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

Discussion Paper
No. 2012-65 | December 21, 2012 | http://www.economics-ejournal.org/economics/discussionpapers/2012-65

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

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**Please cite the corresponding journal article:**
http://dx.doi.org/10.5018/economics-ejournal.ja.2014-13

**Abstract** This paper discusses the underpinnings of the financial crisis of the last decade. It explores the endogenous reasons of this crisis, and in particular a possible link between delayed and unequal growth of household incomes in post-transition countries on one hand and the instability of their growth and depth of recession after the financial crisis on the other. It indicates possible microeconomic factors underpinning rapidly growing indebtedness of households, enabling faster consumption growth, but subject to fluctuations. It claims also that 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 the inflow of financial funds contributed to, but did not cause instability growth in this region.

Paper submitted to the special issue
Economic Perspectives Challenging Financialization, Inequality and Crises

**JEL** I38, J48, P51

**Keywords** Welfare; labour market; post-transition economies; stability

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## 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 hardly hit once the crisis arrived. This came about although they neither issued or bought any toxic assets. 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 the migration of the labour force (together with remittances they used to send to the mother country). Once the crisis in more developed economies cut down those flows to post-transition economies, their growth vanished (EBRD, 2010).

In the present text I will reflect on another 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) and also by authors in comparative economics (Tridico, 2012). They explain that the structural changes, making wages lag behind profit growth, while growth was based on consumption, contributed to instability worldwide and finally to financial crisis.

I will argue that changes in the labour market of 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 of household indebtedness. The secondary effect of consumption growth and favourable profit rates was investment, often financed from abroad as FDI or by credit. Growing, but unstable investments also contributed to the vulnerability of growth in those countries.

All data used in this paper come from public Eurostat database, unless indicated otherwise.

## 2. At a glance - growth and decline

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 level of the countries of the European Union. Also consumption per inhabitant converged to EU 15 almost in the same degree as GDP per inhabitant[2].

[2] At current prices, for comparability with earnings in the Table 4

Table 1. Growth and convergence of GDP

| Country | Cumulated growth 2008/1995 | GDP per inhabitant, in PPS, as percentage of EU15 | | Consumption per inhabitant, as a percentage of EU15 | |
|---|---|---|---|---|---|
| | | 1995 | 2008 | 1995 | 2008 |
| EU27 | 1,352 | 100,0% | 100,0% | 100,0% | |
| Bulgaria | 1,543 | 27,6% | 39,4% | 7,0% | 17,2% |
| Czech Republic | 1,560 | 65,9% | 72,9% | 21,8% | 44,9% |
| Estonia | 2,227 | 31,2% | 62,5% | 11,3% | 39,2% |
| Latvia | 2,254 | 27,1% | 50,9% | 9,2% | 36,6% |
| Lithuania | 2,395 | 30,6% | 55,6% | 8,5% | 36,1% |
| Hungary | 1,489 | 44,1% | 57,8% | 18,3% | 35,2% |
| Poland | 1,805 | 37,1% | 50,9% | 15,5% | 33,5% |
| Romania | 1,581 | n.a. | 42,2% | 7,4% x/ | 23,3% |
| Slovenia | 1,729 | 64,1% | 81,9% | 44,4% | 57,7% |
| Slovakia | 1,903 | 41,2% | 65,3% | 14,8% | 39,2% |

x/ 1996

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. However, this fast growth experienced till 2008 terminated in a deep fall in all (except two – Poland and Slovakia) post-transition economies after 2008.

Table 3. Increase/decrease of GDP 2008-2011

| Country | Change of GDP in % |
|---|---|
| EU 27 | -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 |

This is not the only puzzle that can be disclosed beneath the “success story” of post-transition countries. While consumption per inhabitant rapidly converged to the EU15 level, the level of wages (average annual earnings in industry and services) still lagged behind. As here the data for the EU as a whole are unavailable (and also for some post-transition countries), the level of wages will be compared to the Netherlands (full data for Germany being unavailable).

