

# Misguided policies risk breaking up the eurozone and the EU

Stefano Micossi

No. 260, December 2011

## Remembering Tommaso Padoa-Schioppa

I met Tommaso Padoa-Schioppa in the early 1970s as a new young professional in the Research Department of Banca d'Italia, where he was head of the monetary policy unit. Many of us newcomers, fresh from American graduate studies, were appalled by the Bank's monetary approach, replete with quantitative controls and administrative measures to channel funds to an insatiable Treasury.

Tommaso, who already participated in the bank's inner policy-making circle, often sobered our fervent criticisms with irony; but it was he who first proposed to the Bank to abandon fixed rates in Treasury bill auctions, opening the way to the complete independence of monetary policy that was to come in the 1980s. Those open exchanges, in an atmosphere of strong commitment to public service, created solidarities and friendships that have lasted up to today, in spite of divergent professional paths.

Tommaso's approach to European affairs was a unique combination of vision and realism. An economist by training, over and over again he showed a special ability to rise above the

prejudices of his profession and push forward institution-building with feasible arrangements that could muster the necessary political support.

In the last years of his life, like many of us, he was deeply concerned for the waning support for the European project. He considered the European construction the most compelling bequest of the 20<sup>th</sup> century in the domain of political institutions. "Nowadays we know, and we must tell our children and teach in our schools that the will to power of nation states as well as individuals may be channelled through a rule eventually capable of depriving it of its capacity to overwhelm and destroy" (quote from his book *L'Europa forza gentile*, Il Mulino, 2001, pp. 13-14, my translation).

But he saw that the construction of Europe was incomplete and he often repeated, in his late days, that either it would find the compromises necessary to strengthen its institutions - notably in the economic domain - or it could go into reverse and break down. He was also convinced that the time of technocratic and elitist decisions was gone and the imbalance between democratic member states and technocratic European institutions had become a straightjacket suffocating further progress.

Stefano Micossi is Director General of Assonime, Visiting Professor at the College of Europe in Bruges, Member of the Board of Directors of CEPS and Chairman of the Board of CIR Group. This paper was prepared for presentation at a conference in memory of Tommaso Padoa-Schioppa, hosted by Banca d'Italia in Rome on 16 December 2011, and is an updated and expanded version of Prof. Micossi's latest CEPS Policy Brief No. 258, "Agreement needed on liquidity provision to restore confidence in the eurozone", November 2011, following the European Council of December 8<sup>th</sup> and 9<sup>th</sup>.

