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## The Cyclical Impact of EU Cohesion Policy in Fast Growing EU Countries

*Most of the newly acceded central and east European EU countries are among the main beneficiaries of EU Cohesion Policy. The main objective of this policy is to improve the long-term growth and employment prospects of the supported regions, and thereby to support convergence towards higher levels of per capita income. In the short run, however, EU Cohesion Policy may at times amplify macroeconomic challenges for supported countries. In periods of a downturn of the economy it can have a stabilising impact. During periods of unsustainably fast economic growth, however, its short-term demand effects may contribute to internal and/or external macroeconomic imbalances. Economic policymakers should thus ensure that EU Cohesion Policy enhances long-term productivity, while avoiding, in times of overheating, an increased risk of unsustainable developments as a result of the additional demand stimulus from EU Cohesion Policy.*

The main objective of EU Cohesion Policy is to improve the long-term growth and employment prospects of the supported countries and regions. For this purpose, regions with a per capita income of less than 75% of the EU average can expect to receive considerable transfers from the EU in the context of the EU's Cohesion Policy ("Funds" hereafter). These amount to around 2.5% of GDP per year in New Member States on average and thus may have a considerable impact on aggregate demand in the economy. In the past, most of the supported Member States experienced relatively moderate rates of growth and had sufficient spare resources in their labour markets. A positive demand shock as arising from the Funds was thus almost invariably welcome. The benefits associated with the Funds, however, may be different, if the supported economies already operate close to or above their current growth potential. In such a scenario, the additional demand stimulus from the Funds may exacerbate labour market bottlenecks, increase wages and prices and may thus contribute to an overheating of the economy. In addition and more generally, the pure size of the transfers has given rise to doubts as to the effective and productive absorption of these Funds. In particular, critics argue that the benefits of the Funds

are smaller than under an optimal use of transfers for various reasons:

- within an inadequate administrative environment, transfers may be used for investment projects with zero or even negative return;
- extra resources for an adequate administrative handling of the funds imply that these resources cannot be used for productive purposes;
- as transfers provide rent-seeking incentives, there is the risk of unproductive investments for the sake of catching a rent in the form of transfers.<sup>1</sup>

While during an economic downturn EU Cohesion Policy may have a stabilising impact on the economy, the contrary may be the case during periods of unsustainably high growth rates. Against this background, the question may be posed whether the EU Cohesion Policy and the associated generous spending is always adequate for the fast-growing central and east European Member States that joined the EU in 2004 and 2007, i.e. Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Slovakia (EU9).<sup>2</sup> In the following, this question is addressed by first reviewing some key features of EU Cohesion Policy including the size of the Funds and their functional distribution. We then look in more detail at the demand effects of the Funds and at the mac-

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<sup>1</sup> For a survey cf. Jan in't Veid: The potential impact of the fiscal transfers under the EU Cohesion policy programme, European Economy Economic Papers, No. 283, 2007.

<sup>2</sup> Given its relative level of per capita income Slovenia is not among the group of main recipient central and east European EU countries. It is therefore not covered in this paper.

## COHESION POLICY

**Table 1**  
**Cohesion Policy Architecture**

2007-2013

Objectives	Eligibility	Financial instruments	Allocation of funds
(1) "Convergence"	<p>* NUTS 2 regions with per capita GDP &lt;75% of EU average</p> <p>* Transitional support for regions with GDP per capita &lt;75% of EU15</p> <p>* Member States with Gross National Income (GNI) &lt;90% of EU</p> <p>* Transitional support for MS with GNI &lt;90% of EU15</p>	<p>1) European Regional Development Fund (ERDF)</p> <p>2) European Social Fund (ESF)</p> <p>3) Cohesion Fund</p>	81.5%
(2) "Regional Competitiveness and employment"	All regions not covered by convergence objective and transitional support	ERDF ESF	16.0%
(3) "European territorial cooperation"	Differentiated by cross-border/ transnational/interegional cooperation	ERDF	2.5%

Source: European Commission: Cohesion policy 2007-13, Commentaries and Statistical texts, Brussels 2007.

roeconomic situation in the EU9 countries. Previous experiences in Greece, Ireland, Spain and Portugal (EU4), the main recipient countries of the Funds prior to EU enlargement, are used as a reference point for this analysis. Finally we briefly look at policy options to reduce possible cyclical risks resulting from the demand effects of the Funds in countries experiencing internal and/or external economic imbalances.