Table 4. Consumption per inhabitant vs. average earnings in post-transition countries, as a percentage of the Netherlands

| | Annual earnings | | Consumption per inhabitant | |
|---|---|---|---|---|
| | 2008 | 2010 | 2008 | 2010 |
| Bulgaria | 8,4% | 9,7% | 15,2% | 14,5% |
| Latvia | 20,1% | 17,9% | 32,3% | 26,7% |
| Hungary | 23,6% | 21,2% | 31,3% | 27,9% |
| Romania | n.a. | 12,7% | 20,6% | 17,9% |
| Slovakia | 21,9% | 23,2% | 34,6% | 35,9% |

One could try to explain this apparent inconsistency by the influence of the "black market" (part of wages not being officially declared), or by the presence of social transfers. However, the available studies prove that earnings in the unofficial economy are by far lower than in the "official" one (*Praca,* 2005). Even if we take into account that a part of additional earnings in some professions (doctors) was undeclared, it could hardly explain the gap between wages and consumption. As for social transfers, they are much smaller as reported in 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.

Table 5. Expenditure on social protection as a percentage of GDP

| Country | 2008 | 2010 |
|---|---|---|
| EU27 | 18,0 | 19,9 |
| EU15 | 18,4 | 20,2 |
| Bulgaria | 11,2 | 13,5 |
| Czech Republic | 12,5 | 13,7 |
| Estonia | 11,6 | 14,6 |
| Latvia | 9,6 | 13,8 |
| Lithuania | 12,3 | 14,5 |
| Hungary | 17,8 | 17,8 |
| Poland | 15,6 | 16,9 |
| Romania | 12,4 | 14,9 |
| Slovenia | 15,9 | 18,7 |
| Slovakia | 10,2 | 12,3 |

The data quoted above shows that there could be structural deficiencies in growth seen by post-transition countries, namely concerning welfare and its underpinnings. Those structural features could contribute to the vulnerability of growth in these countries. The origin and the particular impact of lagging welfare gains will be clarified in the following sections.

## 3. Explanations of crisis in post-transition economies in 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. For example EBRD (2010) points that sudden declines in output in the fourth quarter of 2008 were mostly impacted on 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.

This integration was beneficial for the exceptionally high growth of the region from mid-1990s on. This was particularly the case for 2005-2007 when commodity prices were soaring and the abundant liquidity on global financial markets was in search of opportunities to invest. The availability of funds boosted mortgage lending in the countries where it had been previously almost nonexistent. It also allowed high lending to firms. The fact that a substantial part of borrowing was contracted in foreign currencies exposed the borrowers to additional risks. EBRD suggested that in the countries aiming to enter the Eurozone quickly the exchange rate risk was underestimated.

However, economic and financial integration created potential channels for the transmission of the crisis to post-transition countries in the event of contraction of demand for their exports and labour, and of narrowing liquidity.

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 (2009) report 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 a number of vulnerabilities present in all or in most post-transition countries in their phase of fast growth: boom of credits often granted in foreign currency and funded from foreign sources (while credit/deposit ratios in banks were rapidly rising), widening current account deficits, in some countries also limited the margin of manoeuver of the policy due to fixed exchange rates. They confirm that global financial crisis did not directly influence those countries who were not holding toxic assets. It was a slump of exports to the West and the indirect effect of crisis via lowering assessment by investors and difficult access to liquidity that hit those countries the most. It interacted with second-round effects of recession and rising non-performing loans. 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 through 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 6, the trend of the decreasing share of labour in the value added prevailed in Europe as a whole in the previous decade until the crisis, and re-started in 2011 with austerity policies.

As to the consequences of the rising proportion of capital gains, it was pointed out that it could predict positive long-term consequences in terms of strong investment and 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.