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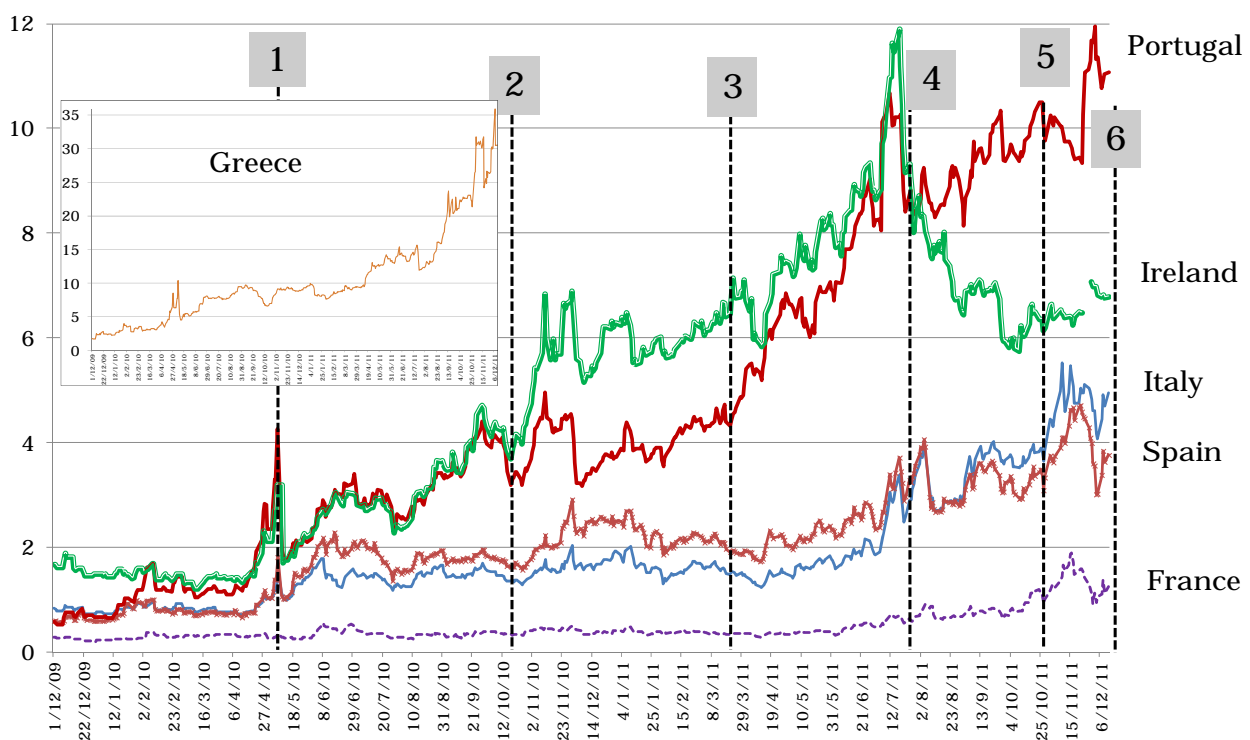
Unfortunately, he was right and his fears were well grounded. Poor leadership has transformed a small debt crisis into a confidence crisis that is threatening the very survival of our monetary union. And, as I will argue, treaty changes under discussion are mainly motivated by political expediency and cannot tackle the existential problems affecting the eurozone and the Union.

The entire European construction is at risk. Unfortunately, Tommaso is no longer with us to help sort out the incredible mess created by short-sighted political leaders.

## Crisis management is failing

Some eighteen months past the first Greek rescue (May 2010), crisis management in the euro zone has clearly failed to restore confidence. Indeed, following each round of emergency measures matters have turned for the worse (see Figure 1 showing the widening spreads, over the German Bund, for sovereign borrowing in the eurozone). The solemn decisions of the December 9 Eurosummit already seem in tatters.

Figure 1. 10-years government bonds spread vs. German bund, 1 Dec. 2009 – 12 December 2011 (%)\*



Notes: [1] May 2010: Adoption of the first financial assistance package for Greece and establishment of the European Financial Stability Fund.

[2] 18 October 2010: Deauville agreement between France and Germany destabilises financial markets.

[3] 24-25 March 2011: European Council agrees on new economic governance.

[4] 21 July 2011: Eurozone leaders agree on a rescue package for Greece and EU crisis management framework but announce 20% loss on Greek debt for private investors.

[5] 26 October 2011: Eurozone economic governance tightened, liquidity support still weak, losses for private creditors raised to 50%.

[6] 8-9 December 2011: European Council reaches bungled agreement on Treaty reform and financing arrangements that fails to convince markets.

\* Daily data.

Source: Financial Times on Thomson Reuters.

Meanwhile, contagion has spread beyond Spain and Italy to the core sovereigns. France is close to losing its Triple A rating and spreads over the Bund have opened up for Austria, Belgium, Finland, The Netherlands. Even Germany has experienced partial failure in a Bund auction on November 23. The banking system Europe-wide is under increasing strain, with term funding all but closed for any bank with significant exposure to distressed sovereign debtors and the interbank market close to seizing up. Deposit withdrawals have surfaced in a number of large banks from the periphery. The euro has started to weaken in foreign exchange markets, narrowing the room for a distinction between the eurozone debt crisis and the euro-currency crisis from which some observers were until recently drawing comfort.

