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

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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 microeconomic factors underpinning the rapidly growing indebtedness of households, enabling faster growth in consumption , but subject to fluctuations. 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.

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Key words: welfare; post-transition economies; crisis; stability

[1] Warsaw School of Economics and European Commission; the opinions expressed in this paper are exclusively those of its author and are not binding in any way on the European Commission

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) and also by authors in comparative economics (Tridico 2012). They explain that the structural factors, making wages lag behind profit growth, while 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. It ensures their 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 the starting date of the first of those periods had to be postponed sometimes to 1996, and even 2000. As to the second period, in some cases the most recent data available were for 2010. The benchmark is the European Union of 15 countries belonging to it before the 2007 enlargement (EU15). The methodology applied is based on indicating logical relationships between the phenomena and then seeking confirmation of their relevance by comparing the configurations of variables in different countries. Due to the insufficiency of data more formal verification methods were not applied.

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 level of the countries of the European Union. Consumption per inhabitant also converged quickly to the level of EU 15[2].

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	n.a.	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%

x/ 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_c&lang=en

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

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

[2] Here and n 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 the Table 4

This is not the only puzzle that can be disclosed beneath the "success story" of post-transition countries. There was also inconsistency between growth of consumption and of earnings. 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 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.

Table 3. Consumption per inhabitant vs. average earnings in post-transition countries, as a percentage of the Netherlands

	Annual gross earnings		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%

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=earn_gr_nace2&lang=en

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 counties 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 we take into account that part of additional earnings in some professions (doctors) was undeclared, it could hardly explain the size of the gap between wages and consumption. 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, 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.

Table 4. Expenditure on social protection as a percentage of GDP

Country	1995	2000	2008	2010
EU15	20,9	19,3	18,4	20,2
Bulgaria	:	12,7	11,2	13,5
Czech Republic	16,0	18,0	12,5	13,7
Estonia	10,8	11,0	11,6	14,6
Latvia	12,7	12,5	9,6	13,8
Lithuania	n .a.	12,0	12,3	14,5
Hungary	17,6	15,4	17,8	17,8
Poland	n .a.	n .a.	15,6	16,9
Romania	10,2	10,5	12,4	14,9
Slovenia	n .a.	17,9	15,9	18,7
Slovakia	14,4	16,0	10,2	12,3

Source: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_a_exp&lang=en

The data quoted above suggest that there could be other structural reasons underpinning the discrepancy 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 manoeuver 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 6, 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.

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 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. 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 (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.

Tridico (2012) underlines the impact of the decreasing trend of wages on instability of growth, and also on the occurence 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 the unemployed[4].

The analyses quoted above (Tridico 2012; Lavoie and Stockhammer 2012) allow us to logically link the development 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 uneven growth of earnings contributed to unstable consumption growth fuelled by credit. I will further study the impact of the delayed rewards to employees and the unstable growth of consumption as the additional factors exposing economies of these countries to growing instability.

[3] 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), its low price due to lowering interest rates by FED, government policy promoting house ownership

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

4. 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 notable 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 they 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 output and of incomes of employees is provided in table 6[5]. 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 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, Poland, Romania, Slovenia) 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 situation for investment.

[5] Data are available only from 1996 on

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%	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%

Source: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en

Table 6. Cumulated change of labour productivity and of labour costs (initial year =1)

	2000/1995	2008/2000	2011/2008	2000/1995	2008/2000	2011/2008
	Real productivity per person employed			Real labour costs		
EU15	1,087	1,087	1,011	0,983	0,975	1,012
Bulgaria	1,065	1,070	1,008	0,902	0,946	1,090
Czech Republic	1,098	1,333	1,078	1,036	1,052	1,032
Estonia	1,152	1,330	1,022	0,886	1,107	0,918
Latvia	1,531	1,425	1,049	0,951	1,154	0,817
Lithuania	1,345	1,460	1,131	1,066	1,024	0,881
Hungary	1,328	1,633	1,015	0,961	0,978	0,948
Poland	1,095	1,315	0,973	0,978	0,873	0,962
Romania	1,326	1,281	1,081	n.a.	0,837	0,884
Slovenia	1,248	1,276	0,993	0,917	0,974	1,046
Slovakia	1,230	1,449	1,043	1,045	0,951	1,034

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_ulc&lang=en

The second feature of incomes in post-transition countries was their increasing inequality. As reported in the database of the World Bank[6], those societies started from being very egalitarian before transition, with Gini coefficient barely exceeding 20. Over ten years this index increased in most of them to 30, ten points more. Thus over a relatively short period they attained the level of income differentiation similar to Western Europe, without having its long historical trajectory of social change.

