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COMMISSION STAFF WORKING DOCUMENT

ON THE MOVEMENT OF CAPITAL AND THE FREEDOM OF PAYMENTS

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This document has been prepared by the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA).

This document is a Commission staff working document for information purposes. It does not represent an official position of the Commission on this issue, nor does it anticipate such a position. It is informed by the international discussion on financial integration and stability, both among relevant bodies as well as in the academic literature. It presents these topics in a non-technical format that remains accessible to a non-specialist public.

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Commission Staff Working Document on the Movement of Capital and the Freedom of Payments

1. INTRODUCTION

This staff working document is part of an annual stocktaking exercise performed by the Economic and Financial Committee to examine capital movements and freedom of payments under Article 134 of the Treaty on the Functioning of the European Union.

It starts by reviewing recent developments in the EU and global capital flows in 2016 and in the first half of 2017 (depending on data availability). It then provides an overview of the applicable legal framework and describes the main initiatives launched by the Commission in 2017 to support the free movement of capital and the freedom of payments.

Finally, the report highlights other important policy challenges that require regular monitoring and reviews the main developments in the international sphere. Further detailed analysis is presented as appendixes. Given the Commission policy initiatives and priorities in 2017 on the Capital Markets Union and the proposal for a Regulation establishing a framework for screening of foreign direct investments into the EU[1], the staff working document will focus on (i) cross-border mergers and acquisitions; (ii) greenfield investment; (iii) profiles of investment into the EU of certain non-EU countries; (iv) the home bias in investment; and (v) risk sharing.

Both global and EU capital flows continued to be subdued in 2016-17, and have stabilised at lower levels than before the financial crisis. In net terms, both the EU and the euro area continued to be net exporters of capital, and their current account surpluses (financial account deficits) reached 2 % and close to 4 % of GDP respectively. The shift in traditional EU financial account patterns from a 'close to balance' position to net outflows that occurred in 2012 continued in the reporting period, and the EU has remained a net exporter of savings.

Investment has been gradually picking up in the reporting period and is expected to underpin an acceleration of trade and economic growth in 2017-19[2]. However, its recovery is still incomplete and remains below pre-crisis levels.

On foreign direct investment (FDI) through extra-EU mergers and acquisitions of European companies, the EU is expected to remain the most targeted investment destination in 2017; this has been the case now for more than 22 years in a row. On greenfield investment, however, the EU is expected to be overtaken by the United States of America as the top global investment destination after 3 years of European dominance. Extra-EU companies prefer to invest in the euro area 14[3] and Denmark, Sweden and the

[1] Proposal for a Regulation of the European Parliament and of the Council establishing a framework for screening of foreign direct investments into the European Union, available at: https://ec.europa.eu/transparency/regdoc/rep/1/2017/EN/COM-2017-487-F1-EN-MAIN-PART-1.PDF.

[2] European Commission, European Economic Forecast, Autumn 2017, DG ECFIN.

[3] Euro Area 14 includes: Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands, Cyprus, Greece, Malta, Italy, Ireland, Spain and Portugal.

United Kingdom through mergers and acquisitions rather than greenfield investment, acquiring existing and well developed production facilities. In contrast, they prefer to enter the market in the other Member States (CEE11[4]) through greenfield investment, helping to develop and create new production capacity.

Current account and financial imbalances in the global economy have returned to the spotlight of the policy debate. In the post-crisis period, there has been an important rotation of excess external imbalances from emerging to advanced economies. This reflects (i) asymmetries in the recovery path between surplus and deficit economies, including their corresponding policy responses; (ii) the transition in China from investment to consumption-driven growth; and (iii) sustained low commodity prices. At the same time, global financial stock imbalances have increased, mainly on the back of the deteriorated external position of the United States. In the latter case, valuation effects also played a role.

An important feature of the post-crisis reconfiguration of global capital flows is the concentration of current account imbalances among advanced market economies. Global imbalances now seem more sustainable than before as the advanced economies with current account deficits / financial account surpluses (mainly the United States and the UK) can, in principle, finance their deficits as their currencies are in most cases also reserve currencies. This was not the case in previous periods, when many emerging market economies ran excessive current account deficits. However, the increased concentration of current account deficits in a few economies could heighten the risk of protectionist responses and may point to weak global adjustment mechanisms.

Against this background, policy initiatives that support investment, such as the Investment Plan for Europe and its European Fund for Strategic Investments (EFSI), have a major role to play. In light of the EFSI's encouraging results in its first year of operation[5], in the December 2017 the European Parliament and the Council have agreed to extend the duration of EFSI to 2020 and bring its level of investment to EUR 500 billion in total[6]. Furthermore, the EFSI now has a target of at least 40% for investments that contribute to climate action, in line with the Paris Climate Agreement goals and an even larger share of financing for small and medium enterprises (SMEs).

Free movement of capital is essential for building truly integrated, open, competitive and efficient European financial markets, which is also the objective of the Capital Markets Union initiative. To consolidate the single market for capital and support projects and investments in key areas, it is also crucial to remove remaining national barriers to cross-border investment. In 2017, the Commission services continued to work with an expert group of Member States' representatives to map national barriers to the free movement of capital in support of the Capital Markets Union project. The Commission published a report[7] taking stock of the results of this mapping and invited Member States to tackle

[4] **CEE11 (Central and Eastern Europe) includes**: Bulgaria, Estonia, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and Slovakia.

[5] https://ec.europa.eu/priorities/publications/commission-evaluation-first-year-efsi_en.

[6]http://www.consilium.europa.eu/en/press/press-releases/2017/11/08/investment-plan-for-europe-efsi-extension-approved-by-council/.

[7] Report from the Commission — '*Accelerating the capital markets union: addressing national barriers to capital flows*', March 2017, available at: https://ec.europa.eu/info/files/170227-report-capital-barriers_en.

unjustified barriers stemming from national legislation or administrative practices that either go beyond EU rules ('gold-plating') or are in areas mainly of national competence. Based on this report, the Economic and Financial Affairs Council (ECOFIN) endorsed a Joint Commission and Member States Roadmap of actions to address national barriers to capital flows.

The EU has one of the most open investment regimes in the world. However, there have been growing concerns within the EU about foreign investors seeking to acquire strategic assets that could allow them to take control of or influence European firms whose activities are critical for our security and public order. In response to these concerns, the Commission proposed a new legal framework on screening FDI within the EU in September 2017[8].

On financial account openness, in the post-crisis period certain emerging market economies have either reversed the advances achieved in capital account liberalisation or have seen progress stall. Nevertheless, capital account liberalisation should remain a long-term objective for both advanced and emerging economies and domestic macroeconomic, structural and macroprudential policies. Market-driven exchange rate adjustments should also take precedence over the use of capital controls. In September 2017, the Greek authorities took further measures to alleviate the impact of capital controls and relax their application in line with a roadmap adopted earlier this year. At the same time, in the international fora there is an ongoing policy debate on the application of capital flow management as well as macro-prudential policies, in particular in view of the review of the *OECD Code of Liberalisation of Capital Movements*.

Although the more subdued net capital flows, improved financial regulation and higher share of FDI and equity instruments in capital flows point to increased financial stability, certain risks remain. The increased concentration of global imbalances among advanced market economies can be a sign of weaker global adjustment mechanisms. High equity market valuations may trigger adjustment and capital flow reversals and retrenchments. Lower transparency in some offshore financial centres may permit regulatory arbitrage and lessens the effectiveness of new financial regulation rules.

2. TRENDS IN EU CAPITAL FLOWS IN THE GLOBAL CONTEXT, 2016-2017

2.1. Global and EU capital flows[9]

Global imbalances[10], or the size of global current account surpluses and deficits and related capital flows, are now less acute than in the years prior to the financial crisis, although they still persist (see Figure 1). However, since the global financial crisis there has been a significant rotation of global imbalances between advanced and emerging countries. We are now faced with a new configuration where current account imbalances

[8] http://europa.eu/rapid/press-release_IP-17-3183_en.htm

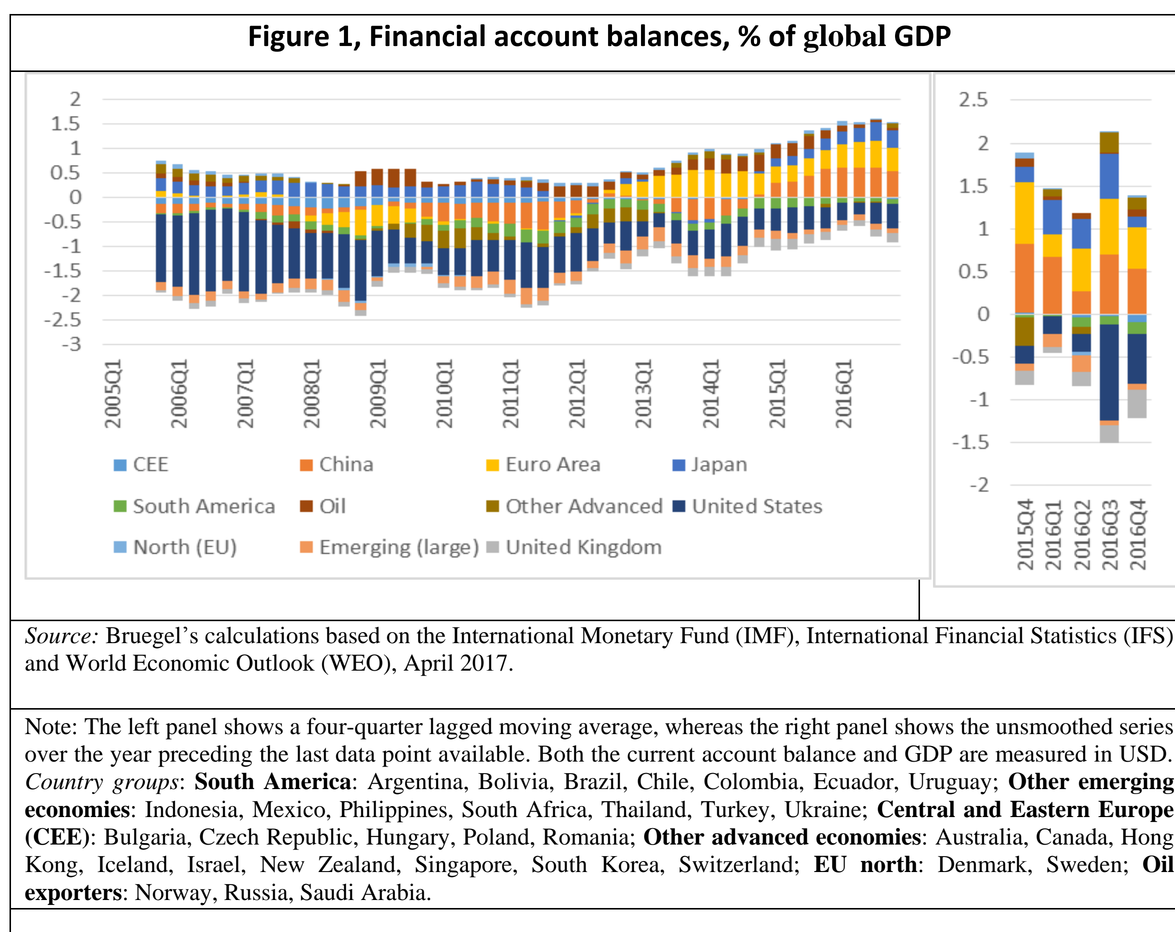
[9] This section incorporates some of the results of a study carried out for the Commission by Bruegel: '*Analysis of developments in EU capital flows in the global context*'.

[10] For detailed analysis on global imbalances and associated risks see "*Global imbalances: an old challenge on the rise?*" by Guergana Stanoeva and Bogdan Bogdanov, forthcoming, Quarterly Review on the Euro Area, European Commission.

have become concentrated mostly among major advanced economies, with the euro area countries registering a current account surplus (mirrored by corresponding net capital outflows in the financial account) that is larger relative to the past. Capital is mainly exported from the euro area, China, Japan and other advanced countries towards the United States, and to a lesser extent to the UK and emerging economies in Latin America and Asia.

The current account of the euro area has switched from close to balance to a surplus in 2012, reflecting significant net outflows of capital to the rest of the world in recent years. In absolute terms, the euro area is now the largest exporter of capital. Together with China and Japan — two countries that have consistently generated current account surpluses — these three economies represent 75 % of global net savings. At the same time, deficits are increasingly concentrated in the United States and the UK in contrast to recent years, when they were mostly concentrated in the emerging economies.