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 for liberalization, resulting among others in wage reduction and increased flexibility on the labour market. Further, Tridico claims that the decreasing trend of wages contributed to the emergence 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[3]. 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 unemployed[4].

The consequences of pro-capital economic policy (profits at the expense of wages) were studied along the lines of 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. They claimed however, 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 ( as US) relying on financial inflows from other countries, being export-led (China). This mode of growth, with conflict between policy and growth regime, is unstable and unsustainable.

The analyses quoted above (Tridico, 2012; Lavoie and Stockhammer, 2012) allow us to logically link the development of the labour market with accelerated borrowing and increasing reliance

[3] It should be noted that a number of other conditions contributed to the rise of household borrowing: availability of credit thanks to securirisation (Shin, 2009), its low price due to lowering interest rates by FED, government policy promoting house ownership

[4] Tridico (2012) indicates other factors weakenning economic growth, namely low real investment and financial speculation to earn higher profits

Table 6. Compensation of employees in value added

| GEO/TIME | 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% | 56,06% |
| Bulgaria | | | | | 42,31% | 41,38% | 41,18% | 40,54% | 40,00% | 40,91% | 40,00% | 41,07% | 40,91% | 42,11% | 44,16% | 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% | 46,75% |
| 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% | 53,85% |
| Latvia | | | | | | 44,44% | 45,00% | 40,91% | 45,83% | 44,83% | 45,71% | 48,84% | 52,63% | 56,25% | 51,92% | 47,06% | 47,54% |
| Lithuania | | | | | | 44,44% | 42,40% | 43,28% | 43,24% | 43,98% | 44,79% | 47,51% | 47,73% | 49,50% | 50,00% | 46,15% | 44,07% |
| 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% | 51,85% |
| Poland | | | | | | 45,09% | 46,15% | 44,39% | 43,08% | 40,93% | 40,53% | 40,57% | 40,74% | 42,66% | 41,53% | 42,20% | |
| Romania | | | | | | | | | | | | | | 47,42% | 45,24% | 44,09% | |
| 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% | 60,93% |
| 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% | 41,74% |

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 in the context of the absence of securitization and toxic assets. I will argue that endogenous changes on the labour market substantially contributed to increase the financial exposure and vulnerability of those countries. I will further show how the phenomena on the labour market steered the choices of agents towards those potentially exposing the economy as a whole to instability.

## 4. Features of consumption growth in post-transition countries. Their reasons and consequences

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 decreasing proportion of wages (compensation of employees) in value added. It was said above that this tendency is worldwide and was present in the countries of the European Union up to the financial crisis. However, in post transition countries the proportion of wages was lower. In some of them (Estonia, Poland, Slovakia) this proportion decreased in 2000s. It means that the proportion of profits in gross value added was higher than on average in EU15 and in some post-transition countries it was increasing (Table 6).

While the growth of wages was limited, incomes became more unequal. Inequality, as measured by the Gini coefficient, was not only already systematically higher in new Member States (the overwhelming majority of which are post-transition countries) than in the EU15 at the beginning of 2000s, thus not so long after transition (starting from very egalitarian society), but also was quickly increasing. Inequality was particularly deep in the Baltic states and in Poland