Table 7. Change of Gini coefficient in post-transition countries over 1990s

	1989	1993	1998
Bulgaria	23,4	24,3 b/	26,4 d/
Czech Republic	19,4 a/	26,6	
Estonia	23 a/	39,5	37,6
Hungary	25,1	27,9	24,9
Latvia	22,5 a/	27	33,5
Lithuania	22,5 a/	33,6	30,2
Poland	26,9	32,3	32,9
Romania	23,3	28,2 b/	29,4
Slovakia	19,5 a/		25,8 c/
Slovenia	n.a.	29,2 b/	28,4

a/ 1988; b/1994 c/1996 d/1997
Source : http://data.worldbank.org/indicator/SI.POV.GINI

According to Eurostat data for the subsequent period (mid-2000s), inequality, as measured by the Gini coefficient, was already systematically higher in new Member States (the overwhelming majority of which are post-transition countries) than in the EU15. However,

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

the degree of inequality tended to stabilize in post-transition countries (or even to decrease in some of them) over the decade, and in particular after the financial crisis. Inequality was particularly deep in the Baltic States, Bulgaria, Romania and Poland. High income inequality radically broadened the layer of the population at risk of poverty[7]. While this percentage in "old" European Union countries is at the level of 20%, it had reached 40% in new Member States in 2005, with particularly high levels in the Baltic States, Bulgaria, Romania and Poland. 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.

Table 8. Indicators of inequality and poverty in 2000s

	Level of Gini coefficient							Population at risk of poverty			
	2000	2005	2006	2007	2008	2009	2010	2005	2008	2010	2011
EU15	29	29,9	29,5	30,2	30,7	30,4	30,5	21,5	21,4	21,7	22,5
New Member States (12)	:	33,2	33	31,8	31,3	30,7	30,3	41,0	31,7	30,8	30,6
Bulgaria	25	25	31,2	35,3	35,9	33,4	33,2	:	44,8	49,2	49,1
Czech Republic	25 a/	26	25,3	25,3	24,7	25,1	24,9	19,6	15,3	14,4	15,3
Estonia	36	34,1	33,1	33,4	30,9	31,4	31,3	25,9	21,8	21,7	23,1
Latvia	34	36,1	39,2	35,4	37,7	37,4	36,1	45,8	33,8	38,1	40,4
Lithuania	31	36,3	35	33,8	34	35,5	36,9	41,0	27,6	33,4	33,4
Hungary	26	27,6	33,3	25,6	25,2	24,7	24,1	32,1	28,2	29,9	31,0
Poland	30	35,6	33,3	32,2	32	31,4	31,1	45,3	30,5	27,8	27,2
Romania	29	31	33	37,8	36	34,9	33,3	:	44,2	41,4	40,3
Slovenia	22	23,8	23,7	23,2	23,4	22,7	23,8	18,5	18,5	18,3	19,3
Slovakia	:	26,2	28,1	24,5	23,7	24,8	25,9	32,0	20,6	20,6	20,6

a/ 2001

Source:
http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_peps01&lang=en
http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_di12&lang=en

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.

5. 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 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.

[7] The threshold of risk of poverty is defined as 60% of the median equivalised income of the country

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.

Table 9. 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%

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=nama_gdp_c&lang=en

In the years 1995-2008, before the financial crisis, the inflow of foreign credits to the post-transition countries amounted to more that 5% of the GDP (with exception of the Czech Republic and Poland). While only part of those credits was channeled to households, it 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 education to be fully aware of their actual possibility to repay .

There is some statistical evidence that income inequality impacts on the propensity to borrow. Namely, other research has 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 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.

This 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

Country	2001	2008	2010
Euro area (17 countries)	75,09	95,06	99,03
Czech Republic	14,22	49,65	52,54
Estonia	18,85	91,91	96,77
Latvia	9,69	70,79	75,12
Lithuania	2,71	44,89	43,11
Hungary	12,65	62,24	67,28
Poland	11,79	48,03	52,23
Slovenia	23,30 a/	41,95	46,77
Slovakia	9,25	35,37	39,15

a/ 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 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). In the absence of data for Bulgaria and Romania, the speed of growth of indebtedness (the highest in the Baltic States and Hungary) correlates with the previously shown level of inequality and proportion of the population at risk of poverty. This suggests a link between inequality and poverty and borrowing.