### Some Key Features of EU Cohesion Policy

EU Cohesion Policy is financed by three funds, namely the European Regional Development Fund (ERDF) ("Structural funds" hereafter), the European Social Fund (ESF) and the Cohesion Fund. As Table 1 shows, between 2007 and 2013 around 82% of total Cohesion Policy funding will be used for countries and regions covered by the "Convergence objective". These are countries or regions whose per capita income (in PPS) is less than 75% of the EU average. This objective covers around 25% of the EU population including the EU9 countries almost entirely.<sup>3</sup> All other parts of the EU receive some support from the Funds under the "Regional competitiveness and employment objective", for which around 16% of total funding is earmarked.<sup>4</sup> In addition, around 2% of the total funding is allocated for regions at the external and internal EU borders ("European territorial

co-operation objective"). Overall, according to the provisions, the funds must not exceed 4% of GDP ("ceiling rule").

The "Financial Perspective 2007-13" amounts to €347.4 billion, starting with €45.5 billion in 2007 and reaching €54.2 billion in 2013. Cohesion Policy is a major component of EU policy to which around one third of the EU budget is dedicated in 2007, increasing from about 5% in 1975,<sup>5</sup> when Cohesion Policy took off with the introduction of the European Regional Development Fund.<sup>6</sup> In 2007 around 0.4% of EU27 GDP was spent on Cohesion Policy, falling back to 0.35% in 2013, which is comparable to the level in the early 1990s.<sup>7</sup> In nominal terms, Poland is by far the main recipient of Cohesion Policy related transfers with commitments under the "Financial Perspective 2007-13" reaching €67.3 billion, followed by Greece (€35.2 bn) and Italy (€28.8 bn). In % of GDP, the EU9 countries will be the biggest beneficiaries of EU Cohesion Policy, with the allocated commitments ranging from 1.6% of GDP in Romania to 2.8% of GDP in Hungary and Lithuania (see Table 2). Commitments, i.e. spending allocations (in % of GDP) peak

<sup>3</sup> Only the capital regions of the Czech Republic, Hungary and the Slovak Republic are too "rich" to qualify.

<sup>4</sup> There are two views in the academic literature with regard to this part of the Cohesion Policy funding. On the one hand it is often argued that distributing some of the funding very widely will almost by definition not have any tangible impact. On the other hand it is stressed that giving some funding to all EU Member States is a politically unavoidable part of the political consensus-building needed to agree on the EU budget.

<sup>5</sup> For more details cf. the Appendix of S. Ederveen, H. de Groot, R. Nahujs: Fertile soil for structural funds? A panel data analysis of the conditional effectiveness of European Cohesion Policy, *Kyklos*, Vol. 59, 2006.

<sup>6</sup> Compared to the Financial Perspective 2000-06, the number of funds as well as programming stages has been reduced. Furthermore, the geographical eligibility rules have been revised. Nevertheless, distributing and managing these funds remains a huge administrative challenge for the European, national and regional administrations involved. For more details cf. European Commission: Cohesion policy 2007-13, Commentaries and Statistical texts, Brussels 2007.

<sup>7</sup> See European Commission: Growing regions, growing Europe, Fourth report on economic and social cohesion, 2007, p. 174.

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**Table 2**  
**EU Support for Cohesion in EU9 Recipient Countries 2007-13: Allocations**  
(in % of GDP)

	2007	2008	2009	2010	2011	2012	2013	Average 2007-13
Bulgaria	1.8	2.3	2.7	2.6	2.6	2.5	2.4	2.4
Czech Republic	2.7	2.5	2.5	2.4	2.4	2.3	2.2	2.4
Estonia	2.4	2.3	2.2	2.2	2.2	2.2	2.3	2.3
Latvia	2.5	2.3	2.2	2.2	2.3	2.3	2.3	2.3
Lithuania	2.8	2.6	2.5	2.5	2.5	2.5	2.4	2.5
Hungary	3.0	3.0	2.9	2.9	2.8	2.8	2.7	2.9
Poland	2.7	2.6	2.5	2.4	2.4	2.3	2.3	2.4
Romania	1.1	1.5	1.8	1.9	1.9	1.8	1.8	1.7
Slovakia	2.4	2.4	2.3	2.4	2.4	2.4	2.3	2.4
EU9 total	2.4	2.4	2.4	2.4	2.4	2.3	2.3	2.4

Note: Owing to a lack of projections, the nominal GDP growth rate for 2013 was set equal to the growth rate for 2012.