Figure 1, Financial account balances, % of global GDP



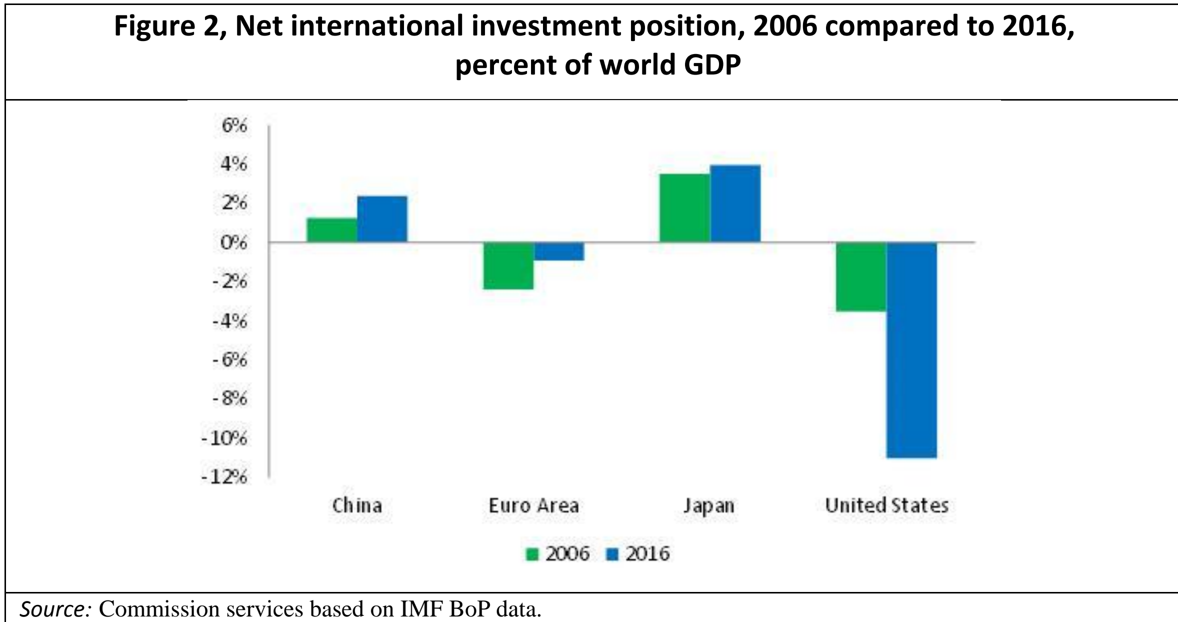
Source: Bruegel's calculations based on the International Monetary Fund (IMF), International Financial Statistics (IFS) and World Economic Outlook (WEO), April 2017.

Note: The left panel shows a four-quarter lagged moving average, whereas the right panel shows the unsmoothed series over the year preceding the last data point available. Both the current account balance and GDP are measured in USD. *Country groups*: **South America**: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Uruguay; **Other emerging economies**: Indonesia, Mexico, Philippines, South Africa, Thailand, Turkey, Ukraine; **Central and Eastern Europe (CEE)**: Bulgaria, Czech Republic, Hungary, Poland, Romania; **Other advanced economies**: Australia, Canada, Hong Kong, Iceland, Israel, New Zealand, Singapore, South Korea, Switzerland; **EU north**: Denmark, Sweden; **Oil exporters**: Norway, Russia, Saudi Arabia.

Although global current account imbalances have narrowed since the crisis, the **external stock imbalances**, as measured by countries net international investment positions (NIIPs) of the major economies continued to build up. In 2016, stock imbalances had grown by around 65% (or added 10 pps. of global GDP) compared to 10 years earlier. Importantly, these imbalances remained mainly polarised among advanced economies (US, Japan) and China (Figure 2).

On the creditor side, the accumulation of net foreign assets between 2006 and 2016 mainly reflects persistent current account surpluses in Japan and China. The growth in creditor positions was mirrored almost entirely by a remarkable three-fold widening of the US net debtor position driven by continuous current account deficits and significant valuation effects. Although still a debtor economy, the NIIP of the euro area has improved significantly over the period driven by stronger current account balances of its individual country members.

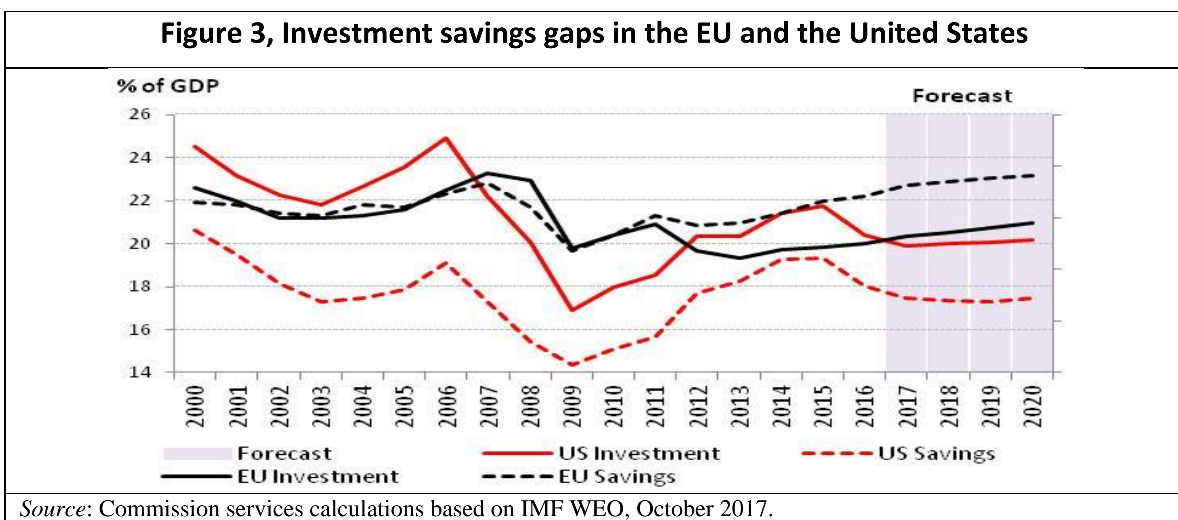
Figure 2, Net international investment position, 2006 compared to 2016, percent of world GDP



Source: Commission services based on IMF BoP data.

The EU investment savings gap, which currently entails a 'savings surplus', implies that net capital outflows may be expected in 2017-20 (see Figure 3). Both the EU and the US investment-to-GDP ratios are expected to recover somewhat over the forecast period, but will still remain below their pre-crisis levels. Under a 'no policy change' scenario, the EU investment-to-GDP ratio is projected to be higher than that of the United States as of 2017, but still lower than the EU savings-to-GDP ratio.

Figure 3, Investment savings gaps in the EU and the United States



Source: Commission services calculations based on IMF WEO, October 2017.

Figure 4 shows the flows between the EU as a single, consolidated economic block and the rest of the world, excluding intra-EU flows. Over the last decade, the financial

account of the EU-28 as a whole has been close to balance, ranging between -2 % and 2 % of GDP. In 2012, the EU-28 balance moved from a deficit to a mild financial account surplus, standing in the last year at around 2 % of GDP.

In terms of investment types, the net result generally consisted of net inflows of portfolio investment from abroad more or less balanced by an outflow of another investment. The exception to the rule took place in 2012, when the two flow types reversed direction.

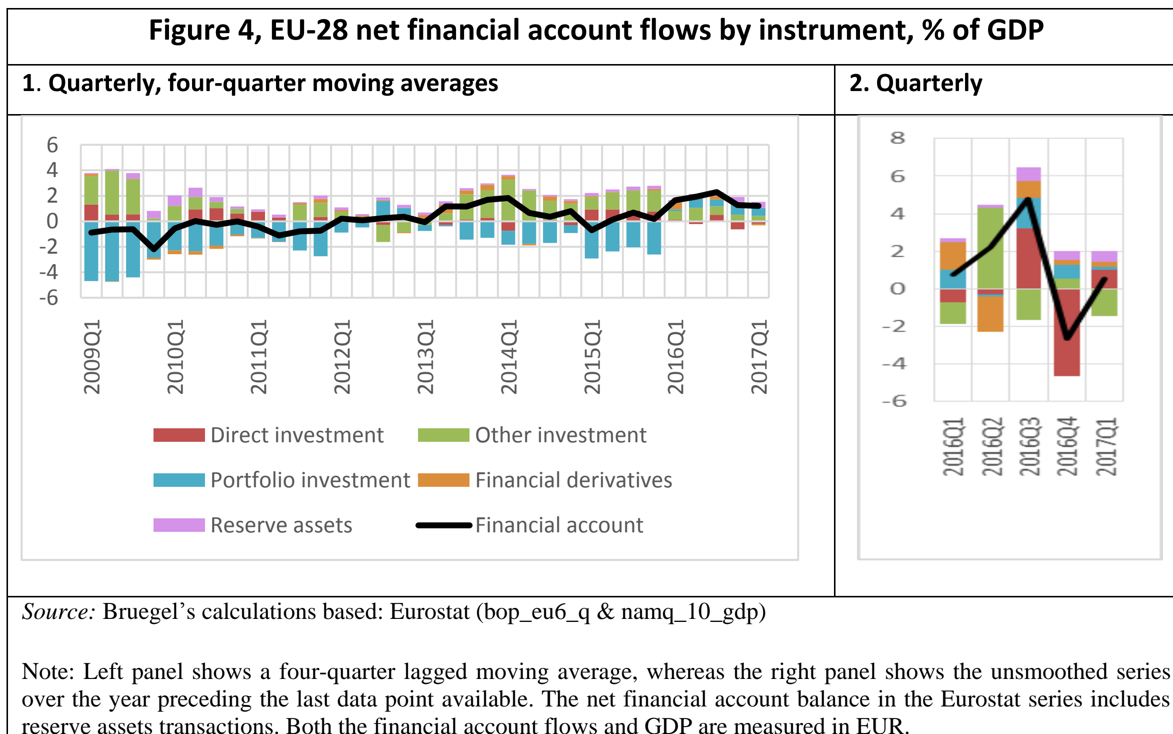


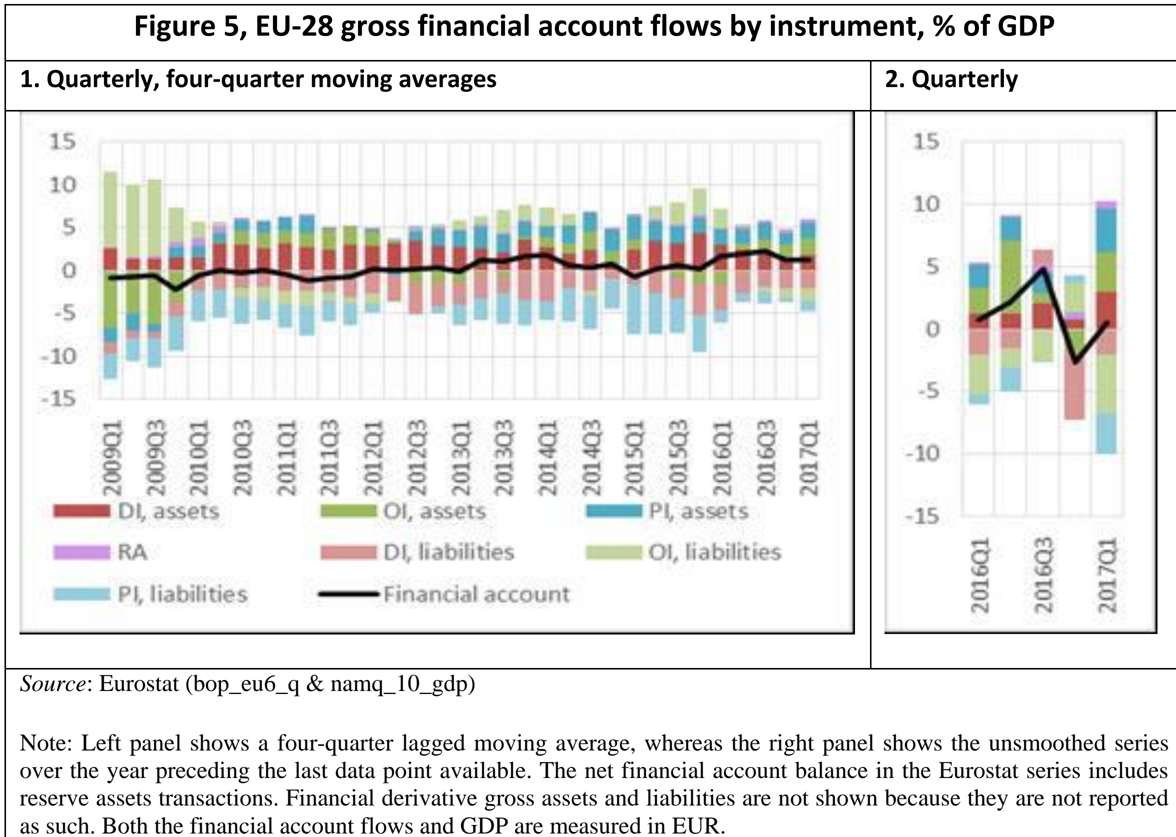
Figure 4, EU-28 net financial account flows by instrument, % of GDP

Source: Bruegel's calculations based: Eurostat (bop_eu6_q & namq_10_gdp)

Note: Left panel shows a four-quarter lagged moving average, whereas the right panel shows the unsmoothed series over the year preceding the last data point available. The net financial account balance in the Eurostat series includes reserve assets transactions. Both the financial account flows and GDP are measured in EUR.