Table 7. Gini coefficients

| geo\time | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| EU (15 countries) | 29 | 29 | : | 30 | 30 | 29,9 | 29,5 | 30,2 | 30,7 | 30,4 | 30,5 | : |
| New Member States (12) | : | : | : | : | 37,4 | 33,2 | 33 | 31,8 | 31,3 | 30,7 | 30,3 | : |
| Bulgaria | 25 | 26 | 26 | 24 | 26 | 25 | 31,2 | 35,3 | 35,9 | 33,4 | 33,2 | : |
| Czech Republic | : | 25 | : | : | : | 26 | 25,3 | 25,3 | 24,7 | 25,1 | 24,9 | 25,2 |
| Estonia | 36 | 35 | 35 | 34 | 37,4 | 34,1 | 33,1 | 33,4 | 30,9 | 31,4 | 31,3 | : |
| Latvia | 34 | : | : | : | : | 36,1 | 39,2 | 35,4 | 37,7 | 37,4 | 36,1 | 35,2 |
| Lithuania | 31 | 31 | : | : | : | 36,3 | 35 | 33,8 | 34 | 35,5 | 36,9 | : |
| Hungary | 26 | 25 | 24 | 27 | : | 27,6 | 33,3 | 25,6 | 25,2 | 24,7 | 24,1 | : |
| Poland | 30 | 30 | : | : | : | 35,6 | 33,3 | 32,2 | 32 | 31,4 | 31,1 | : |
| Romania | 29 | 30 | 30 | 30 | 31 | 31 | 33 | 37,8 | 36 | 34,9 | 33,3 | 33,2 |
| Slovenia | 22 | 22 | 22 | 22 | : | 23,8 | 23,7 | 23,2 | 23,4 | 22,7 | 23,8 | 23,8 |
| Slovakia | : | : | : | : | : | 26,2 | 28,1 | 24,5 | 23,7 | 24,8 | 25,9 | |

It seems that delayed labour gains and increasing inequality were implied or enabled by changes in the labour market in post-transition period. One of these was sharply rising unemployment. Eurostat statistics report high unemployment figures even 10 years after transition: up to 19,5% in Bulgaria and Slovakia, 20% in Poland. As it was up from zero previously, it would undeniably change labour market relations to the detriment of actual and potential employees..

As to the state of the labour market, OECD data for the first decade of XXI century show low levels of employment protection indices in post-transition countries.

Table 8. Employment protection indices[1/] (OECD)

| | 2000 | 2008 |
|---|---|---|
| Germany | 2,57 | 2,39 |
| CZ | 1,94 | 1,99 |
| HU | 1,54 | 1,85 |
| PL | 1,86 | 2,19 |
| SK | 2,17 | 1,82 |
| SI | | 2,57 |

1/ EP_v2 defined as a weighted sum of version 1 sub-indicators for regular contracts weighted by 5/121, for temporary contracts weighted by 5/12 and collective dismissal (weighted by 2/12)

Source:
http://www.oecd.org/employment/employmentpoliciesanddata/onlineoecdemploymentdatabase.htm

It should however be kept in mind that labour protection indices are calculated according to expert assessment and weighted according to the weights attributed to different areas of labour protection. Thus different chains of indicators may be provided. The deficiency of the OECD dataset on employment protection indices is that it does not cover the earlier post-transition period, while it is known that in the centrally planned economies the protection of employees was very high ( those who did not work could even be punished) (Lissowska, 2010). The second set of labour protection indices, exhibited in the table below, was calculated by the experts from the International Labour Organisation and they are not fully coherent with OECD estimates for the early 2000s in Table 8. However, they show that between the late 1990s and 2003 a substantial deterioration of labour protection in post-transition countries took place. This could be the underpinning of reduced gains of labour in the value added and increased – of capital, as indicated previously.

Table 9. Employment protection indices (ILO)

| Country | Late 1990 | 2003 |
|---|---|---|
| Bulgaria | 2,8 | 2,0 |
| Czech Republic | 2,2 | 1,8 |
| Estonia | 2,4 | 2,3 |
| Hungary | 1,8 | 1,6 |
| Lithuania | | 2,8 |
| Poland | 2,0 | 2,1 |
| Slovakia | 2,3 | 1,8 |
| Slovenia | 3,3 | 2,4 |

Source: Cazes, Nesporova (2007)

## 5. Consequences of delayed and unequal growth of welfare

Growth of wages was thus limited compared to the speed of economic growth and also unequal. This inequality could hardly be compensated 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 decreased in the last decade. It seems that the limited and unequal growth of incomes coupled with high welfare expectations and an actual shortage of housing resulted in the propensity to fund consumption and residential investment by borrowing. The statistical data reveal rapidly growing levels of household indebtedness (both consumer and mortgage credit) in post-transition countries.