Sources: ECB calculations; European Commission (for cohesion policy related EU expenditure); European Commission AMECO database (for nominal GDP for the period 2007-09); IMF World Economic Outlook database (for nominal GDP growth rates for the period 2010-12).

in 2007 for all countries except Bulgaria and Romania and are expected to decline only slightly over the period 2007-13. In the cases of Bulgaria and Romania, allocations in % of GDP gradually increase in the first years of the period and peak in 2009 and 2010 respectively.<sup>8</sup>

<sup>8</sup> Romania receives relatively little funds (in % of GDP) despite the fact that it has the second lowest GDP per capita in the EU because of the following reasons: Among others, the funds for the period 2007-13 were allocated on the basis of average 2001-03 GNI per capita in euros (PPS), expressed in 2004 prices and indexed for inflation (2%). Growth in nominal GDP over the past few years has, however, been much stronger than anticipated and, in addition, the currency has appreciated significantly. In this respect, Romania might benefit from a review of commitments scheduled for 2010. According to Annex 2 to Council Regulation No. 1083/2006 of July 2006, if by 2010 "it is established that any Member State's cumulated GDP for the years 2007 to 2009 has diverged by more than +/- 5% from the cumulated GDP [...] including as a consequence of exchange rate changes", allocations will be adjusted accordingly. However, the adjustment may not exceed 3 billion euros per country (in the case of Romania 3 billion euros correspond to around ¼% of GDP per year over the period 2007-13).

**Table 3**  
**Structural and Cohesion Fund Expenditures in the EU4 Countries 1994-99 and 2000-06**  
(annual averages, in % of GDP)

	1994-99	2000-06
Greece	3.7	2.9
Spain	1.7	1.4
Ireland	2.8	0.6
Portugal	4.0	2.9

Source: European Commission: Reports on Economic and Social Cohesion.

To put the support for the EU9 countries during the 2007-13 period into perspective, Table 3 provides an overview of Cohesion Policy expenditures during the past two EU financial programming periods for the main beneficiaries prior to the 2004 enlargement, i.e. Greece, Ireland, Spain and Portugal (EU4).

The intensity of financial support peaked at around 3.7 and 4% of GDP during the 1994-99 period in Greece and Portugal respectively.<sup>9</sup> During the 2000-06 period the intensity of support (in % of GDP) declined in all EU4 countries given their progress with real convergence – in particular in the case of Ireland.

Structural funds are mainly used for three broad categories of expenditure: "infrastructure" (transport, telecommunications and information society, environment, energy), "human resources" (labour market policy including equal opportunities, social inclusion, education and vocational training and entrepreneurship) and "productive environment" (research and technological development, assistance to businesses including tourism, rural development, agriculture, forestry and fisheries). Table 4 provides an overview of the share of these categories in per cent of total Structural Fund expenditures in the EU4 countries during the periods 1994-99 and 2000-06.

<sup>9</sup> The lower level for Spain was mainly due to the fact that not all its regions were eligible for the most resource-intensive type of Cohesion Policy support.

**Table 4**  
**Functional Distribution of Structural Fund Expenditure in Greece, Ireland, Portugal and Spain, 1994-2000 and 2000-2006**  
(in % of total)

Type of expenditure	1994-1999				2000-2006			
	Greece	Spain	Ireland	Portugal	Greece	Spain	Ireland	Portugal
Infrastructure	45.9	40.4	19.7	29.7	21.9	28.1	29.5	33.5
Human resources	24.6	28.4	43.9	29.4	19	23.3	27.3	20.3
Productive environment	27.8	30.5	36.2	35.7	56.5	48.2	42.7	44.3

Source: European Commission: Reports on Economic and Social Cohesion.

**Table 5**  
**Execution of Structural Funds: Ratio of Actual Payments and Commitments**

EU7	56%	Latvia	45%
Czech Republic	46%	Lithuania	56%
Estonia	66%	Poland	57%
Hungary	66%	Slovakia	55%

Source: European Commission.