Switching attention to the underlying gross flows uncovers interesting patterns (see Figure 5). First, portfolio investment appears to have been driven by the evolution of portfolio liabilities, while the acquisition of foreign portfolio assets has been more stable except for the financial crisis in 2008-09. The surplus in the financial account observed since the beginning of 2016 also seems to be accounted for by non-residents acquiring fewer EU-28 assets. Second, from 2013 to 2016 non-residents reduced their other investment exposures in the EU-28, resulting in a sizeable outflow of other investment overall. This process now seems to have come to an end, with other investment from non-residents into the EU resuming in the last few years. Last but not least, whereas in net terms FDI contributes little to the overall balance, it is the outcome of robust and relatively (compared to other types of investment) sizeable gross flows that offset each other. In total, the level of flows of EU-28 assets and liabilities has remained more or less stable in the aftermath of the economic and financial crisis.

Figure 5, EU-28 gross financial account flows by instrument, % of GDP



Source: Eurostat (bop_eu6_q & namq_10_gdp)

Note: Left panel shows a four-quarter lagged moving average, whereas the right panel shows the unsmoothed series over the year preceding the last data point available. The net financial account balance in the Eurostat series includes reserve assets transactions. Financial derivative gross assets and liabilities are not shown because they are not reported as such. Both the financial account flows and GDP are measured in EUR.

2.2. Financial account openness and FDI restrictiveness

The level and extent of restrictions on the free movement of capital still varies considerably across regions and countries, with the EU having one of the most open investment regimes in the world. Without restrictions and distortions, capital should in theory flow towards productive investment with the highest returns. For companies that need capital, openness can lower the cost of investment and improve access to finance. Overall, free movement of capital should in theory foster allocative efficiency[11], consumption smoothing[12] and risk sharing. However, financial liberalisation — in particular the reliance on external financing — also has the potential to expose economies to vulnerabilities, as many episodes of sudden stops of capital flows and current account reversals have proven in the past.

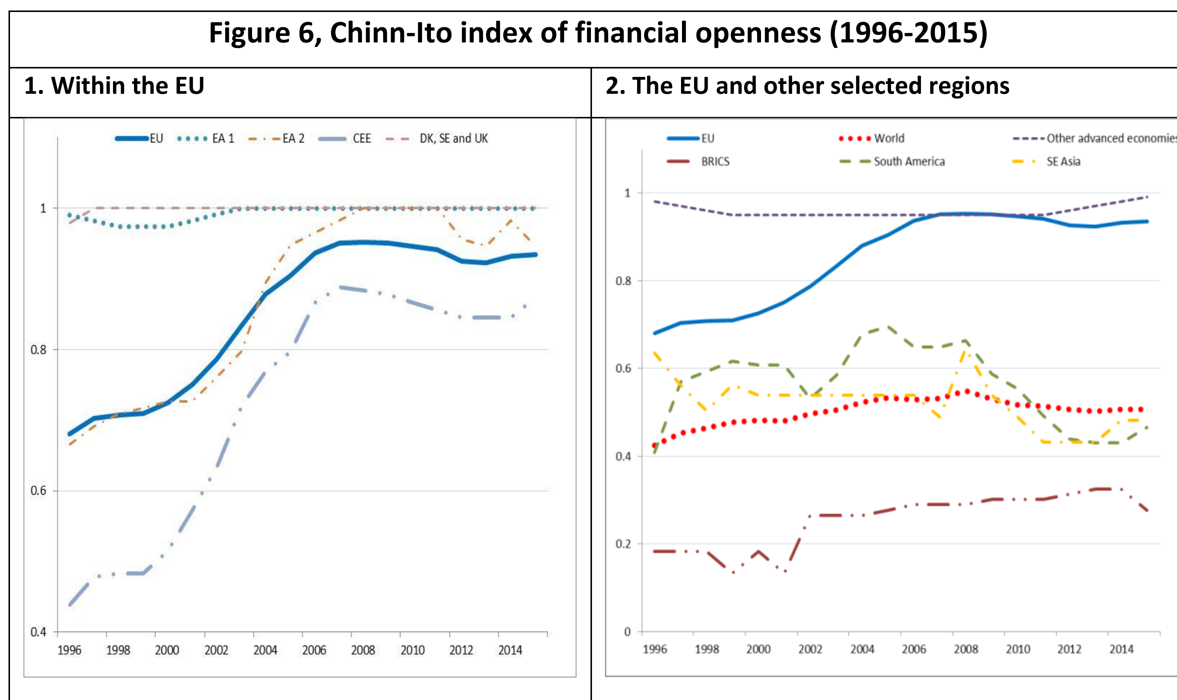
Measuring the openness of the financial account in a standardised way is challenging. First, collecting such information is difficult; the readily available primary sources of information required to achieve this are scarce. Second, quantifying the level of controls is not straightforward. Third, even if the aforementioned problems are addressed, *de jure* controls are only an approximation of *de facto* openness that ultimately matters for capital flows.

[11] Allocative efficiency occurs when organizations in public and private sectors spend their resources on projects that will be the most profitable and do the most good for the population.

[12] Consumption smoothing occurs when people strike a proper balance of spending and saving during the different phases of their life.

The index of financial openness devised by Chinn-Ito (2006)[13], which is based on information from the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions, is presented in Figure 6. It goes from 0 to 1, with a value of 0 meaning a closed financial account and 1 a fully open one.

Figure 6, Chinn-Ito index of financial openness (1996-2015)



Source: Commission services calculations based on Chinn-Ito (2006) as updated in 2017.

Note: Non-weighted averages. EU excludes Luxembourg as data is not available in Chinn-Ito. It includes the other 27 Member States. **EA 1** includes Austria, Belgium, France, Germany and the Netherlands. **EA 2** includes Cyprus, Malta, Greece, Spain, Portugal, Italy and Ireland. **CEE includes**: Bulgaria, Estonia, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and Slovakia. **Other advanced economies** include the United States, Canada, Japan, Australia, New Zealand and Switzerland. **SE Asia** includes Indonesia, Vietnam, Thailand, Malaysia and Singapore. **BRICS** includes Brazil, Russian Federation, India, China and South Africa. **South America** includes Argentina, Chile, Bolivia, Peru, Columbia, Ecuador and Venezuela.

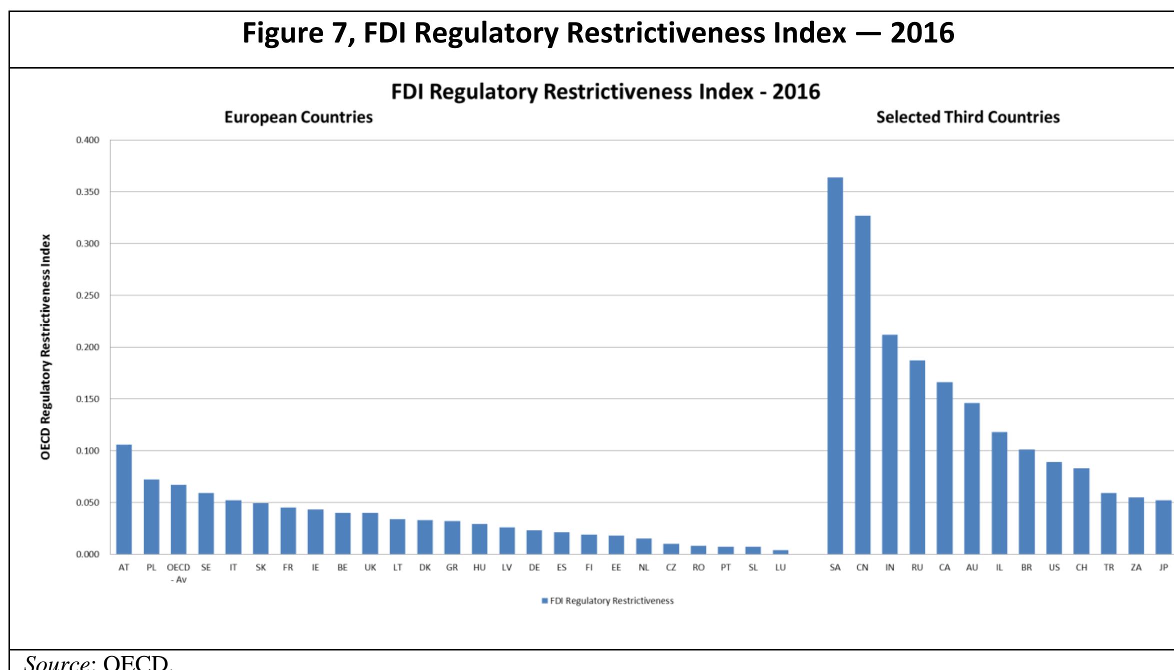
Figure 6.1 presents non-weighted averages of the index of financial openness for four sub-groups of Member States. The euro area core countries (EA 1) together with Denmark, Sweden and the UK already had very few restrictions in place 20 years ago and continue to be very open today. EA 2 countries and CEE countries belonging to the EU were in comparison much more restrictive in the 1990s and went through a process of liberalisation in the early 2000s. While the process peaked just before the financial crisis and the trend was slightly reversed afterwards, liberalisation efforts resumed in 2014.

This trend is also apparent when comparing the EU to other regional groups of countries (see Figure 6.2), with the EU becoming as open as other advanced economies. The EU remains much more open to cross-border capital flows than the world average or other significant groups such as the BRICS, South America or South East Asia.

[13] Chinn, Menzie D. and Hiro Ito (2006). 'What Matters for Financial Development? Capital Controls, Institutions, and Interactions,' Journal of Development Economics, Volume 81, Issue 1, Pages 163-192 (October). Available at: http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

Another measure of openness is the OECD FDI Regulatory Restrictiveness Index, which measures statutory restrictions on foreign direct investment in 62 countries worldwide. Figure 7 shows that major EU economic partners have more investment restrictions in place than the EU.

Figure 7, FDI Regulatory Restrictiveness Index — 2016



Source: OECD.

2.3. FDI developments

2.3.1. *Global FDI developments and the EU*[14]

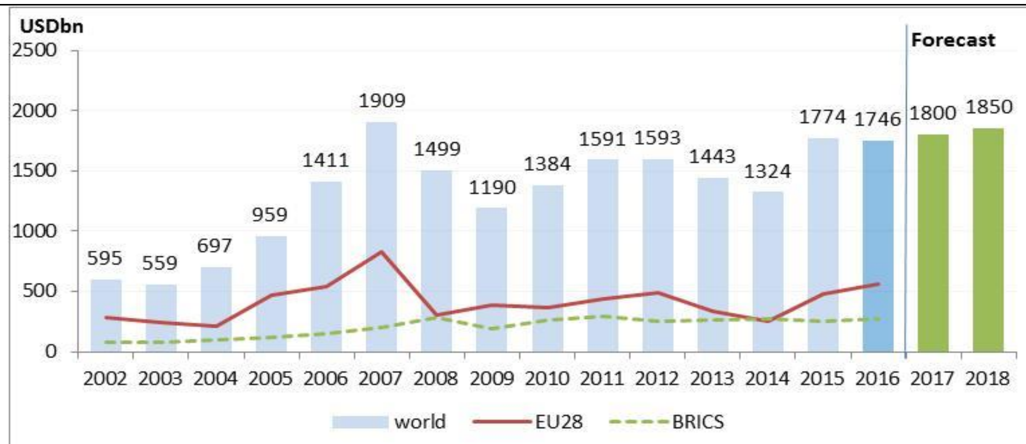
Global FDI flows declined by almost 2 % in 2016, after increasing strongly by more than 34 % in the previous year (see Figure 8). According to the latest forecast from the United Nations Conference on Trade and Development (UNCTAD), global investment is expected to have increased by more than 3 % in 2017 and to rise by a further 2.9 % in 2018 to USD 1.85 trillion. However, it is not expected to surpass the pre-crisis peak of USD 1.9 trillion within the forecast period[15].

Inward FDI into the EU-28 accounted for more than half of the rebound in global FDI in 2015. In 2016, cross-border investment into the EU-28 increased by a further 17 % compared to the previous year.

[14] Unless otherwise indicated, this sub-section uses FDI data from UNCTAD, which is based on the directional principle and excludes investment through resident special-purpose entities. Data availability by the cut-off date of this report is up to the end of 2016.

[15] UNCTAD, World Investment Report 2016.

Figure 8, Global and EU inward FDI



Source: Commission services calculations based on UNCTAD.