These developments raise once again the fundamental question: what is it that is not working? Why is it that dramatic changes in our policies and institutions within the eurozone are failing to halt the meltdown of confidence? An answer is needed, and needed soon – because along this path the breakdown of the eurozone is a concrete possibility.

### Reform under way in the eurozone

One important strand of opinion, notably in Germany and other Northern European countries, maintains that the culprit is lax fiscal policies and excessive debt accumulation by some eurozone member states. Greece, for one, is defaulting on its debt obligations, despite very harsh corrective measures – albeit its plight have been aggravated by its economy, as a consequence, going into free fall and its political system coming under close-to-unbearable strain to keep the austerity course. But the numbers are small and would not endanger the solidity of Europe's banking system even under extreme hypotheses of debt restructuring.

Ireland, Portugal and Spain have adopted public sector consolidation measures and market reforms which have won good marks by the Commission, the ECB and the IMF; and indeed their sovereign interest rate spreads over the German Bund were all receding – dramatically so for Ireland – up until the latest round of meetings by the Eurosummit at end-October and early December (Figure 1). Last summer sovereign selling pressures extended to Italy, which has a

small deficit but a large debt-to-GDP ratio (120%). Eventually, harsh budgetary measures, including a sweeping pension reform, were decided to anticipate budgetary balance to 2013, and a fresh round of structural reforms and market opening measures were decided. Meanwhile, the economy is falling into recession and the spread over the Bund remains in the upper-400-basis-points region.

In sum, budgetary consolidation seems well under way in all 'sinning' countries together with long-awaited structural reforms. Based on IMF forecasts to 2016, after increasing in the aftermath of the 2008-09 financial and economic crisis, sovereign debts are expected to stabilise at manageable ratios to GDP in all of the eurozone countries except Greece – but will not decline, due to persistently slow growth. And market assessments of their sovereign debts are barely improving.

Furthermore, the eurozone suffers from large competitive imbalances between its members which are reflected in large and growing imbalances in current external payments. Germany and the Netherlands in 2011 are expected to record current external surpluses close to 6% of GDP, with their counterpart largely represented by deficits in the eurozone periphery – with the exception of Ireland that has a 3% surplus. With the unfolding confidence crisis, the increase in private savings in the periphery has prompted large widening of public sector deficits, while private capital flows turned away from the periphery and the financing of external deficits fell almost exclusively on official sources – showing up as ECB Target balances. This evidence has prompted some authors to read the ongoing crisis in the eurozone as a balance of payment crisis.<sup>1</sup>

Thus, the eurozone has turned into a straightjacket where everyone is tightening budgetary policies, growth falters and, in addition, the periphery countries must engineer substantial real exchange rate devaluations to regain competitiveness and reabsorb their external deficits – while the core countries will do

<sup>1</sup> Hans-Werner Sinn and Timo Wollmerschauer, "Target Loans, current account balance and capital flows: the ECB's rescue facility", NBER Working Paper 17626, National Bureau of Economic Research, Cambridge, MA, November 2011.

nothing to strengthen aggregate demand and relieve pressure on their partners. Thus, if the periphery succeeds, both the core and the periphery will suffer from falling aggregate demand; if it doesn't succeed, either the deficits will continue to be financed, leading to further accumulation of external debt, or the entire eurozone will fall into depression, with sovereign debtors eventually defaulting on their liabilities.<sup>2</sup>

This unsustainable policy pattern may be at least in part responsible for the crisis of confidence gripping the eurozone. If this is the case, a lasting solution will have to include credible measures to raise the eurozone growth rates – a theme notably absent, so far, in the Eurosummit agendas.