Table 4 shows a considerable dispersion in countries' strategies to use the Funds. Whereas infrastructure was the main category of expenditure in Greece and Spain during the 1994-99 period, Ireland focussed during the same period mainly on human resources and in Portugal the largest share of the funding went to "productive environment". During the 2000-06 period the latter was the most popular type of activity in all EU4 countries, followed by infrastructure. However, the three very broad headline categories are likely to underestimate the importance of infrastructure in total expenditure. Measures taken in the field of tourism or rural development for example tend to require considerable building activity as well.

In the course of 2007 the individual EU countries submitted their "National Strategic Reference Frameworks" (NSRFs) for approval by the European Commission, providing detailed information on the planned use of the allocated Cohesion Policy related funds over the 2007-13 period. While a comparison of the functional distribution of funds with the one observed over the 2000-06 period is difficult because the main chapters of Cohesion Policy have been redesigned, infrastructure projects are likely to account for a large share of Cohesion Policy related funds in the EU9 countries, in particular given the large infrastructure needs in these countries. The NSRF of Latvia, for example, foresees that around 70% of committed funds will be allocated to the improvement of infrastructure and public services, with the rest being allocated to the promotion of R&D, innovation and human capital accumulation. Under the rather conservative assumption that half of the funds allocated to projects in the area of infrastructure and public services require some building input, this would imply a persistent stimulus of around 1% of GDP for the construction industry in Latvia.

#### **Macroeconomic Implications of the Funds in Fast-growing Economies**

For assessing the demand effects of Cohesion Policy, one has to distinguish between commitments

made within the Cohesion Policy framework and actual payments as the time profile of actual payments under the EU Cohesion Policy can differ substantially from the time profile of expenditure commitments. Table 5 gives information on the execution of Structural Funds, revealing that over the period 2004 to September 2007 the EU Member States which joined in 2004 on average were able to execute only 56% of the committed Structural Funds. As regards the Cohesion Fund, the ratio of actual payments to commitments was even as low as 22% for the same group of countries. As regards Bulgaria and Romania, the European Commission estimates that in 2007 the actual payments under the EU Cohesion Policy will reach only 37% and 23% of commitments respectively. A low rate of executed funds is indicative of poor administration and planning. This is rather problematic given that the empirical literature analysing the impact of EU Funds on economic growth emphasises that the quality of institutions is a key determinant of the success of the Funds in promoting long-run economic growth.<sup>10</sup>

As past experience shows, actual payments from the Funds tend to increase towards the end of the planning period due to "teething problems" at the start of the planning period.<sup>11</sup> Furthermore, Structural Funds are subject to an "additionality" principle, requiring that transfers from the EU must not substitute projects that would also have been implemented in the absence of financial support from Structural Funds. In contrast, Cohesion Fund related transfers are allowed to replace national spending by up to 85%. To increase countries' incentives to use Structural Funds efficiently, a co-financing requirement was introduced into the Cohesion Policy framework. This necessitates that projects under Objective 1 ("Convergence") receive at least 25% (20% if the region is eligible for Cohesion Fund support) national financial resources, while projects under Objectives 2 ("Regional competitiveness and employment") and 3 ("European territorial cooperation") require 50% of national resources,

<sup>10</sup> Overall, the size of the estimated effects of the impact of EU funds on real GDP growth, though usually positive, differs significantly across studies (see, e.g., S. Ederveen, H. de Groot and R. Nahujs, op. cit. Lolos and Theodoulides find for the new EU Member States that EU funds of 1% of GDP increase GDP growth by ½ percentage point. Cf. S. Lolos, A. Theodoulides: The role of EU Structural Funds in the Development of Lagging behind European Regions, in: *Economic & Financial Modelling*, Vol. 8, No. 1, 2001, pp. 29-46. For a survey of the macroeconomic impacts of EU funds in the New Member States see C. Allard, N. Choueiri, S. Schadler, R. van Elkan: *Macroeconomic effects of EU Transfers in New Member States*, IMF Working Paper, WP/08/223, September 2008.

<sup>11</sup> European Commission spending rules allow the funds to be carried over to the next year, although some restrictions apply. For structural funds the maximum carry-over period is n+3 years for commitments till 2010, reduced to n+2 years thereafter.