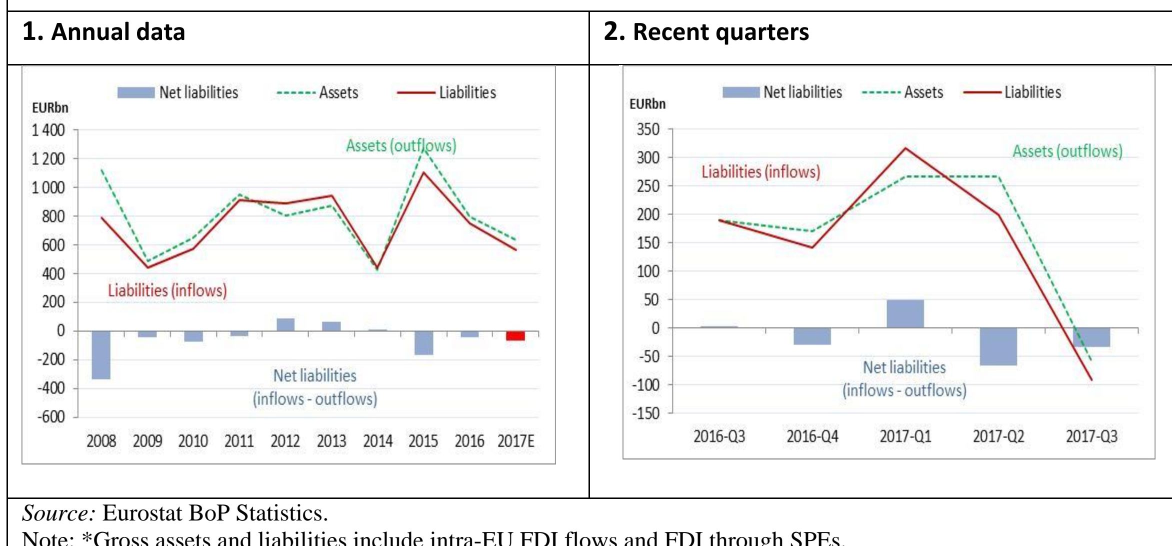
2.3.2. *European FDI developments*[16]

For the second year in a row, net cross-border investment in the EU remained negative in 2016 as FDI net incurrence of liabilities ('inflows') exceeded net incurrence of assets ('outflows'). Net cross-border FDI is also expected to remain in negative territory in 2017. After exceptionally high gross inflows and outflows in 2015, FDI inflows into the EU and investment abroad both slowed to just below 2011-2013 levels, reaching EUR 748 billion and 795 billion respectively (see Figure 9, panel 1).

However, FDI inflows increased in the first two quarters of 2017 and had already reached EUR 515 billion, a 23 % increase compared to the same period in 2016. FDI investments abroad followed the same pattern and were up 24 % in the first half of 2017 compared to 2016, reaching EUR 533 billion (Figure 9, panel 2). However, in the third quarter of 2017 FDI activity had slowed down sharply, with outflows still exceeding inflows. This left the net balance again in negative territory (net outflows FDI position).

[16] Unless otherwise indicated, this sub-section refers to EUROSTAT data based on the assets/liabilities principle and including flows through special-purpose entities.

Figure 9, EU FDI assets and liabilities flows, Q1-2008 – Q3-2017



Source: Eurostat BoP Statistics.
Note: *Gross assets and liabilities include intra-EU FDI flows and FDI through SPEs.

2.3.3. *Intra-EU and extra-EU FDI*

Since 2012, intra-EU FDI inflows have been on a downward path. They fell below extra-EU FDI inflows for the first time in 2013. In 2016, intra-EU FDI inflows decreased by 1 % to EUR 457 billion compared to 2015. Extra-EU FDI inflows decreased even more (54 %, although from a higher level in 2015) and remain well below intra-EU FDI inflows at EUR 291 billion (see Figure 10, panel 1)[17].

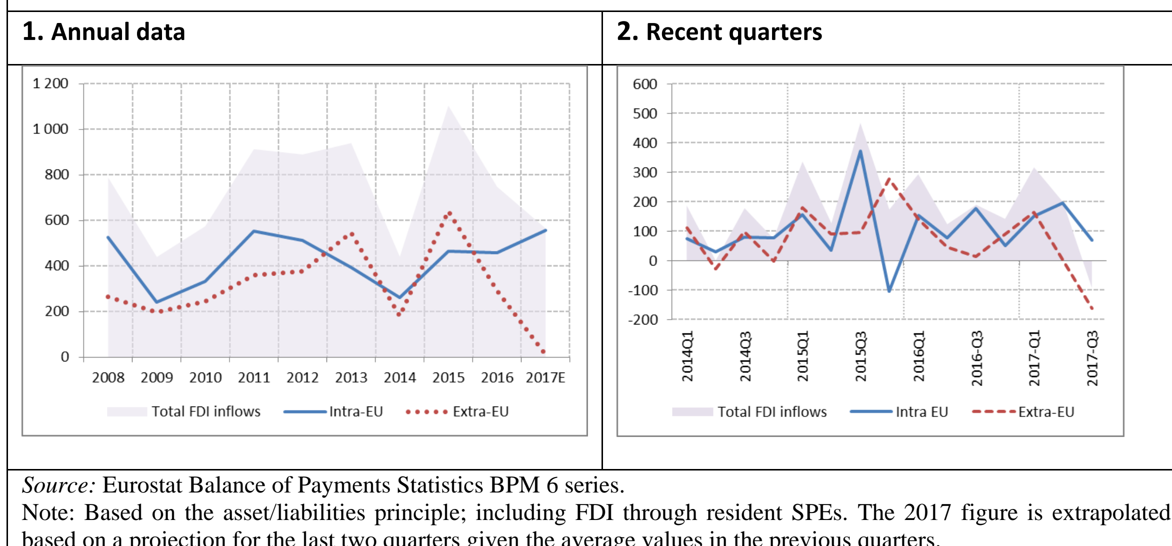
Preliminary figures indicate that extra-EU FDI inflows are expected to decline sharply in 2017 due to negative figures in the third quarter. On the other hand, intra-EU FDI inflows are expected to recover.

In the pre-crisis period and until 2011, intra-EU FDI inflows consistently exceeded extra-EU FDI inflows. However, in the post-crisis period the adjustment of EU FDI seems to be happening mostly through a curtailment of intra-EU cross-border investment. In some years, namely in 2014, it even fell below extra-EU FDI inflows.

[17] The switch to a new statistical reporting methodology and principles in 2014, based on the revised IMF Balance of Payments Manual (BPM 6) and the 4th edition of the OECD Benchmark Definition of Foreign Direct Investment, does not permit a consistent comparison over several years in the past.

Figure 10, Intra and extra-EU FDI inflows, Q1-2008 – Q3-2017, EUR billion

1. Annual data	**2. Recent quarters**



Source: Eurostat Balance of Payments Statistics BPM 6 series.
Note: Based on the asset/liabilities principle; including FDI through resident SPEs. The 2017 figure is extrapolated based on a projection for the last two quarters given the average values in the previous quarters.

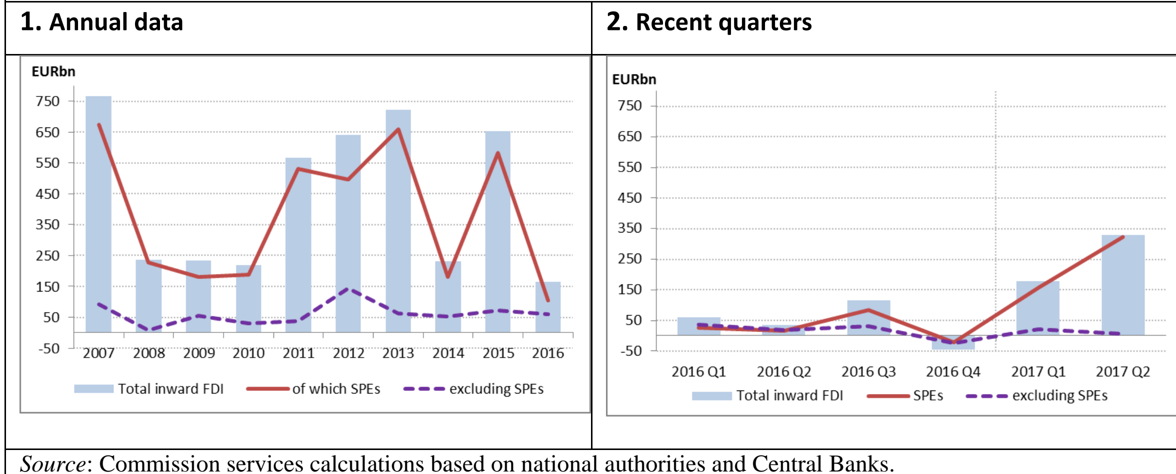
From the beginning of 2016 to the beginning of 2017, extra and intra-EU FDI inflows stabilised at relatively equal levels, with shares of around 50 % in total FDI inflows. However, extra-EU FDI inflows dropped sharply in the second and third quarter of 2017 (see Figure 10, panel 2). It is not yet clear whether extra-EU FDI inflows will remain subdued.

2.3.4. *FDI through resident special-purpose entities (SPEs)*

After declining sharply in 2014 and recovering in 2015, FDI liabilities in resident SPEs[18] again embarked on a downward path in 2016. For instance, FDI inflows in SPEs in four EU countries with traditionally large shares of FDI flows through SPEs, namely Austria, Hungary, Luxembourg and the Netherlands, decreased by 82 % year-on-year in 2016 (see Figure 11). However, in the first quarter of 2017 this indicator turned positive for these four countries, with inward FDI through SPEs rebounding strongly.

[18] SPEs are entities with a minor physical presence in the host economies. However, SPEs provide important services for multinational companies in the form of financing or holding of assets.

Figure 11, FDI inflows in resident SPEs in Netherlands, Austria, Luxembourg and Hungary, 2007 — Q2-2017

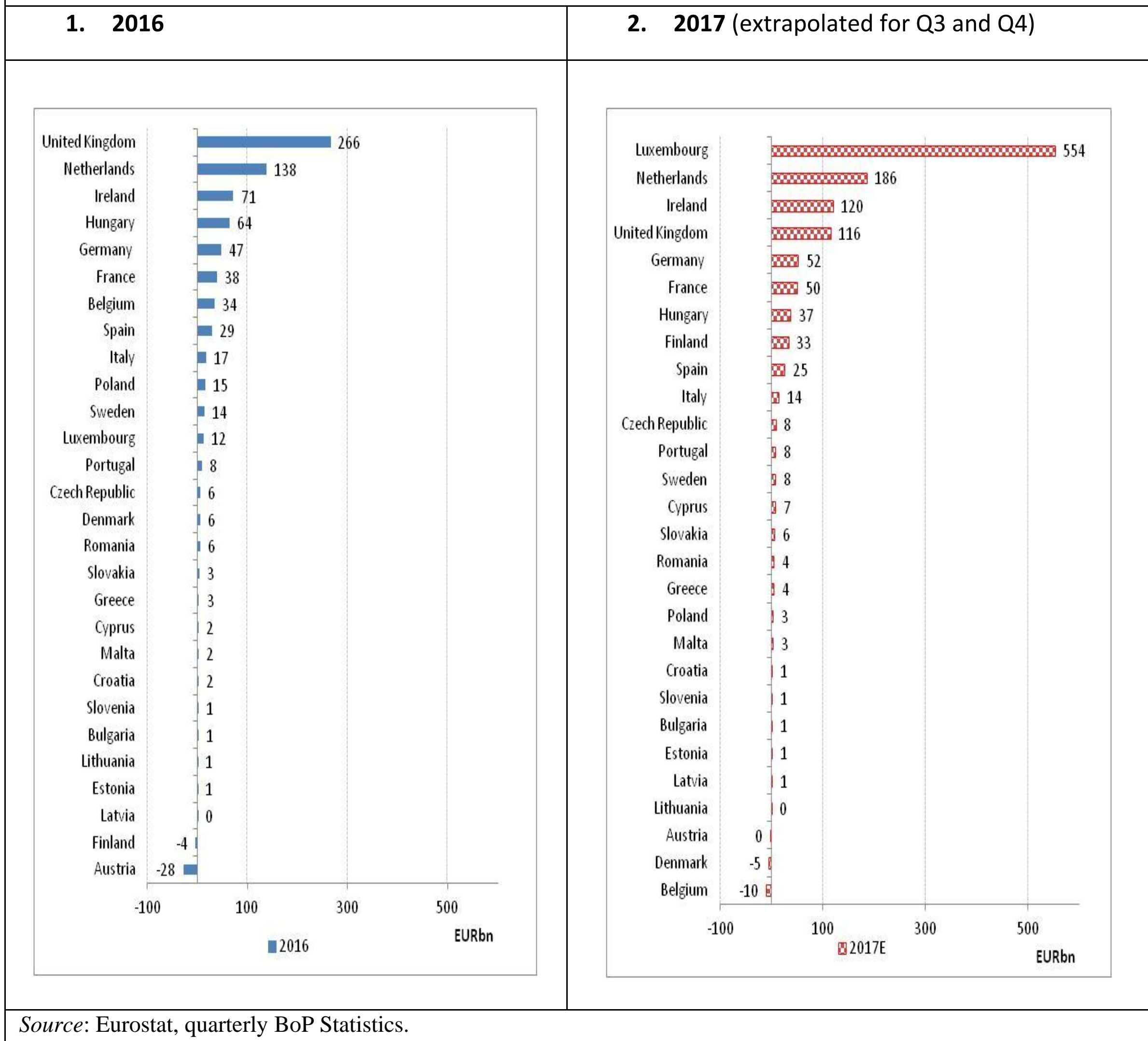


Source: Commission services calculations based on national authorities and Central Banks.