### Stronger economic governance

Meanwhile, economic governance in the eurozone has been strengthened to unthinkable heights as regards both substance and enforcement procedures. The Integrated Policy Guidelines of Article 121 TFEU are now assisted by legally binding enforcement procedures, while the European Semester ensures ex-ante coordination of economic policies and time-consistent decision-making processes in the Member States and the European Council. And the Eurosummit has formalized a new governance structure for the euro area entailing regularly meetings of the Heads of State or Government (“at least twice a year”) and a permanent presidency; a strengthened role of the Eurogroup which will set up its own permanent structure in Brussels; and a special monitoring committee comprising the presidents of the Eurosummit, the Commission and the Eurogroup which will meet “at least” once a month.

The excessive deficit procedure has been reinforced in both its preventive and corrective arm, and now includes fresh constraints on the growth of public expenditures and operational criteria for public debt reduction (the ‘1/20 rule’); and there is a new procedure, also legally binding and assisted by sanctions, for the correction of ‘excessive economic imbalances’, explicitly targeting competitive imbalances and their underlying causes. The Euro-Plus Pact details the enhanced policy commitments of eurozone

members for budgetary stability, structural reforms and market opening.

Eurozone members are also required to strengthen their national budgetary frameworks with the adoption of multi-year planning, top-down decision-making procedures and independent evaluation agencies. Italy and Spain have already decided to insert balance-budget rules in their constitutions.

The European Commission has been given independent powers to signal emerging deviations from agreed policy guidelines, and make recommendations to the Council on the opening of formal procedures, down to the phase of sanctions, that the Council can only reject or weaken with ‘reverse’ qualified majorities. New proposed Regulations, now before Council and Parliament for approval, will require eurozone member states to present their draft budgets at the same time each year and, before national parliaments decide on them, give sufficient time to the Commission to assess them and, if need be, ask for revisions when it considers that the draft budget violates the Stability and Growth Pact. Stronger provisions are envisaged for eurozone countries in excessive deficit procedure.<sup>3</sup>

Against this background, it is worth dwelling for a moment on the new decisions on economic governance taken by the Eurosummit on December 9. Once again, failure of the previous Eurosummit, on October 26, to halt financial turmoil, raised pressure on Germany to expand liquidity support in eurozone sovereign debt markets. Once again, half-baked, unconvincing measures to that effect were accompanied by new demands to tighten the governance screws, so as to appease a recalcitrant domestic public. Enters the new “fiscal compact”.<sup>4</sup>

<sup>2</sup> Martin Wolf, “A disastrous failure at the summit”, *Financial Times*, 14 December 2011.

<sup>3</sup> Proposal for a Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area, COM(2011)821 of 23.11.2011, and a Regulation on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area, COM(2011)819 of 23.11.2011.

<sup>4</sup> These requests were anticipated by President Draghi of the ECB in his Statement before the European Parliament on December 1, where he stated that “I am confident that the new surveillance framework will restore confidence



A treaty change will oblige eurozone members to adopt a balanced-budget rule in their constitutions, and the European Court of Justice will be empowered to verify their correct transposition in national legislations. Members in excessive deficit shall submit an 'economic partnership' programme detailing the necessary structural reforms to ensure an 'effectively durable' correction of their deficits. And a mechanism will be put in place for the *ex-ante* reporting by Member States of their national debt issuance plans. The deficit and debt-reduction obligations under the excessive deficit procedure will be 'enshrined in new provisions', and there will be mechanisms for the automatic correction of any slippages. With national budgetary powers for sinners and potential sinners transferred to a new "compact" governed by Germany and managed on her behalf by a Committee made up by the presidents of the Eurosummit, the Commission and the ECB (with the IMF in attendance).

One wonders whether all this is really feasible, technically and politically. For one thing, economic policy is a fairly complex matter, and past experience may reveal a poor guide to future decisions - as was the case with the deficit and debt criteria, which famously failed to detect developing imbalances in the private sector in the Irish and Spanish economies. For another, interactions between the Member States would be entirely overlooked, which seems quite odd in a highly integrated area: for instance, would an exogenous increase in the propensity to save in Germany always have to be met by a deflationary adjustment in Italy?