**Table 6**  
**Key Macroeconomic Indicators for the EU4 Countries, 1994-99 and 2000-06**  
 (period average)

	GDP growth		Employment rate		Unemployment rate		Harmonised index of consumer prices		Compensation per employee	
	1994-99	2000-06	1994-99	2000-06	1994-99	2000-06	1994-99	2000-06	1994-99	2000-06
Greece	2.8	4.3	53.0	53.8	10.1	10.3	5.8	3.4	11.7	8.2
Spain	3.4	3.4	52.8	61.9	16.7	10.3	3.1	3.3	6.3	6.7
Ireland	9.1	5.7	58.4	67.6	10.2	4.4	2.2	3.6	10.1	9.8
Portugal	3.6	1.1	68.0	71.1	10.3	8.4	3.0	3.1	6.8	4.7
Av. (unw.)	4.8	3.6	58.0	63.6	11.8	8.4	3.5	3.3	8.7	7.4
Euro area	2.5	1.8	61.3	65.6	6.3	6.0	1.9	2.2	3.1	3.4

Sources: European Commission; AMECO database; own calculations.

which can be private and public. The extent to which this co-financing requirement leads to additional demand via national resources in transfer-receiving countries is an issue of debate.

According to calculations by the European Commission for the year 2007, the impact of structural and cohesion funds on the general government budget is negligible in % of GDP, i.e. 0.05% for Bulgaria and 0.03% for Romania, the countries for which these calculations have been presented.<sup>12</sup> This relates to the assumption that the direct impact of transfers on the budget balance is neutral as in the case of strict additivity the expenditure the government needs to spend on a project equals the additional revenue it receives from the EU transfer. As regards the indirect effects, transfers that are not subject to strict additivity may partly substitute for national expenditure (e.g. as is the case with cohesion funds). The budgetary impact for the transfer receiving country would thus be slightly positive on average. In general, the exact demand impact of the Funds depends on the assumptions regarding the amount of “additionality” within the co-financing arrangements.<sup>13</sup> Given the

<sup>12</sup> These calculations assume an absorption rate of 20%, a rate of 80% of transfers that go to the general government, an average co-financing rate of 15% for all funds and that 1/3 of the total structural and cohesion funds are not subject to a strict additivity requirement. It is further assumed that countries use to the maximum extent possible opportunities of substituting EU transfers for national spending. See European Commission: Public Finances in EMU - 2007, Brussels 2007. The estimated aggregate budgetary impact of all EU transfers (including, inter alia, transfers from the Common Agricultural Policy (CAP) as well as these countries' contributions to the EU budget) is much larger, i.e. 1.05% of GDP in Bulgaria and 0.37% of GD in Romania.

<sup>13</sup> Rosenberg and Sierhey conclude that EU funds in the new EU Member States may have led to a fiscal drag of up to 1% of GDP in the first years of membership, mainly due to co-financing arrangements. Instead, Commission estimates show that the impact of EU funds on the national budgets may have been positive, arguing that as co-financing is not subject to the “additivity” requirement, the related funds may be taken from other national budget lines. See C. Rosenberg, R. Sierhey: Interpreting EU funds data for macroeconomic analysis in the New Member States', IMF Working Paper No. 07/77, 2007.

short-term “rigidity” of national budget lines, it can be assumed that national co-financing is to a large extent additional in the short-run.<sup>14</sup> In principle, the extent to which co-financing requirements lead to a need to mobilise additional resources can be limited by aligning projects with national spending priorities.

Although the Funds' main aim is to support the medium-term growth prospects of the supported countries and regions, EU Cohesion Policy can also have a considerable cyclical impact. Against this background it is interesting to look at recent macroeconomic conditions in the EU9 countries and to compare them with the situation in the EU4 countries during the two previous Cohesion Policy “programming periods”, i.e. 1994-99 and 2000-06. Table 6 provides an overview of key macroeconomic indicators for the EU4 countries during the periods 1994-99 and 2000-06.

The average growth rate for the EU 4 countries was above the euro area average during both periods, indicating some catching-up, whereas the employment rate remained below, and the unemployment rate above the euro area figures. Given the importance of structural factors in labour markets, lower employment and higher unemployment rates are not necessarily clear indicators for the degree of spare capacity in the economy. Nevertheless, the stylised facts compiled in Table 6 suggest that the EU4 economies, the main beneficiaries of the EU Funds during the periods 1994-99 and 2000-06, had at least as much if not more spare labour market capacity during these periods than the euro area average.<sup>15</sup>

Turning to the current macroeconomic environment in the EU9 countries, Table 7 provides an over-

<sup>14</sup> See European Commission, op. cit., pp. 277.