2.3.5. *FDI performance by Member States*

In 2017, FDI inflows (liabilities to non-residents from EU and non-EU countries) are expected to increase in 13 Member States and to decline in 10 Member States; they are expected to remain broadly at last year's levels in five Member States (see Figure 12). The UK hosted the most significant FDI inflows in 2016. However, it is expected to slip to fourth place in 2017, with Luxembourg set to head the rankings of Member States as FDI recipients due to large investment flows in the second quarter of 2017 and a recovery in FDI through SPEs. Luxembourg and the UK have traditionally been very high in the rankings as hosts of inward FDI.

Figure 12, Ranking of Member States as recipients of FDI, 2016 - 2017



Source: Eurostat, quarterly BoP Statistics.

On ranking within groups of Member States, Hungary, Poland and the Czech Republic are expected to be the CEE11 countries that host the most FDI in 2016 and 2017 respectively. Ireland is expected to be the Member State from the EA 2 countries with the most significant cross-border FDI inflows in both years. It is expected to be followed by Spain and Italy again in both years.

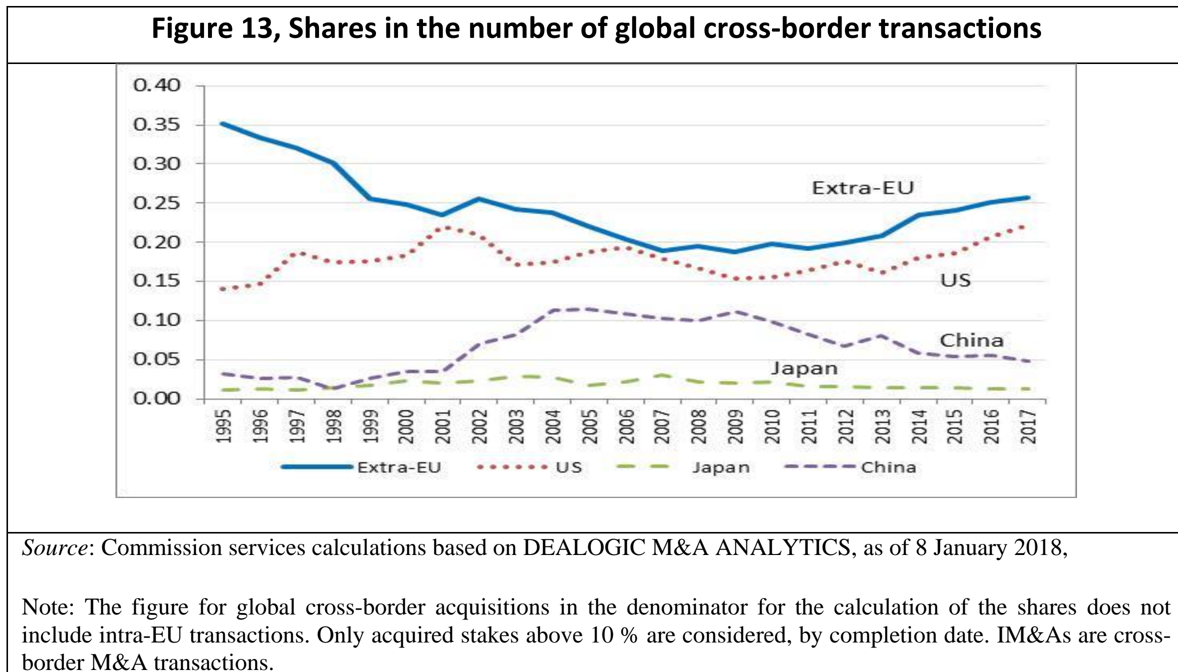
On the changes in the levels of inward FDI between 2016 and 2017, Luxembourg is expected to register the highest increase, while the UK is expected to record the most significant decline in absolute terms.

2.3.6. *Mergers and acquisitions*[19]

The EU is expected to retain its top global ranking in 2017 as a host destination of cross-border mergers and acquisitions (M&As) for the 22nd consecutive year (see Figure 13). The EU has been hosting the highest number of inward M&A deals since 1995 (the year in which our database was launched).

The share of extra-EU M&As in the number of all cross-border transactions worldwide is expected to increase further in 2017 to 26 %, up from 24 % in 2015. The United States hosted 22 % of all global cross-border deals in 2017, while China (excluding Hong Kong) hosted 5 % of all global deals in the same year. China's share in the number of inward cross-border transactions worldwide has been falling since 2004.

Figure 13, Shares in the number of global cross-border transactions



Source: Commission services calculations based on DEALOGIC M&A ANALYTICS, as of 8 January 2018,

Note: The figure for global cross-border acquisitions in the denominator for the calculation of the shares does not include intra-EU transactions. Only acquired stakes above 10 % are considered, by completion date. IM&As are cross-border M&A transactions.

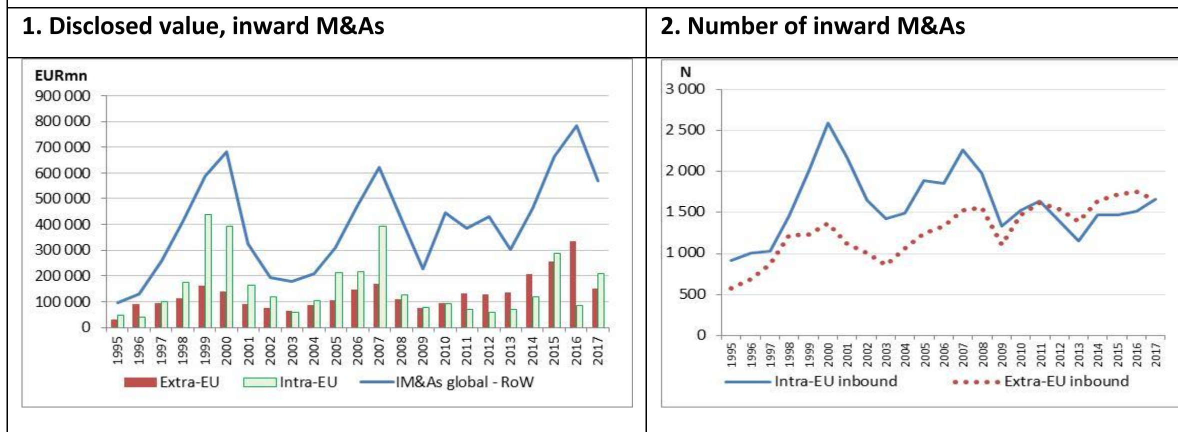
EU-targeted mergers and acquisitions

Against the backdrop of lower M&A activity in the rest of the world in 2017, cross-border transactions in the EU were a bright spot and continued to increase both in terms of disclosed value and the number of transactions (see Figure 14). This increase in 2017 was due to intra-EU activity as the disclosed value and number of announced intra-EU M&As increased more than twofold. For the first time since 2009 (with the exception of 2015), intra-EU acquisitions were again higher than extra-EU acquisitions in line with the traditional pattern recorded in the pre-crisis period. While extra-EU acquisitions declined, they remained at high levels. Most of the decline in extra-EU M&As in 2017 was due to lower inflows from the United States.

[19] For more details on FDI through mergers and acquisitions, see Appendix I.

Figure 14, Intra and extra-EU inward M&As, 1995 – 2017

1. Disclosed value, inward M&As	**2. Number of inward M&As**



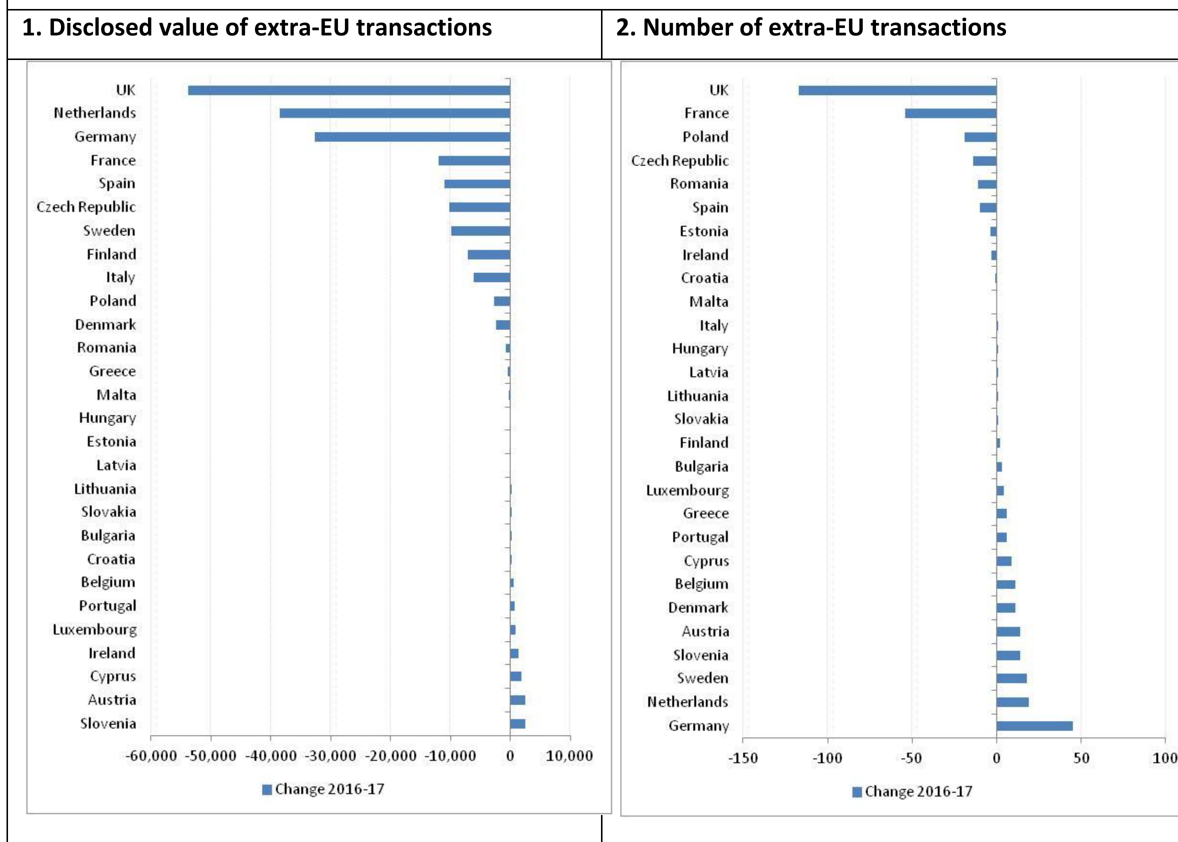
Source: Commission services calculations based on DEALOGIC M&A ANALYTICS.

Note: Final stakes higher than 10 %, by announcement date, as of 8 January 2018.

There were some shifts in the usual intra-EU rankings of Member States as hosts of M&A transactions in 2017. Spain led the rankings as a host of intra-EU M&As (with 263 transactions announced), while the UK — which had traditionally been one of the most targeted EU countries — slipped to fourth place. On outbound intra-EU M&As, France had the highest number of announced outbound intra-EU acquisitions in 2017 (285 intra-EU acquisitions), followed by Germany (257 transactions) and Italy (245 transactions).

On extra-EU inward acquisitions, the UK, Germany and France hosted the highest volume and number of transactions announced in 2017. They were followed by the Netherlands and Spain (4th and 5th respectively in terms of disclosed value of transactions). The UK kept its top ranking as a host of extra-EU transactions in 2017. However, it was the one Member State that recorded the most significant annual decline in both the number as well as the disclosed value of extra-EU acquisitions (down by 114 transactions and EUR 54 billion respectively compared to 2016).

Figure 15, Change in the number and disclosed value of inward extra-EU transactions in 2016-2017



Source: Commission services calculations based on DEALOGIC M&A ANALYTICS as of 8 January 2018.

Note: Final stakes higher than 10 %, by announcement date.

Ranking of extra-EU countries by total stock of their M&As in the EU

Table 1 presents the ranking of extra-EU countries by the total stock of their acquisitions of European companies in 1995-2017. The United States has the largest cumulative value of M&A acquisitions in the EU (almost 50 % of the total stock of non-EU country acquisitions in the EU). It is followed by China including Hong Kong (7 % of the total stock of all extra-EU M&As) and Switzerland (also 7 % of the total stock of extra-EU M&As).

While the first, third, fourth and fifth places are taken by advanced economies that are traditionally important EU investment partners like the United States, Canada, Switzerland and Japan, China including Hong Kong has recently been ranked second among non-EU countries with the highest disclosed value of their acquisitions in the EU. In the ranking by number of transactions, China including Honk Kong only takes sixth place, which indicates that it has relatively fewer acquisitions with higher average value.