Table 10. Indebtedness of households – debt as a percentage of disposable income

| geo\time | 2000 | 2008 | 2010 |
|---|---|---|---|
| Euro area (17 countries) | 74,94 | 95,21 | 99,31 |
| Czech Republic | 13,33 | 49,65 | 54,21 |
| Estonia | 15,01 | 91,33 | 94,53 |
| Latvia | 9,1 | 70,79 | 74,25 |
| Lithuania | 2,19 | 45,55 | 46,61 |
| Hungary | 9,57 | 62,23 | 68,42 |
| Poland | 9,79 | 48,03 | 52,02 |
| Slovenia | : | 41,54 | 46,79 |
| Slovakia | 9,47 | 46,52 | 54,61 |

Source: Eurostat

The level of indebtedness of households in post-transition countries was finally not higher than in the countries of euro area, but it had increased drastically (from 4 to 20 times). Clearly, there seems to be a logical link between the type of the growth of welfare and its unequal distribution during the period of fast growth on the one hand ,and increase of household debt, on the other.

Beneath this statistical evidence (parallelism between limited and unequal growth of wages and indebtedness) there seems be a deeper microeconomic underpinning. Namely, other research confirms that in Eurozone countries households with lower incomes tend to be more indebted in consumer credit and suffer much higher credit service burdens as 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 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 a big cultural change 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 credits 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. On the contrary, the richest and youngest households tend to take mortgages under pressure of housing needs. Thus both higher income differentiation and lagging incomes (in particular the lowest) may underpin household decisions causing high debt (Bialowolski, 2012).

The other side of the coin is, obviously, the availability of finance (often provided from abroad) which enabled households to borrow. Credit offers, often together with aggressive marketing and loose creditworthiness assessment, enabled households to think about satisfying previously suppressed needs with rapidly expanding offers of goods. Lending proposed frequently by the sellers (of household equipment, of cars) could by an additional factor boost indebtedness.

It seems that it was mostly borrowing that made a difference between the (lower) convergence of wages and (higher) consumption to the EU. It also made consumption growth in some CEE volatile. As a result, growth of consumption in post-transition countries was very substantial, much higher than in EU15, but also very unstable. Reliance on borrowing exposed consumption to decline once financial flows were cut down.

Table 11. Features of consumption growth in post-transition countries

| Country | Average (%) | Standard deviation (%) | Coefficient of variation 1/ |
|---|---|---|---|
| European Union (27countries) | 1,8 | 1,02 | 0,57 |
| Bulgaria | 2,7 | 5,94 | 2,21 |
| Czech Republic | 2,2 | 1,92 | 0,87 |
| Estonia | 4,3 | 5,68 | 1,32 |
| Latvia | 4,0 | 8,03 | 1,99 |
| Lithuania | 4,4 | 5,88 | 1,34 |
| Hungary | 1,7 | 3,34 | 2,01 |
| Poland | 4,0 | 1,58 | 0,39 |
| Romania | 4,0 | 5,30 | 1,33 |
| Slovenia | 2,7 | 1,60 | 0,60 |
| Slovakia | 3,7 | 3,02 | 0,81 |

1/ Coefficient of variation was calculated as a quotient of standard deviation to average

## 4. Instability of investment and its relation to labour market features

Growth of consumption (and also demand for housing) and expectations of further economic growth increased the propensity to invest in post-transition countries. This exceptionally high growth of investment (fixed capital formation) was also highly unstable.