<sup>15</sup> While real wages rose more strongly during the two periods in EU4 countries than in the euro area on average, real unit labour costs fell more strongly in EU4 countries.

## COHESION POLICY

**Table 7**  
**Key “Overheating” Indicators for the EU9 Countries 2006-09**

(change over previous period, unless otherwise indicated)

	BG	CZ	EE	LV	LT	HU	PL	RO	SK
Inflation <sup>1</sup>									
2006	7,4	2,1	4,4	6,6	3,8	4,0	1,3	6,6	4,3
2007	7,6	3,0	6,7	10,1	5,8	7,9	2,6	4,9	1,9
2008	9,9	6,2	9,5	15,8	10,1	6,3	4,3	7,6	3,8
2009	5,9	2,7	5,1	8,5	7,2	3,7	3,4	4,8	3,2
Compensation per employee (whole economy)									
2006	7,4	6,2	14,0	23,6	15,1	8,4	1,9	17,8	7,9
2007	17,9	7,0	26,5	33,2	14,1	8,4	8,1	20,2	8,3
2008	13,7	7,2	13,6	21,0	15,0	6,9	8,0	18,1	8,4
2009	10,9	7,2	8,2	12,0	9,6	6,7	7,0	16,4	8,6
Unemployment rate minus NAWRU <sup>2</sup>									
2006	-0,3	0,4	-1,8	-1,4	-2,6	0,7	-0,3	0,4	0,5
2007	-0,8	-0,8	-1,7	-1,1	-1,9	0,1	-1,9	-0,2	-0,9
2008	-0,2	-0,8	1,1	0,5	0,1	0,7	-1,6	-0,2	-2,0
2009	0,7	-0,1	2,5	2,1	1,3	-0,1	0,2	-0,1	-2,2
Current account (% of GDP)									
2006	-16,3	-3,1	-15,7	-22,5	-10,5	-6,5	-3,1	-10,4	-7,7
2007	-22,0	-2,3	-14,9	-22,9	-13,8	-5,0	-3,7	-13,9	-5,0
2008	-21,2	-2,9	-11,2	-17,7	-12,3	-4,4	-4,6	-16,1	-4,0
2009	-20,9	-2,6	-9,3	-15,5	-11,2	-3,9	-5,5	-16,2	-3,1
Output gap (% of potential output)									
2006	1,6	0,8	4,7	3,2	1,9	1,8	0,6	3,4	-1,6
2007	1,4	2,0	4,0	4,8	2,6	0,2	1,2	3,0	1,9
2008	0,8	1,4	-0,5	1,0	1,4	-0,8	0,5	2,6	2,7
2009	0,2	1,1	-2,9	-3,5	-1,1	-0,5	-0,7	1,2	2,5

Notes: <sup>1</sup> Harmonised index of consumer prices. <sup>2</sup> Non-accelerating wage rate of unemployment.

view of some key indicators. Looking first at inflation, Table 7 shows that except for the Czech Republic, Poland and Slovakia all EU9 countries had HICP inflation rates close to or above 5% in 2007. This picture is expected to change somewhat by 2009, after a worsening in 2008. Growth rates for compensation per employee confirm the overall picture of strong wage and price increases in many EU9 countries, with double-digit growth rates in Bulgaria, the Baltic countries and Romania in 2007, 2008 and – despite a projected clear deceleration in some countries – in 2009. The tightness of the labour markets in many EU9 countries can also be illustrated by looking at the difference between the unemployment rate and the estimated NAWRU. Except for Hungary unemployment in 2007 was below the estimated NAWRU.

Another indicator for overheating is the external balance in the EU9 countries. Here the picture is rather mixed. Bulgaria, the Baltic countries and Romania all show external deficits above 10% of GDP in 2007 (in the case of Bulgaria and Latvia even clearly above 20% of GDP) and, apart from Esto-

nia, the current account deficits for these countries are not expected to decrease below 10% of GDP until 2009. By contrast, the central European EU9 countries have significantly smaller external imbalances. Current output gap estimates for the EU9 countries complete the picture and confirm that the main beneficiaries of the Funds during the 2007-13 period currently operate above potential growth, although to different degrees. Only in 2009 are the Baltic countries expected to experience a relatively large negative output gap.