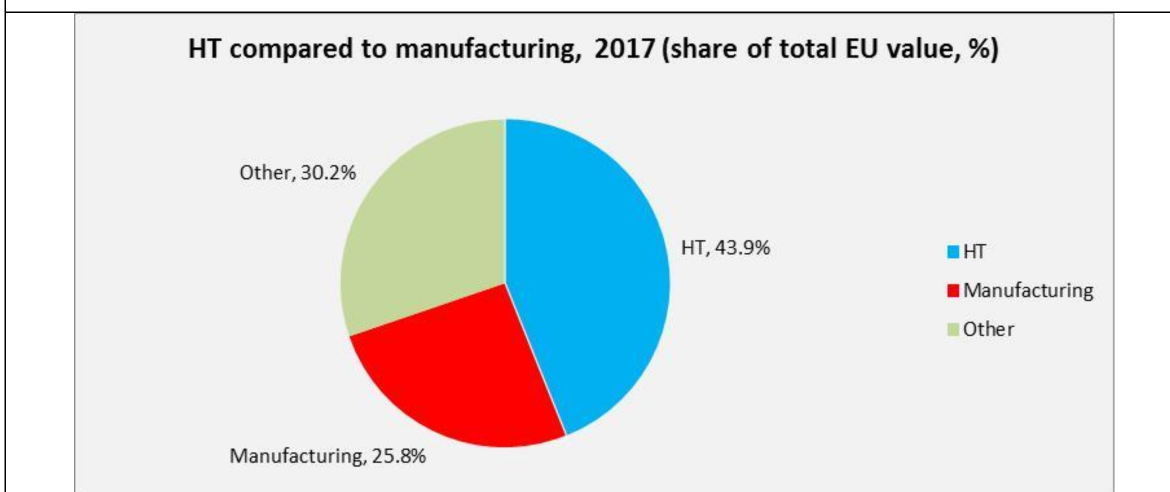
Table 1, Ranking of the top 5 extra-EU countries by total stock of their M&As in the EU, 1995-2017						
	Value of transactions (EURmn)	Ranking by value	Shares in total value	Number of transactions	Ranking by number	Shares in total number
US	1 550 002	1	0.52	14 515	1	0.49
China including Hong Kong	229 987	2	0.08	1 292	6	0.04
Canada	203 416	3	0.07	1 873	3	0.06
Switzerland	200 116	4	0.07	3 047	2	0.10
Japan	168 894	5	0.06	1 514	5	0.05
Total	**2 997 466**		**0.78**	**29 567**		**0.75**

Source: Commission services calculations based on DEALOGIC M&A ANALYTICS.

Extra-EU acquisitions in the high tech sectors and in manufacturing

Extra-EU acquisitions in European high tech sectors are expected to total more than 43 % in 2017. The share of investment in EU manufacturing companies is expected to be less than two thirds of that figure at around 26 % of the total value of extra-EU acquisitions.

Figure 16, High tech compared to manufacturing, extra-EU M&As — state of play in 2017



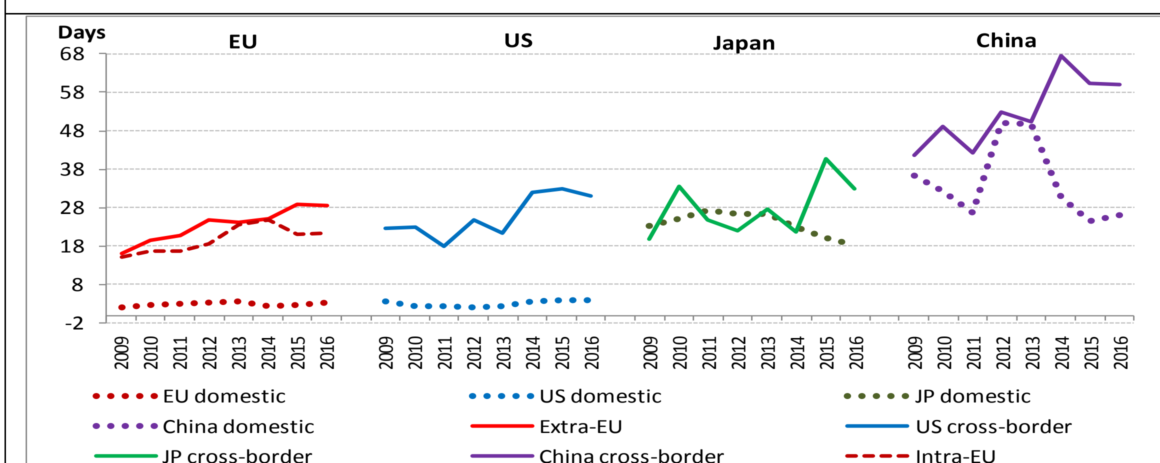
Source: Commission services calculations based on DEALOGIC M&A ANALYTICS as of 8 January 2018.

Note: By announcement date. *High tech* is defined here as aerospace, renewables, biotechnology, consumer electronics, electronic components, chemicals, engines/turbines, medical equipment, pharmaceuticals, semiconductors, software/IT services, space/defence, telecommunications; *Manufacturing* is defined as automotive, beverages, building/construction materials, business machines, ceramics, coal/gas/oil, consumer products, food, industrial machinery, metals, minerals, paper, plastics, rubber, textiles, wood products.

Average time to complete extra-EU M&As acquisitions

The average duration of negotiations involving M&A transactions can be measured as the time period between the date when the transaction was announced and the date when it was completed. It can be considered as a rough proxy for the scrutiny and administrative burden of regulatory and legal procedures, even though other factors can also influence the length of the negotiation period (for instance, corporate governance requirements, shareholder activism or the complexity of the transaction).

Figure 17, Time to complete M&A transactions: EU compared to other large economies, (average, in days)



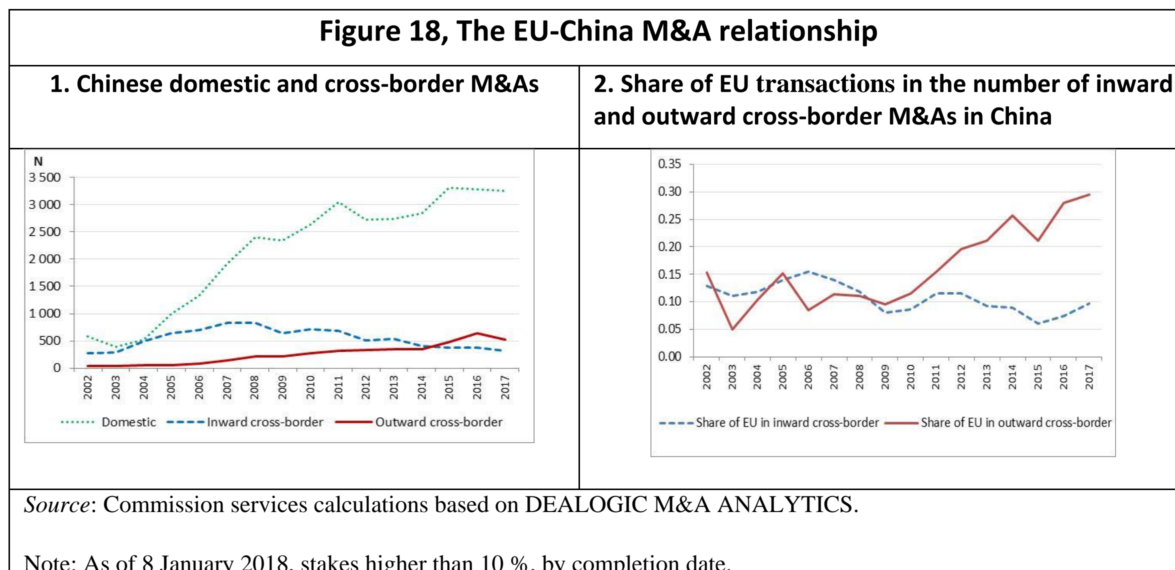
Source: Commission services calculations based on DEALOGIC M&A ANALYTICS as of 10 November 2017.

Note: By date of announcement.

In 2016, the average time to complete extra-EU transactions was around 29 days for the EU as a whole. It was higher than that for intra-EU acquisitions (21.5 days on average), but in the same range as the time to complete cross-border acquisitions in the United States (27.4 days on average). In contrast, the time to complete inward cross-border acquisitions in China was much higher (60 days on average).

EU-China inbound and outbound M&As

After increasing more than twofold and reaching record high levels in 2016, the value of announced Chinese outbound M&As is projected to decline in 2017. However, the share of EU-targeted transactions in the total number of Chinese outbound cross-border M&As is projected to increase again in 2017 to more than 29 % compared to 28 % in 2016. The share of EU-targeted transactions in the number of all completed Chinese inward acquisitions is projected to be around 10 % in 2017 (see Figure 18). Domestic restructuring has been levelling off in 2015-2017. However, the share of cross-border transactions in the total number of transactions remains relatively low at around 9 %.



Source: Commission services calculations based on DEALOGIC M&A ANALYTICS.

Note: As of 8 January 2018, stakes higher than 10 %, by completion date.

2.3.7. *Greenfield investment*[20]

Global developments

Global greenfield FDI is set to significantly decline in 2017, with a reduction of 39.2 % over the same period last year, a volume of roughly 12 000 projects and an expected value of EUR 460 bn by the end of 2017.

If current trends continue into the fourth quarter, the United States stands out in 2017; it is projected to close the year having attracted an impressive EUR 87 bn worth of investment — equivalent to 18.8 % of the global value of greenfield FDI — from some 1 600 greenfield projects. The EU is expected to attract some EUR 59 bn in investments by the end of 2017 — equivalent to 12.8 % of the global total — from 2 000 investment projects, a 12.2 % decrease over last year’s figures.

Some 800 greenfield projects have been announced in developed economies, attracting an estimated EUR 54 bn. This represents a sharp decrease in overall project numbers but a strong increase in value from EUR 44.37 bn, which was mostly driven by large-scale investments in the United States.

Inward greenfield FDI figures for developing economies in 2017 continued the downward investment trend witnessed since 2008, albeit at an accelerated rate given the global FDI downturn that primarily affects emerging and developing economies. Developing economies attracted an estimated 3 500 projects with a total Capital Expenditure (Capex) value of EUR 128.2 bn, a sharp decline over last year’s EUR 219.9 bn.

As a share of global greenfield investment, long-term trends indicate a convergence between developed and developing economies in both inward and outward FDI.

[20] The analysis of greenfield investment in this section and in Appendixes I and II incorporates work from the European Political Strategy Centre's Greenfield Investment Monitoring series.

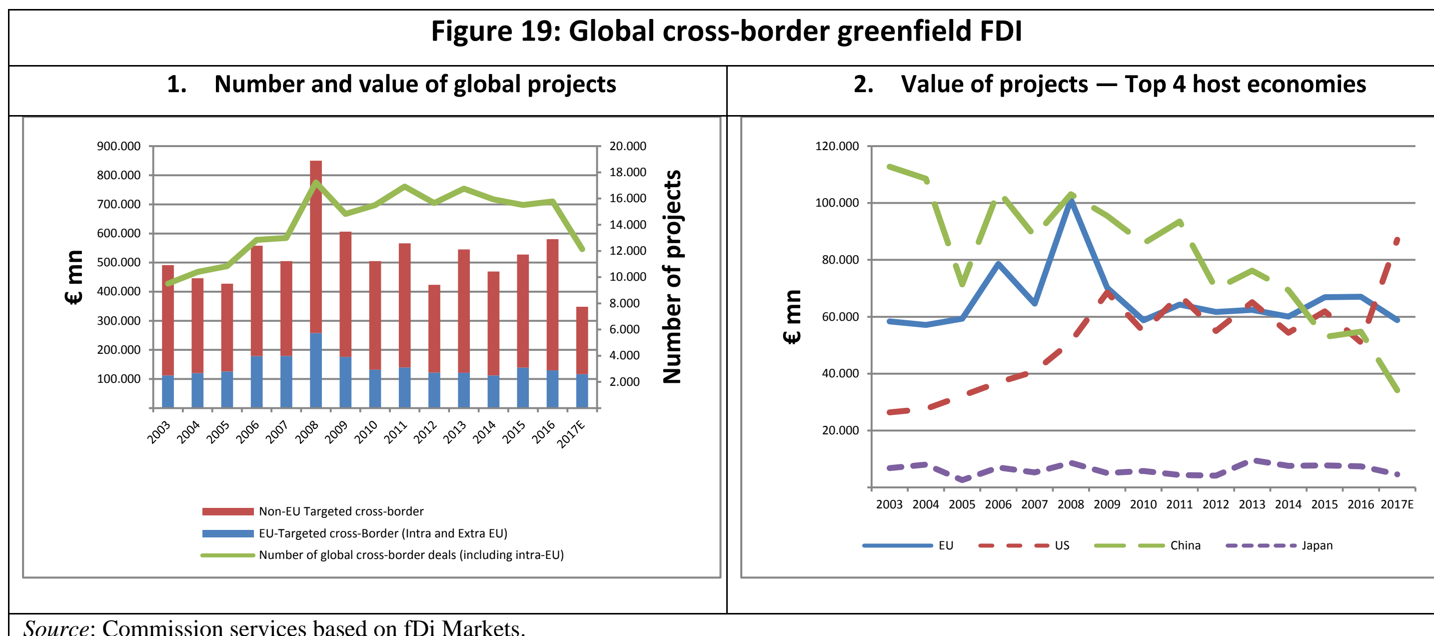


Figure 19: Global cross-border greenfield FDI

Source: Commission services based on fDi Markets.