As for the proposed treaty change, for the second time in less than a year<sup>5</sup> a fundamental change in common policies in the eurozone would be enacted with an intergovernmental treaty outside the Union framework - opening the way to an

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over time. I am also quite sure that countries overall are on the right track. But a credible signal is needed to give *ultimate insurance over the short run*. What I believe our economic and monetary union needs is a new *fiscal compact* - a fundamental restatement of the fiscal rules ..." (my italics). Thus, rather than large liquidity supply, the 'big bazooka' to stabilize financial markets in the short term is a new fiscal rule.

<sup>5</sup> The first was the amendment to Article 136 TFEU to set up the ESM.

awkward combination of German direct rule over national fiscal policies under French inter-governmentalism. Thus, the UK veto offered the pretext for a solution that fitted well with the Franco-German intentions but is potentially disruptive for the entire Union.

First, there is a need to clarify why, in order to strengthen the legal underpinning of the new governance obligations, the leaders did not consider the possibility of using Article 136 TFEU, which empowers to "adopt measures specific to those member states whose currency is the euro". Most, if not all of the measures of strengthened economic governance could be adopted under this legal basis - with the exception perhaps of the balanced budget 'golden rule', which is already in the Euro-Plus Pact and could anyway be turned into a political commitment. Incidentally, Article 136 procedure would allow to proceed more speedily, with qualified majority voting of eurozone members in the Council (unanimity only for provisions relating to the excessive deficit procedure), while the treaty changes envisaged by the Franco-German duo could well require two-to-three years to come into effect, barring an adverse referendum in some members (e.g. Ireland).

Second, and more important, the treaty may well be reopened, but then more fundamental questions concerning the fiscal union would inevitably arise: including issues of explicit centralization of budgetary powers and related legitimizing controls at eurozone level, as well as the relation to be built between the Union and the eurozone institutions. More broadly, building up enhanced cooperation for economic policies outside the Union legal framework could over time damage the latter irreparably, owing to the temptation to pick and choose the most convenient legal framework in response to contingent political goals.

### The foreign currency syndrome

Far from abating financial turmoil, the announcement of ever harsher governance measures has apparently provided fresh fuel to the fire. Either the announcements lack credibility - which does not seem the case, with policies on the right track everywhere - or there is something else which is missing in the leaders' policy responses.

For one thing, non-eurozone countries, such as the US and the UK, not to mention Japan, with its mountainous public debt, have no problems in selling their paper, while within the eurozone even countries with a smaller debt/GDP ratio than Germany – Austria, Finland and the Netherlands – must pay a positive spread over the Bund on their government issues.

Thus, the eurozone seemingly suffers from some special disease. That disease is the ‘foreign currency syndrome’ that was brought into full light by Professor Paul De Grauwe.<sup>6</sup> Please note that if Professor De Grauwe is right – as I believe he is – then in all likelihood we are letting financial markets push us onto a path of excessive deflation that may eventually frustrate our efforts at budgetary consolidation – Greece *docet*.<sup>7</sup>

The fundamental difference between a country which is a member of a monetary union and a country which has its own currency is that the former needs the permission of an institution that it does not control to increase liquidity – say to compensate for an outflow of liquidity through the banking system or stabilize the government bond market – while the latter does not. To each of the monetary union members, to all practical purposes the euro is like a foreign currency, since no one enjoys access to the euro printing press. As a consequence, eurozone members are exposed to currency runs. Such a system can switch rapidly from ‘fair weather’, where foreign currency risks are underpriced, to ‘bad weather’ where risks become overpriced. In the second scenario, the explosion of financing costs can make fears of a run self-fulfilling.