Table 12. Features of growth of fixed capital formation 1995-2008

| | Average (%) | Standard deviation (%) | Indicator of vartiation |
|---|---|---|---|
| European Union (27 countries) | 3,27 | 2,52 | 0,77 |
| Bulgaria | 12,72 | 16,19 | 1,27 |
| Czech Republic | 3,62 | 4,86 | 1,35 |
| Estonia | 12,06 | 12,77 | 1,06 |
| Latvia | 15,58 | 17,05 | 1,09 |
| Lithuania | 12,15 | 10,35 | 0,85 |
| Hungary | 4,93 | 3,61 | 0,73 |
| Poland | 7,98 | 9,30 | 1,17 |
| Romania | 9,66 | 8,99 | 0,93 |
| Slovenia | 7,42 | 4,56 | 0,61 |
| Slovakia | 6,18 | 11,46 | 1,85 |

While undeniably investment and demand generated by investment itself impacted on growth, the role of expectation of growth of consumption in inspiring it can not be denied[5].

It is interesting to see what contributed to this investment growth. An important source of financing was foreign direct investment. The following table (FDI according to the financial account, as a percentage of GDP) prove of high importance of FDI in all post-transition countries (except Slovenia) and also of high volatility of FDI. As FDI constituted a substantial part of investment as a whole, their volatility had necessarily consequences for volatility of the growth of investment growth exhibited in table 12.

Table 13. FDI as proportion of GDP (1995-2008)

| | Average (%) | Standard deviation (%) | Indicator of variation |
|---|---|---|---|
| Bulgaria | 9,98% | 8,29% | 0,830 |
| Czech Republic | 5,78% | 3,02% | 0,522 |
| Estonia | 8,37% | 4,27% | 0,510 |
| Latvia | 5,30% | 2,10% | 0,396 |
| Lithuania | 3,85% | 1,88% | 0,489 |
| Hungary | 5,39% | 1,89% | 0,350 |
| Poland | 3,92% | 1,45% | 0,370 |
| Romania | 5,45% | 3,47% | 0,636 |
| Slovenia | 1,98% | 1,66% | 0,838 |
| Slovakia | 5,53% | 3,99% | 0,721 |

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

[5] 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

them. Also, 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) (Kinoshita and Campos, 2003).

Some of the confirmed motivations of FDI in post-transition countries could be related to the phenomena linked to welfare in post-transition countries described above: lowering labour costs due to the lagging proportion of earnings in the value added (and, additionally, possibility to reap higher profits) and good selling prospects due to the fast growth of consumption boosted by debt.

Statistics of hourly labour costs in absolute terms is available only for some post-transition countries and only for the end of the last decade. If we take the Netherlands as benchmark, in 2010 those costs were two times lower in Slovenia than in the Netherlands, 3-4 time 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. Moreover, the proportion of costs and productivity of labour changed in time. Table 14 exhibits the percentage points difference between the change of labour productivity and the change of labour costs in post-transition countries. A decrease (or low increase) of labour costs during the early 2000s in parallel with rapidly growing labour productivity provided for increased comparative advantage in labour-intensive exports and could attract FDI seeking cheap labour[6].

It should also be underlined that investment (among which FDI flows played a substantial role) did not bring about meaningful results in terms of technical progress. According to the Innovation Union Scoreboard 2011 all but two post-transition countries (Estonia and Slovenia) are at the very bottom of the ranking of EU countries regarding to innovation (*Innovation*, 2012).

It is also true that loans from abroad were another factor enabling the growth of investment (as also that of consumption). Table 15 shows the relationship between the inflow of foreign loans to GDP. This proportion was very substantial (even going to 30% of GDP in some years) and highly fluctuating. 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.

[6] High negative or positive values of difference after 2008 are due to a slump in production followed only with a delay by decrease of labour costs. This negative difference – dues to the decrease in productivity via decrease of production not followed initially by labour costs, was frequently counter-balanced by a subsequent positive difference – when labour costs decreased accordingly.