Consequently, while the key rationale for the Funds is precisely to increase potential growth in the receiving countries, recent macroeconomic data for the EU9 countries illustrate that the additional demand stimulus due to EU Cohesion Policy may at times coincide with considerable external and internal economic imbalances. In other words, from a macroeconomic perspective Cohesion Policy may sometimes first make matters worse before the expected positive supply side effects of the Funds help to overcome possible growth bottlenecks.

### Conclusions and Policy Recommendations

The EU Funds that the EU9 countries will receive over the 2007-2013 period are lower as a percentage of GDP than those received by the largest recipients among EU15 countries in the past. However, in some EU9 countries Cohesion Policy transfers at times take place in a macroeconomic environment which is characterised by unsustainably fast growth. The resulting possible need to prevent the Funds contributing to economic imbalances may create additional challenges for the efficient implementation of EU Cohesion Policy. In this respect, policy measures need to aim at reconciling possible conflicts between negative short to medium-run overheating effects and positive long-term growth effects of Cohesion Policy. Such policy measures can be grouped into two categories. First, measures within the operational confines of the Funds and, second, more general economic policy measures in the fields of monetary, fiscal and structural policy.

Turning to the first set of measures, national governments that may face overheating problems should pay special attention to the macroeconomic environment when deciding on the sequencing of Cohesion Policy measures over the programming period. In countries with clear signs of overheating, postponing the implementation of EU-financed projects may avoid further fuelling macroeconomic imbalances. The fact that in the recent past EU9 countries have been able to spend only about half the allocated cohesion-policy transfers might at times have helped “accidentally”. The low rate of executed funds is, however, mainly due to shortcomings in administration and planning, which in fact puts the success of the Funds in terms of promoting long-run economic growth at risk.

Turning to more general policy measures, the guiding principle for economic policymakers should be to ensure that the additional demand stimulus from the Funds does not increase the risk of unsustainable, overheating-type developments. Preventing such developments requires a combination of monetary, fiscal and structural policy measures.<sup>16</sup> The extent to which monetary policy tools can be used depends largely on the chosen monetary and exchange-rate regime. In some countries the price stability objective is pursued by inflation targeting

<sup>16</sup> This distinction is to some extent judgemental as some policy options may fall into different categories. For example, tax changes relating to the housing market can be regarded as both fiscal and structural policy measures.

while in other countries a fixed exchange rate has been chosen.<sup>17</sup> These arrangements significantly constrain the room for monetary policy to impact on domestic demand including a possible demand shock arising from the Funds.<sup>18</sup>

Given the limited contribution of monetary policy to macroeconomic stabilisation in a number of countries, fiscal policy needs to take greater responsibility. In fact, the cyclical situation in fast-growing countries may at times require more fiscal tightening, particularly when the additional inflow of EU Funds is taken into account. This implies that these countries implement the co-financing requirements by using existing budget lines, i.e. reducing expenditures on other budget items. At the same time, given that the construction sector, which is often a key driver of very fast growth, is likely to get a further boost from the EU Funds, tax benefits and subsidies relating to construction should be reviewed and possibly discontinued if there is indeed a risk of unsustainable developments in this part of the economy. More generally, tax and benefit systems should be designed to maximise employment incentives, given the existing labour market shortages in these countries. In addition, governments need to ensure that public sector pay and benefit increases do not lead to additional wage pressures in the private sector.

Finally, structural policy options cover a wide range of areas, including the housing/mortgage market. In addition, structural policy measures should be used to strengthen the supply side of the economy and to increase flexibility. By their very nature these measures may only alleviate demand pressures in the medium term and are unlikely to be a “quick” solution to a possible excessive demand situation due to the inflow of EU Funds. Nevertheless, in most EU9 countries there is room for improvement in a number of areas, ranging from the functioning of labour markets, agreements among social partners to ensure wage developments in line with productivity, enhancing FDI, increasing domestic competition and entry of foreign competitors, enhancing labour mobility, reducing labour market mismatches and addressing large regional disparities.

<sup>17</sup> Currency boards exist in Bulgaria, Estonia and Lithuania, while a very narrow exchange rate band is unilaterally set in Latvia.

<sup>18</sup> A tightening of minimum reserve requirements is one of the few remaining monetary policy options. In addition, supervisory and prudential frameworks can be strengthened, which could contribute to limiting credit and hence demand growth.