The switch from ‘fair weather’ to ‘bad weather’ is not an entirely unpredictable event. A further feature of the monetary union is that one monetary policy must fit all – regardless of divergent prices and wages, productivity, market structure, public spending and taxation. When a country with higher inflation and structural rigidities joins a monetary union, initially it typically finds itself awash with liquidity, since the foreign-exchange risk premium disappears, real interest rates turn negative and borrowing becomes an irresistible bargain. Meanwhile, its

real exchange rate will appreciate and business competitiveness will suffer, leading to rising unemployment; but abundant credit will encourage to postpone adjustment and preserve inefficient jobs with public money. Public spending will rise and the public sector deficit will widen, while politicians will thrive on distributing subsidies and protections to broaden electoral consensus.

Lax financing conditions may prevail for quite a long time, but sooner or later they are bound to come to a halt, as growing external and public sector deficits become unsustainable. Till one day, typically as a consequence of some exogenous shock, investors flee, liquidity evaporates and the divergent country finds itself unable to refinance its debts in private markets at acceptable prices – as it happened to Greece and Portugal.

A variant of the model is one in which the economy in the divergent country experiences a real estate boom and rapid economic expansion, leading to unsustainable private indebtedness, while the public sector stays in good health thank to buoyant growth. But again, the real estate boom must come to an end and, when house prices start falling, private debts cannot be serviced and lending financial institutions become insolvent. Governments are then obliged to step in and rescue the banks: this is where unsustainable private indebtedness is turned into large government debt – as happened to Ireland and (to a lesser extent) Spain.

Thus, lax and divergent national policies do carry responsibility for the sudden switch in confidence. When that happens, even countries that did not run divergent policies or, at any rate, maintain manageable exposures in ‘fair weather’, may find themselves unable to manage them after the shift to ‘bad weather’. With an extra ingredient: which is that national banking systems have in the meantime become highly interconnected – as ‘core’ country banks over-lent to divergent country banks and governments. Thus, any doubts on the sustainability of sovereign obligations in divergent countries are readily transformed into doubts on the sustainability of the banking system in the core, stable countries.

Confidence in financial markets is a fickle commodity, that may evaporate quite rapidly unless investors can be reassured that a liquidity

<sup>6</sup> De Grauwe, P (2011), “The Governance of a Fragile Eurozone”, CEPS Working Documents, CEPS, Brussels.

<sup>7</sup> Latin for ‘teaches’.

crisis will not be allowed to develop into a solvency crisis for one member after another of the monetary union. Which is what has happened in the eurozone since Greece was first bailed out in May 2010.

### Liquidity support and debt restructuring

A confidence crisis spreading contagion even to the 'sound' part of a monetary union can be stopped by abundant supply of liquidity by the central bank or by a common fund performing the same service, conditional on appropriate policy conditionality, with resources lent by the central bank or raised in capital markets – and in all likelihood both are needed, in some appropriate combination.

Failure by the Eurosummit to agree on a strong and effective rescue fund has stiffened the ECB, which fears that losses on its distressed sovereigns holdings may one day force to turn to national governments for capital, and thus lose independence.

Two stumbling blocks have so far impeded adequate liquidity support. The first one is fear that liquidity will reduce pressure on 'sinners' to adjust. All arguments that sinners are now mending their ways, under much strengthened common economic governance arrangements, have so far failed to convince – even if, as I have recalled, policies have turned in the right direction everywhere. Some will not be satisfied till they have direct powers by the union to intervene and change national policies, when these deviate from their policy commitments. However, everyone should be aware that even the best policy course will need time to produce its effects; in the meantime, adequate financing flows must be maintained, or adjustment policies will fail to prevent a currency run.

The second ingredient in the unfolding drama is the intermingling of liquidity support and fiscal transfers, which inevitably arises if some of the countries under life support become insolvent and thus require debt restructuring. In this regard, Germany is adamant that liquidity support can never entail fiscal transfers – which would breach the no-bail out provision of the treaty (e.g. Article 125 TFEU) – and have on this account maintained strong pressure on the ECB to limit its open market operations in support of distressed sovereigns.