Table 14. Difference between growth of labour productivity and of labour costs (in percentage points)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| European Union (27 countries) | 1,1 | 1,4 | 1,4 | 3,3 | 1,6 | 2,8 | 2,2 | -1,6 | -5,5 | 4,1 | 1,9 |
| Bulgaria | 3,1 | 7,4 | 3,1 | 6,2 | 5,3 | 6,6 | 3,1 | -0,2 | -11,0 | 2,6 | 9,8 |
| Czech Republic | 3,2 | -2,0 | 2,4 | 6,1 | 5,0 | 5,7 | 4,2 | -0,7 | -4,0 | 3,5 | 0,5 |
| Germany | 1,9 | 1,3 | 0,7 | 2,5 | 2,3 | 5,4 | 3,8 | -1,6 | -9,4 | 4,9 | 1,0 |
| Estonia | 7,7 | 5,9 | 5,4 | 5,4 | 8,8 | 4,2 | 1,6 | -12,1 | -7,1 | 14,0 | 3,4 |
| Latvia | 9,6 | 8,4 | 4,2 | 8,1 | 3,7 | 1,3 | 0,0 | -11,1 | 1,4 | 12,4 | 5,1 |
| Lithuania | 14,0 | 1,6 | 6,1 | 6,6 | 5,8 | 2,6 | 8,7 | 3,0 | -11,0 | 16,0 | 9,0 |
| Hungary | 4,3 | 4,5 | 3,5 | 6,7 | 4,1 | 4,9 | -0,7 | 3,3 | -3,6 | 7,0 | 0,6 |
| Poland | 0,6 | 9,0 | 8,8 | 10,2 | 3,7 | 5,5 | 3,5 | -3,1 | 2,6 | 2,6 | 4,7 |
| Romania | 1,5 | 35,7 | 7,3 | 21,0 | -3,0 | 12,2 | 4,4 | 0,7 | -3,5 | -2,0 | 7,9 |
| Slovenia | 2,1 | 3,7 | 4,2 | 3,7 | 4,7 | 5,2 | 4,9 | -1,0 | -11,9 | 2,6 | 2,0 |
| Slovakia | 5,1 | 4,2 | 4,9 | 8,3 | 3,5 | 7,3 | 8,8 | 0,9 | -11,2 | 7,6 | 3,7 |

Table 15. Inflow of foreign credits as percentage of GDP

| Country | Average 1995-2008 | Standard deviation 1995-2008 | Indicator of variation 1995-2008 | Average 2009-2011 |
|---|---|---|---|---|
| Bulgaria | 5% | 6% | 108% | -2% |
| Czech Republic | 3% | 3% | 114% | 0% |
| Estonia | 9% | 7% | 75% | -6% |
| Latvia | 15% | 10% | 67% | -3% |
| Lithuania | 6% | 4% | 72% | -6% |
| Hungary | 4% | 6% | 134% | 1% |
| Poland | 2% | 2% | 131% | 2% |
| Romania | 4% | 3% | 75% | 3% |
| Slovenia | 7% | 7% | 102% | -7% |
| Slovakia | 4% | 6% | 162% | 5% |

## 5. 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 this volatility may be indicated. Namely, unemployment and labour market relations less favourable for the employed enabled the delayed and unequal growth of incomes. Confronted with high welfare expectations and with the pressure of an abundant offer of goods (often together with an offer of a loan) this resulted in a propensity to consume on credit. The availability of finance from abroad enabled but did not cause this tendency.

The growth of consumption boosted by borrowing and high rewards of capital contributed to speeding up investment, in a substantial part constituted by FDI. Bigger was the part of FDI seeking local demand and cheap labour, it could be more volatile when those advantages vanished. Easily available finance from abroad also stimulated local investors, who counted on the continuous growth of local consumption and of the economy as a whole.

It is thus true that the growth of post-transition countries was to a substantial degree debt-led, but the roots of this were, at least partly, due to the politically chosen limited and unequal growth of earnings.

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 with the highest income inequality in 2008, the fastest 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. All those countries (Slovenia included) were recipients of a high inflow of foreign credits. It confirms the relevance of external

finance to vulnerability, while in some cases it might not be linked to households' inequalities.

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