EU overview

The volume of intra-EU greenfield projects is expected to total around 2 350, while total Capex investments are estimated to be around EUR 57.7 bn, similar to expected extra-EU investments into the EU of EUR 59 bn. This once again highlights the importance of intra-EU investments.

Regional analysis indicates that investments in the *euro area 1*[21] countries have seen a marked decline in both the number and total value of investments compared to 2016 figures. *Euro area 2*[22] countries achieved investment figures in 2017 similar to those in 2015 and 2016, while Denmark, Sweden and the UK saw a drop in investments in the last 2 years, largely driven by a slump in investment in the UK. The CEE11 countries have continued to see a general decline over the last 10 years.

There has been a general decline across all regions of the EU in investments from outside, with expected Capex figures of some EUR 59 bn and 2 000 projects by the end of 2017, a sharp decrease from EUR 66.58 bn and 2 852 projects in 2016.

Sectoral breakdown of investments in the EU

A little over half of all intra-EU greenfield investment projects focus on five sectors: (i) textiles with 17.2 %; (ii) software & IT services with 9.5 %; (iii) consumer products with 8.7 %; (iv) business services with 7.9 %; and (v) food & tobacco with 7.7 %. Together they accounted for 705 projects in the first three quarters of 2017. While intra-EU investments in high and medium-high technology intensive industries remain high, they are subdued compared to extra-EU investments.

[21] *Euro area 1* includes Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands.

[22] *Euro area 2* includes Cyprus, Greece, Malta, Italy, Ireland, Portugal and Spain.

Extra-EU investments in ICT as a share of all projects came to 27.6 % with 423 approved investments, the largest share of any other sector in the EU. Other sectors of importance for foreign investors in the EU are financial services and business services with 10.4 % and 6.9 % of the share respectively, with textiles accounting for 8.3 % of total extra-EU projects.

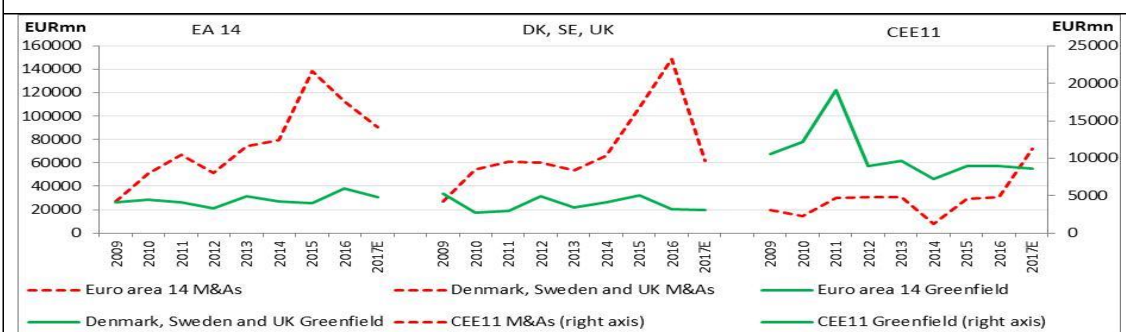
The EU managed to attract 533 greenfield projects in the first three quarters of 2017 in high-technology intensive sectors, accounting for almost 35 % of all inbound investments in the EU.

Box 1, ICT spotlight
The EU is the number one destination for global ICT sector investments, followed by the United States. It has managed to attract roughly a quarter of all global investments in ICT, with almost 900 projects in 2016 and Q1-Q3 2017 and a combined project value of EUR 32 billion. The UK, Germany and France have been the main EU ICT investment destinations in 2016 and 2017 so far, with the United States, India, Australia, Singapore, China and Canada making up the other top global ICT investment destinations. The United States has been the source of 67 % of all ICT investments in the EU in the 2003 — Q3 2017 period. Canada, Switzerland, India, China and Japan have followed the United States as the most prominent investment partners in the EU in the ICT sector, with each making up roughly 4 % of the total share of announced projects in the last 14 years.

2.3.8. *M&As compared to greenfield investment as a preferred mode of investment for non-EU countries into the EU*

This section compares the modes of entry into the EU of third country investors by groups of Member States. Non-EU investors have preferred to enter the EU market through M&As in the euro area 14 countries as well as Denmark, Sweden and the UK (see Figure 20), acquiring existing and well developed production facilities. The disclosed value of completed acquisitions in these Member States far exceeds that of greenfield investment in the post-crisis period. In contrast, non-EU country investors have preferred greenfield investment as a mode of entry into the new Member States (CEE11), which has helped develop new production capacities. A more recent trend has seen M&As in CEE11 countries starting to increase as of 2016, and they even exceeded greenfield investment in 2017.

Figure 20, Non-EU M&As and greenfield investment by groups of Member States



Source: Commission services calculations based on DEALOGIC M&A ANALYTICS and fDi Markets.

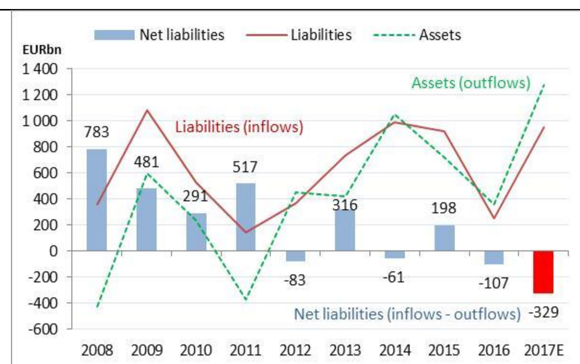
Note: M&A data — by date of completion. **Euro area 14** includes: Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands, Cyprus, Greece, Malta, Italy, Ireland, Spain and Portugal.

2.4. Portfolio investment developments

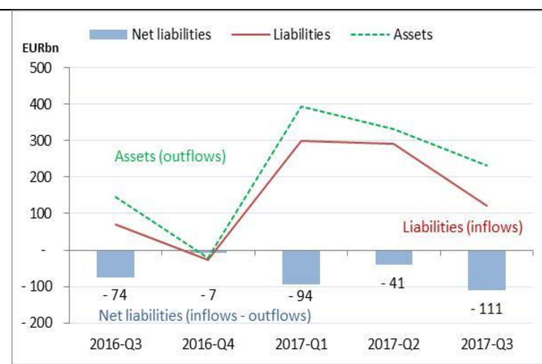
In 2016, portfolio investment outflows halved compared to 2015. The fall was even steeper for gross portfolio investment inflows, with a 77 % decrease. As a result, net portfolio investment inflows turned negative (see Figure 21.1). The EU has traditionally enjoyed a positive balance for portfolio investment inflows; outflows exceeded inflows on an annual basis only in 2012. 2016 showed the highest negative balance yet (minus EUR 107 billion). In the first three quarters of 2017, both gross portfolio investment inflows and outflows rebounded significantly, although the negative net balance for inflows increased (see Figure 21.2).

Figure 21, Portfolio investment flows, 2008 - Q3 2017

1. Annual data



2. Most recent quarters



Source: Eurostat, quarterly BoP Statistics.

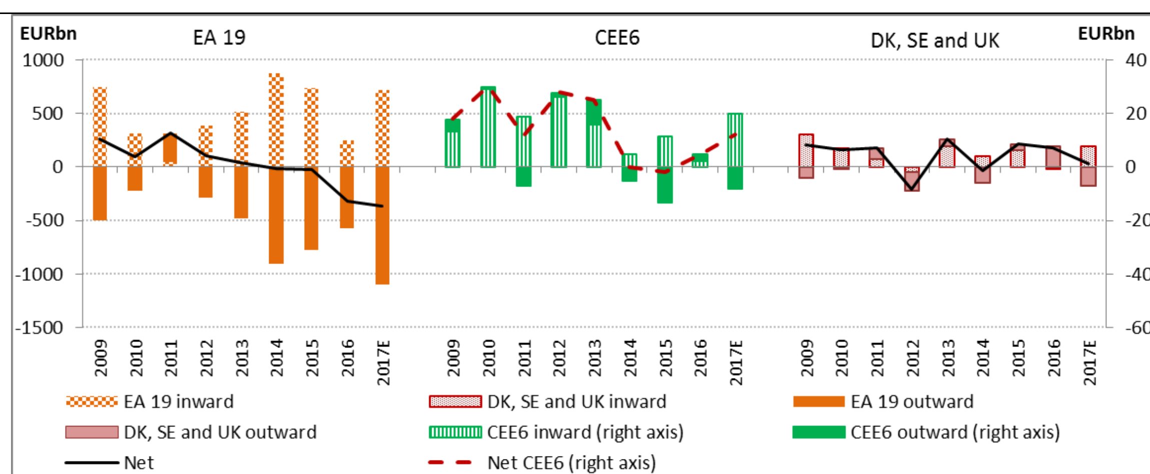
Note: Gross assets and liabilities include intra-EU portfolio investment flows. The projected 2017 figures are based on actual data up to Q3-2017 and an estimate for the fourth quarter, taking into account average quarterly flows in 2017.

This negative balance can be attributed to a decline in portfolio investment inflows and to developments in the euro area. In the euro area, the negative balance was due to a 80 % drop in inflows, which was not matched by the decrease of outflows (down 30 %). In particular, non-residents have been reducing their holdings of euro area long-term debt

securities since June 2014. The process accelerated after the ECB's extended bond-buying programme started in the second quarter of 2015 and continued throughout 2016. Against this background, increases in central banks' holdings of sovereign debt were offset by disposals of debt securities by other institutional sectors or by non-residents[23]. The decline in non-resident holdings of debt securities may therefore have contributed to the negative net balance in euro area portfolio inflows.

Gross portfolio investment inflows decreased significantly in Denmark, Sweden and the UK as well as in the CEE 6 countries[24] (see Figure 22). A strong disinvestment of foreign securities by residents of both country groups resulted in a positive net balance of portfolio investment inflows for 2016, although it was lower than in the previous year for both groups of countries.

Figure 22, Net portfolio investment inflows by groups of Member States, 2009-2017



Source: Eurostat balance of payments statistics.

Note: Including bilateral intra-EU portfolio investment flows. Portfolio investment assets are represented multiplied by minus one. CEE6 are the six recent non-euro Member States: Bulgaria, Croatia, Czech Republic, Hungary, Poland and Romania. The projected 2017 figures are based on actual data up to Q3-2017 and an estimate for the fourth quarter, taking into account average quarterly flows in 2017.

2.5. Home bias in equity and bond markets[25]

Home bias is the tendency to invest in domestic equities or bonds despite the benefits of international diversification. Despite increasing financial liberalisation since the 1990s and a considerable reduction in barriers to international portfolio investment, recent studies suggest that equity and bond home bias is still significant. In the United States for example, investors keep over 70 % of their assets in US equities despite the fact that the

[23] For more details, see Hüttl and Merler (2016), available at: http://bruegel.org/2016/05/sovereign-bond-holdings-in-the-euro-area-the-impact-of-qe/.

[24] CEE 6 are the recent non-euro Member States: Bulgaria, Croatia, Czech Republic, Hungary, Poland and Romania.

[25] This section and Appendix III have been prepared by the JRC.

US stock market makes up 36 % of the global market[26]. Home bias in equity investments for euro area countries is 10 percentage points higher[27].

Trying to measure and monitor home bias can therefore help improve our understanding of the drivers behind capital flows and how they change over time or as a result of regulatory and policy interventions. Home bias in securities markets can also point to remaining barriers or disincentives to the free movement of capital.

Trying to reduce home bias in equity and debt capital markets should be a priority. One way to reduce home bias is to ensure effective enforcement of EU competition rules in order to facilitate competitive cross-border business models in the EU equity and debt capital markets. Potential abuses of dominance by incumbent players in equity capital markets prevents such cross-border business models and should be signalled by clients or entrants to facilitate enforcement.

Figure 22 details the average home bias in equity and bond markets measured by the share of domestic equities and bonds in the investment portfolio of residents in each of the EU-28 (see Appendix III for details on definitions and methodology)[28].