It seems that borrowing was a substantial factor in the difference between the (lower) convergence of wages in post-transition countries and the (higher) convergence of consumption in 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.

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 CEE countries. 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, instability of consumption growth (the highest in Hungary and the Baltic States) correlates with the speed of growth of indebtedness of households. Also, the countries experiencing the fastest consumption growth before the crisis (in part fuelled by credit) suffered the highest drops later.

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

	1996-2008				2009-2011
	Consumption			GDP coefficient of variation	Consumption average growth (%)
Country	Average growth (%)	Standard deviation (%)	Coefficient of variation a/		
EU15	2,1	0,87	0,406	0,441	-0,1
Bulgaria	4,9	5,06	1,023	1,376	-2,0
Czech Republic	3,1	2,03	0,660	0,659	0,6
Estonia	7,6	4,81	0,635	0,624	-4,6
Latvia	7,7	6,27	0,814	0,561	-5,1
Lithuania	7,6	2,92	0,386	0,460	-5,4
Hungary	3,2	3,17	0,997	0,500	-3,0
Poland	4,6	1,95	0,422	0,378	2,6
Romania	7,0	5,81	0,835	1,078	-3,1
Slovenia	3,2	1,53	0,480	0,261	0,8
Slovakia	5,1	2,32	0,458	0,513	-0,3

a/ Coefficient of variation was calculated as a quotient of standard deviation to average
Source: http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_k&lang=en

6. 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 na 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 among the reasons contributing to economic instability.

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, it was also highly unstable.

Table 12. Features of growth of fixed capital formation

	1995-2008			2009-2011
	Average growth (%)	Standard deviation (%)	Coefficient of vartiation	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

While undeniably GDP 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[8].

An important source of financing was foreign direct investment. The following table (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 correlation 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			FDI as percentage of gross fixed capital formation		
	Average (%)	Standard deviation (%)	Coefficient of variation	Average (%)	Standard deviation (%)	Coefficient of variation
Bulgaria	9,98%	8,29%	0,830	44,63%	16,45%	0,369
Czech Republic	5,78%	3,02%	0,522	20,86%	12,48%	0,598
Estonia	8,37%	4,27%	0,510	27,66%	14,30%	0,517
Latvia	5,30%	2,10%	0,396	23,39%	15,57%	0,666
Lithuania	3,85%	1,88%	0,489	16,92%	8,76%	0,518
Hungary	5,39%	1,89%	0,350	23,94%	9,59%	0,401
Poland	3,92%	1,45%	0,370	19,43%	6,71%	0,346

[8] 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

Romania	5,45%	3,47%	0,636	23,89%	17,67%	0,740
Slovenia	1,98%	1,66%	0,838	7,88%	7,91%	1,004
Slovakia	5,53%	3,99%	0,721	20,77%	17,55%	0,845

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=bop_q_c&lang=en

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 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, thus, the possibility to reap higher profits) and good selling prospects due to the fast growth of consumption boosted by debt. However, looking for those short term gains would expose FDI to instability.

The countries having the highest proportion of FDI 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. If we take the Netherlands as benchmark[9], 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 in this region.

Moreover, as it was said previously and exhibited in the table 6, labour productivity in post-transition countries was rising 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.

It is also true that loans from abroad, as shown in the table 9 were another factor enabling the growth of investment (as also that of consumption). 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

[9] Data neither for EU as a whole nor for Germany were available

this inflow in Poland should be noted together with generally low propensity to fund investment by credit (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. Thus 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 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.

Table 14. Size of external flows of goods and services and of external deficit

	Average growth of imports 1996-2008	Average current account balance as 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=nama_gdp_k&lang=en
http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_gdp_c&lang=en

7. 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 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) this resulted in a propensity to consume on credit. On the other hand, the more wealthy and younger social groups wished (or had to, due to withdrawal of the State) invest in better housing.

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 indirect consequences for economic growth of post-transition countries. Unsaturated markets in the countries previously constrained by acute shortages attracted Foreign Direct Investment. In some countries (Bulgaria, Romania, Slovakia) the comparative advantages due to decrease of real labour costs seem also to be an important factor of FDI while this statement cannot be generalized. 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 limited 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: 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 for vulnerability, while propensity to absorb this finance was at least partly linked to households' income inequalities.

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