30% of GDP in some years) and highly fluctuating. It should be noted that this inflow was the highest in the countries experiencing the fastest growth of consumption and investment (Latvia, Estonia, Lithuania). However, at the end of the period rather the reverse flows took place. While this source of finance was obviously very helpful both for consumption and for investment, it was unavoidably unsustainable. The low value of this inflow in Poland should be noted together with generally low propensity to fund investment by credit by the companies (Boguszewski and Lissowska 2012).

Internal offer of goods and services was obviously insufficient, at least in the terms of differentiation, to cover all the needs of growing consumption (and also of investment), in particular in smaller countries. As shown in Table 14, imports were quickly rising and also the deficit of current account balance. This feature of instability was also the most pronounced in the countries experiencing the fastest



*Figure 7: Relationship between the Change of Unit Labour Costs and the Ratio of FDI to GDP*



On X axis: change of real labour costs 1995–2000.

On Y axis: FDI as percentage of GDP in 2001–2008.

*Table 14: Size of Imports of Goods and Services and of External Deficit*

|                | Average growth of imports<br>1996–2008 | Average current account balance as<br>percentage of GDP (1995–2008) |
|----------------|--|---|
| Bulgaria       | 11.5                                   | –7.31%  |
| Czech Republic | 8.7                                    | –3.91%  |
| Estonia        | 10.8                                   | –9.38%  |
| Latvia         | 10.8                                   | –10.01%   |
| Lithuania      | 12.2                                   | –8.93%  |
| Hungary        | 12.3                                   | –6.51%  |
| Poland         | 11.6                                   | –3.96%  |
| Romania        | 15.5                                   | –7.09%  |
| Slovenia       | 8.1                                    | –1.68%  |
| Slovakia       | 9.9                                    | –6.67%  |

Source : [http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop\\_q\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=bop_q_c&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_k&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en)  
[http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama\\_gdp\\_c&lang=en](http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en)

consumption growth (the Baltic States, Romania, Slovakia, Bulgaria). It should be noted that while imports of Poland, also having high consumption growth, were important, they were sufficiently counter-balanced by exports, without provoking high deficit.

## 8 Conclusion

The data from post-transition countries show that their fast growth was actually very volatile. Completing what is usually claimed, that this volatility and vulnerability stemmed mostly from fast integration with the global economy, namely by incoming financial flows and increased trade, the endogenous roots of some reasons of this volatility may be indicated. Namely, it was delayed and unequal growth of household incomes. The income differentiation was rapidly increasing and the layers of population at risk of poverty broadening. Confronted with high welfare expectations and with the pressure of consumerism under an abundant offer of goods (often linked with an offer of a loan) the households revealed high a propensity to consume on credit. Additionally, the wealthier and

younger social groups wished (or had to, due to withdrawal of the State) invest in better housing.

The comparison between the countries shows that both higher income inequality (measured by Gini coefficient) and broader layer of population at risk of poverty coincided with higher speed of borrowing. As rising outstanding loans meant that the households acquired new credit, this source could facilitate rise of consumption. Higher increase of borrowing in a country coincided with high speed of consumption in pre-crisis period, but also with higher fall after the crisis.

Incontestably, the availability of finance from abroad was an important factor of first, rapid growth and, then, decline of GDP and consumption in particular in those post-transition countries where the foreign financial flows were the most substantial. However, the internal factors impacting on the propensity of households to finance consumption and housing investment by credit had also important influence on growing indebtedness of households. This indebtedness exposed consumption to vulnerability when financial inflows vanished and, moreover, households had to pay back existing debt.

Quickly rising consumption fuelled by credit together with still lagging wages had some broader indirect consequences for economic growth of post-transition countries. In some countries (Bulgaria, Romania, Slovakia) the comparative advantages due to decrease of real labour costs and relatively low wages seem to be an important factor of FDI while this statement cannot be generalized to all countries.. Unsaturated markets in the countries previously constrained by acute shortages also attracted Foreign Direct Investment. Instability of consumption growth, in part based on credit and thus depending on its availability and, moreover, subject to requirement of debt repayment, was one of the factors of instability of FDI. As FDI constituted in the majority of post-transition countries high proportion of investment, their sensitivity to consumption growth impacted on vulnerability of investment as such. Also it cannot be denied that rapidly rising consumption incited non-FDI internal investment, in substantial part financed by foreign credits.