In reality, if adjustment works, there is no reason why liquidity support should be turned into fiscal transfers. To the extent that confidence is hit by fears of insufficient liquidity, the simple act of restoring adequate liquidity would stop the run and make insolvency, and the need for fiscal transfers, unlikely. On the other hand, if there is a collapse of liquidity, fiscal transfers may become inevitable at least to rescue own (German) banks, following the chain-collapse of all other sovereign debtors in the union.

Germany has also insisted that the private sector should share the burdens of any debt restructuring. As a result of disastrous communication, private sector involvement (PSI) has become a promise of losses on all outstanding eurozone sovereign exposures, without sufficient differentiation. Thus investors have started to dampen most eurozone sovereigns; even Germany has been affected. A cursory look at Chart 1 will confirm that contagion really started following the Franco-German announcement in Deauville that PSI would be part of any financial assistance programme, in October 2010. Two further jumps in the spreads are clearly associated with the July and October, 2011, meetings of the Eurosummit, as the announcements of rising 'haircuts' on Greek debt have combined with inadequate liquidity support for the other distressed debtors in making private investors in eurozone sovereigns run for the door.

The disgraceful insistence on private sector participation has now been abandoned, and our wise leaders have reverted to "the well established IMF principles and practices" whereby each case is assessed on its own merits and there is no presumption of losses for private investors in connection with financial assistance programs. Also the EFSF, later the ESM, will be allowed to lever its resources and the unanimity rule in decision making will be substituted by qualified majority voting (with an 85% majority).

In general, recent decisions have once again failed to convince financial markets that the liquidity problem has been tackled. The ESM has not gained liquidity access to the ECB, as had been envisaged by President van Rompuy in his preparatory note for the summit; the total available resources have been raised, perhaps, but it is not sure. The Eurogroup is still struggling to make sense of the cumbersome arrangements that

have been proposed to lever the EFSF resources. The persistent refusal to back EFSF obligations with the joint and several guaranty of eurozone members has left financial markets uncertain as to whether individual guaranties will be sufficient, as more and more members are hit by contagion. And everyone is puzzled by the fact that eurozone members are willing to put up euro 200 billion in credit lines for the IMF to defend the euro, hoping that more will come from the emerging world, while they are not willing to do it directly with the EFSF and the future ESM.

The only new development was the announcement by the ECB of a new unlimited term-lending facility for banks, whose undeclared but transparent purpose is to encourage banks to buy sovereigns again. The snag in the scheme is that banks are not likely to buy securities that eurozone governments are collectively unable to support. Continuing to try to circumvent problems, rather than tackling them, will not do.

Thus, it looks like till the next summit we are in for further turmoil, which no doubt will lead to more requests by Germany for stronger economic governance rules. As Albert Einstein once famously remarked: "Folly is doing the same thing again and again, and expecting different results".

## In conclusion

The eurozone has proven so far collectively unable to develop a convincing economic strategy to revive economic growth, bring excessive public debts back to normal levels, restructure the Greek debt, and raise credible liquidity walls around the other distressed sovereigns. Meanwhile, the costs of adjustment in divergent countries are ballooning thanks to rising interest rates and falling activity, heralding further budgetary cuts and further deflation.

The Eurosummit has to go back to the drawing board and agree on a less unbalanced policy combination between discipline, liquidity support and growth policies. If it cannot be done, the risk that the eurozone and the Union will break up, with gigantic economic dislocations, will stay high.

As to proposed new fiscal compact by intergovernmental treaty, it is already clear that it will go nowhere: which is good, since the Union institutions might suffer fundamental damage if they were to go down that road. The ready alternative is to follow the Article 136 procedure, which allows eurozone members to insert in the TFEU special provisions applicable only to themselves.





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