It should be noted that early opening of post-transition economies to import enabled satisfaction of rising consumption needs financed by credit, but also exposed them to additional vulnerability, taking into account limited export capacities. Only Slovenia (due to tourism services), and the Czech Republic and Poland (stable exporters) escaped high imbalance of current accounts.

It is thus true that the growth of post-transition countries was to a substantial degree debt-led and, as it is generally claimed, fast integration with global economy (by financial and trade flows) implied their vulnerability. But the roots of this vulnerability were, at least partly, in exceptionally high propensity to boost growth of consumption and of housing investment, on credit, underpinned by relatively suppressed and unequal growth of earnings of households.

While many institutional and structural factors shaped growth and contributed to the vulnerability of particular countries, it can be noted that those hardest hit by recession (Latvia, Lithuania, Estonia, Romania) were the ones cumulating at least two of the following features: high income inequality in 2008, the fast growth of indebtedness of households and a higher than average proportion of FDI in GDP. This pattern is however not relevant for Slovenia, where the crisis was also very deep, without high or rising income inequality. On the other hand, Poland, revealing high and rising income inequality but absorbing the lowest proportion of foreign credits whilst having limited increase of household indebtedness has enjoyed stable growth. However, many country-specific factors stabilized Polish economy: its size, robustness of export to Germany as principal partner, early regulation of lending to consumers, prudent attitude of investing companies.

All the countries suffering deep recession (Slovenia included) were recipients of a high inflow of foreign credits. It confirms the relevance of external finance for vulnerability, while propensity to absorb this finance was at least partly linked to households' income inequalities.

## References

- Ahrend, R. (2010). Monetary Ease: A Factor behind Financial Crises? Some Evidence from OECD Countries. *Economics: The Open-Access, Open-Assessment E-Journal*, Vol. 4, 2010-12. <http://dx.doi.org/10.5018/economics-ejournal.ja.2010-12>
- Becker, T., Daianu, D., Darvas, Z., Gligorov, V., Landesmann, M.A., Petrovic, P., Pisani-Ferry, M., Sapir, A., and Weder di Mauro, B. (2010). *Whither Growth in Central and Eastern Europe. Policy Lessons from an Integrated Europe*. Bruegel Blueprint Series, Vol. XI, Brussels: Bruegel.  
<http://www.bruegel.org/publications/publication-detail/publication/453-whither-growth-in-central-and-eastern-europe-policy-lessons-for-an-integrated-europe/>
- Białowolski, P. (2014). Patterns of Debt Possession in Poland - a Multi-Group Latent Class Approach. *Bank i Kredyt*, 45(2), forthcoming.
- Boguszewski, P., and Lissowska M. (2012). Low Reliance on Credit of Polish Firms – Blessing in Financial Crisis? *Gospodarka Narodowa* (7–8): 1–25.
- Campos N.F., and Kinoshita Y. (2003). Why Does FDI Go Where it Goes? New Evidence from the Transition Countries. IMF Working Paper WP/03/228. Washington CD: International Monetary Fund.  
<http://www.imf.org/external/pubs/ft/wp/2003/wp03228.pdf>
- Cynamon B.Z., and Fazzari S.M. (2013) Inequality, the Great Recession, and Slow Recovery. (January 23, 2014). Available at SSRN:  
[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2205524](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205524)
- De Serres A., Scarpetta S., and De La Maisonnette, C. (2001). Falling Wage Shares in Europe and in United States : how Important is Aggregation Bias? *Empirica* 28(4): 375–401. <http://ideas.repec.org/a/kap/empiri/v28y2001i4p375-401.html>
- EBRD (2010). *Transition Report 2009. Transition in Crisis?* London: European Bank for Reconstruction and Development.  
[www.ebrd.com/downloads/research/transition/TR09.pdf](http://www.ebrd.com/downloads/research/transition/TR09.pdf)
- Ellis, L., and Smith, K. (2007). The Global Upward Trend in the Profit Share. BIS Working Papers 231, Bank for International Settlements, Basel.  
<http://www.bis.org/publ/work231.pdf>
- Erlingsson, E.J., Teglio, A., Cincotti, S., Stefansson, H., Sturluson, J.T., and Raberto, M. (2014). Housing Market Bubbles and Business Cycles in an Agent-Based Credit Economy. *Economics: The Open-Access, Open-Assessment E-Journal*, Vol. 8, 2014-8. <http://dx.doi.org/10.5018/economics-ejournal.ja.2014-8>

- Gardo, S., and Martin, R. (2010). The Impact of Global Economic Crisis on Central, Eastern and South-Eastern Europe. A Stock Taking Exercise. ECB Occasional Paper Series 114, European Central Bank, Frankfurt.  
<http://www.suomenpankki.fi/pdf/166571.pdf>
- Gomez-Salvador, S., Lojschova, A., and Westermann, T. (2011). Household Sector Borrowing in the Euro Area. A Micro Data Perspective. ECB Occasional Paper Series 125, European Central Bank, Frankfurt.  
<http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp125.pdf>
- Guscina, A. (2006). Effects of Globalisation on Labor's Share in National Income. IMF Working Paper WP/06/294. International Monetary Fund, Washington, D.C.  
<http://www.imf.org/external/pubs/ft/wp/2006/wp06294.pdf>
- ILO (2008). *World of Work Report 2008. Income Inequalities in the Age of Financial Globalization*. International Labour Organisation, Geneva.
- IMF (2009). Global Financial Stability Report. Responding to the Financial Crisis and Measuring Systemic Risks. International Monetary Fund, Washington, D.C.  
<http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf>
- Jayadev, A. (2007). Capital Account Openness and the Labour Share of Income. *Cambridge Journal of Economics* (31): 423–443.  
<http://ideas.repec.org/a/oup/cambje/v31y2007i3p423-443.html>
- Lankes, P., and Venables, A. (1996). Foreign Direct Investment in Economic Transition: The Changing Pattern of Investments. *Economics of Transition* 4: 331–347.  
[http://econpapers.repec.org/article/blaetrans/v\\_3a4\\_3ay\\_3a1996\\_3ai\\_3a2\\_3ap\\_3a331-347.htm](http://econpapers.repec.org/article/blaetrans/v_3a4_3ay_3a1996_3ai_3a2_3ap_3a331-347.htm)
- Lavoie M., and Stockhammer, E. (2012). Wage-Led Growth: Concept, Theories and Policies. ILO Working Papers Conditions of Work and Employment Series 41. International Labour Organisation, Geneva.  
[http://www.ilo.org/wcmsp5/groups/public/---ed\\_protect/---protrav/---travail/documents/publication/wcms\\_192507.pdf](http://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---travail/documents/publication/wcms_192507.pdf)
- Myant, M., and Drahokoupil, J. (2011). *Transition Economies: Political Economy in Russia, Eastern Europe, and Central Asia*. John Wiley & Sons.
- Naastepad, C.W.M. (2006). Technology, Demand and Distribution: A Cumulative Growth Model with an Application to the Dutch Productivity Growth Slowdown. *Cambridge Journal of Economics* 30: 403–434.  
[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=904504](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=904504)
- Onaran, O., and Galanis, G. (2013). Is Aggregate Demand Wage-Led or Profit-Led? National and Global Effects. ILO Working Papers, Conditions of Work and Employment Series, No 40, International Labour Organisation, Geneva.

- Onaran, O., Stockhammer E., and Graft L. (2011). Financialisation, Income Distribution and Aggregate Demand in the USA. *Cambridge Journal of Economics* 35: 637–661. <http://cje.oxfordjournals.org/content/35/4/637.abstract>
- Praca nierejestrowana w Polsce w 2004 r. (2005). Warszawa: GUS.
- Shin, H.S. (2009). Securitisation and Financial Stability. *The Economic Journal* 119: 309–332. <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0297.2008.02239.x/abstract>
- Stockhammer, E. (2012). Decline in Wage Share: Causes and Prospects. Paper written for the Project: “New Perspectives for Wages and Economic Growth: The Potentials for Wage-Led Growth?” ILO Working Papers, International Labour Organization, Geneva (forthcoming).
- Tridico, P. (2012). Financial Crisis and Global Imbalances: Its Labour Market Origins and the Aftermath. *Cambridge Journal of Economics* 36: 17–42. <http://cje.oxfordjournals.org/content/36/1/17.abstract>

Please note:

You are most sincerely encouraged to participate in the open assessment of this article. You can do so by either recommending the article or by posting your comments.

Please go to:

<http://www.economics-ejournal.org/economics/journalarticles/2014-13>

The Editor