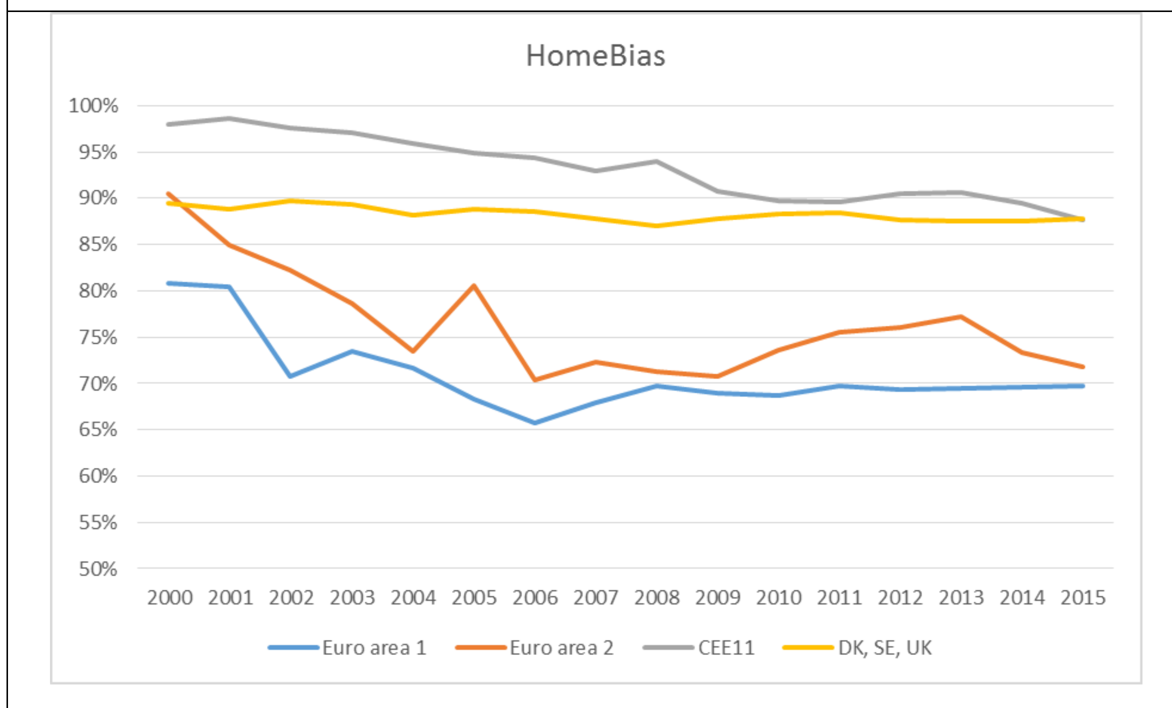
Euro area countries have the lowest home bias within the EU-28, some 20 percentage points lower than in the CEE countries. After 2008, home bias in the euro area core countries (Euro area 1) has been stable at around 70 %, a few percentage points lower than in the second group of euro area countries (Euro area 2); this group has been on a downward trend and is almost back to the pre-crisis level in the last 2 years (2014-15). A relatively constant downward trend has been observed for the CEE11 countries where home bias has been falling steadily — from 94 % to 88 % (2008 was the exception). No significant change has been observed in the aggregate for Denmark, Sweden and the UK.

[26] http://www.businessinsider.com/world-stock-market-capitalizations-2016-11?IR=T, 2016 data.

[27] Appendix IV contains detailed figures on equity and debt home bias.

[28] Bilateral cross-border holdings of debt and equities were used for the calculations based on the Finflows dataset. Finflows is a joint JRC-ECFIN dataset of bilateral cross-border investment stocks and flows for some 200 countries worldwide. The dataset, based on multiple data sources (OECD, IMF-CPIS, IMF-CDIS, BIS, ESTAT), distinguishes between foreign direct investments, portfolio investments and other investments (mainly banking flows) and records both equity and debt instruments. The data used here are the bilateral cross-border stocks of portfolio investments (debt and equity) for the EU-28 countries.

Figure 23: Home bias in bond and equity markets



Source: Finflows, JRC computations. Average between equity and debt home bias. **Euro area 1** includes Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands. **Euro area 2** includes Cyprus, Malta, Greece, Spain, Portugal, Italy and Ireland. **CEE11** includes all the CEE countries, including the Baltics.

2.6. Sharing risks: diversification of portfolio investments within the EU and consumption smoothing[29]

When a shock hits a country's economy, it is likely to affect people's consumption, investments and savings. Market and institutional channels (e.g. fiscal policy, cross-border capital and credit markets, government intervention) should dampen the shock, allowing households and individuals to maintain their consumption levels. The percentage of output shocks absorbed and therefore not passed onto consumption is known as risk sharing. Among the channels, cross-border capital markets play a key role in protecting domestic consumers. It is also crucial for the proper functioning of the Economic and Monetary Union. To measure the extent of domestic protection using cross-border channels, two measures of risk sharing are computed.

The first, an indirect measure, is based on the idea that more diversified inward and outward cross-border holdings improve a country's ability to respond to idiosyncratic shocks. Economies with more diversified outward investments are better able to cope with domestic shocks as part of the shocks will be smoothed using income from foreign assets or investments made abroad. Likewise, more diversified inward investments better insulate domestic economies from shocks generated abroad as only a fraction of the

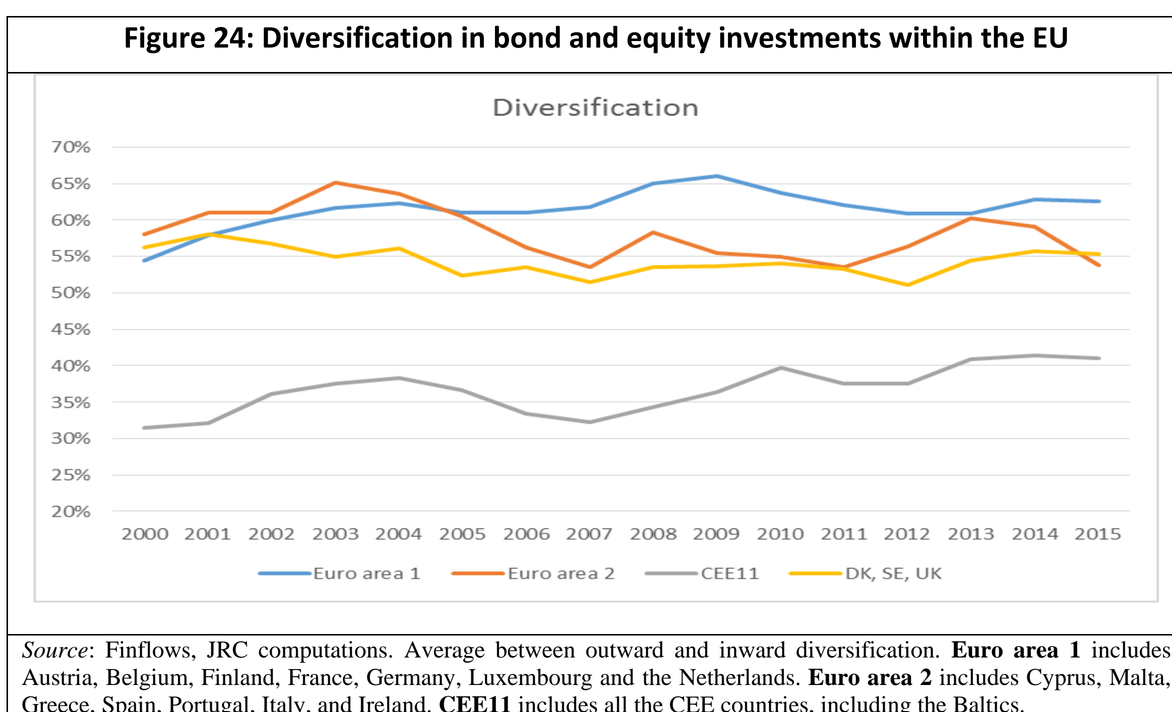
[29] This section and Appendix IV has been prepared by Pilar Poncela and Filippo Pericoli, from the Joint Research Centre.

shock could be transmitted to the domestic economy via foreign retrenchment (dis-investments).

Figure 24 displays an average of outward and inward diversification indicators for bond and equity investments within EU countries[30] (further details are available in the appendices).

Euro area core countries (Euro area 1) tend to be more diversified than the rest of the EU-28 after 2005. Following the effects of the 2008 crisis, diversification returned to pre-crisis levels in 2015. The diversification indicator for Denmark, Sweden and the United Kingdom has been more or less stable from 2005 onwards. The second group of euro area countries (Euro area 2) shows a volatile trend in the level of diversification: relative peaks were observed in 2004, 2008 and 2013. However, in 2015 a sharp decrease was recorded in both inward as well as outward diversification indicators. Finally, CEE11 countries have shown continuous improvement in diversification except in 2006 and 2011; their level of diversification is still rather low compared to the other EU countries.

Figure 24: Diversification in bond and equity investments within the EU



Source: Finflows, JRC computations. Average between outward and inward diversification. **Euro area 1** includes Austria, Belgium, Finland, France, Germany, Luxembourg and the Netherlands. **Euro area 2** includes Cyprus, Malta, Greece, Spain, Portugal, Italy, and Ireland. **CEE11** includes all the CEE countries, including the Baltics.

A more traditional approach to risk sharing looks directly at the cross-border channels that help smooth income and consumption when a country is hit by an output shock. These channels include:

1) the capital markets, essentially based on the income from cross-border activities;

2) the credit markets channel (gross savings), which includes net lending/borrowing to/from the rest of the world; and

[30] Being interested in risk sharing in EU countries, we only consider EU-28 investments within Europe. This implies that a country with low diversification in the EU could be diversified outside Europe.

3) the fiscal channel, which includes the international transfers made by the government and workers' remittances by migrants.

The risk sharing model is estimated for all EU countries using annual data from national accounts statistics for 1960-2016 (the appendix contains additional details on the methodology and estimation).

The main findings are as follows:

- On the amount of risk sharing for EU countries, the average risk sharing for the EU-14[31] in 1960-2016 was around 40 % compared to over 80 % for the United States[32]. In other words, some 40 % of GDP shocks are not directly transmitted to consumption and are absorbed by the different channels. This figure increases slightly for the 1999-2016 subsample.
- The bulk of risk sharing takes place through the credit markets (savings) channel, which counts for over 30 % of total risk sharing, comparable with the 27 % computed for the United States over a similar time frame.
- Although it practically did not exist during the first part of the sample, the capital markets channel is growing, reaching 12 % in 1999-2016 after the introduction of the euro. In the United States, risk sharing via capital markets is around 45 %.
- In the EU, risk sharing through international transfers (fiscal channel) has been almost non-existent for all periods and countries analysed. The US figure is around 8 %.

On the channels through which risk sharing occurs, the analysis shows that the different channels mentioned above (the credit markets channel, the capital markets channel and the fiscal channel) tend to act as substitutes — if one increases over time, the others tend to decrease. This implies that policies supporting one of the channels are likely to have spill-overs in the effectiveness of the other channels.

The country-by-country analysis (below) reveals that the degree of risk sharing across countries is quite heterogeneous, although higher in Ireland, Sweden, Finland, Belgium and Greece. It mainly involves the credit channel.

[31] EU-14 includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and the UK.

[32] Quarterly Report on the Euro Area, Vol. 15, No. 2, 2016.

Table 2: Risk sharing across EU countries

EU14, sample 1961-2016				
Country	**Total**	**Capital**	**Gov**	**Credit**
Austria	3	-3	1	4
Belgium	46	0	-3	49***
Denmark	13	-2	1	14
Finland	43	-1	0	45***
France	9	1	2	6
Germany	23	-1	2	22**
Greece	42	0	-2	44***
Ireland	79	17**	3	59***
Italy	26	5	-1	21**
Netherlands	31	0	1	31
Portugal	15	-3	-1	19
Spain	27	3	3	21**
Sweden	63	-8	0	72***
UK	18	2	3	14

Note: Data source AMECO, JRC estimations. The symbols ** and *** indicate statistically significant at 5 % and 1 %.

2.7. Performance of large and systemically important European and global banks

Given the importance of global systemically important banks (G-SIBs) and the European large banking groups not only for their domestic economies but also for cross-border lending and capital flows, this section explores their recent performance across a set of indicators.

More specifically, their cross-border exposures account for a significant share of bank-related and portfolio investment cross-border flows in Europe. As most of the European global systemically important banks (European G-SIBs) are also corporate groups with truly European ramifications and dimensions, their performance also has a bearing on FDI flows.

Recent regulatory developments have fostered the collection of various additional data and indicators for global and European Economic Area (EEA) systemically important banks that are normally not available for all banks; these enable additional insights into the performance of these economic groups. For instance, one of the reporting indicators for G-SIBs focuses on their cross-border exposures, which is important in terms of monitoring bank-related capital flows.

Additional insights can be obtained by comparing European global systemically important banks with the rest of the G-SIBs. In November 2017, the Financial Stability

Board (FSB) updated the list of G-SIBs, removing one European bank and adding one Canadian bank. This left the total number of G-SIBs unchanged (30 in total, 10 of which are from the EEA)[33]. The European Banking Authority added 23 other European financial institutions to this group that it deems potentially systemically important. They are therefore subject to the same disclosure requirements as those identified by the FSB[34].

Overall, average G-SIBs indicator scores are lower, suggesting that those banks are becoming less systemically important as a group, especially in terms of capital market-related activities. However, increasing skewness in some categories (mostly size) suggests individual firms are likely becoming systemically more risky even if G-SIBs as a whole are becoming less so.

On European G-SIBs, the following observations can be made: (i) the cross-jurisdictional claims indicator is by far the largest contributor to the systemic importance of European G-SIBs; (ii) the systemic relevance of European G-SIBs has been shrinking in comparison to the overall sample; (iii) European G-SIBs have pulled back from some capital market activities in 2013-2016; and as a result (iv) euro area and UK G-SIBs have become less systemically important: there were broad declines in euro area and UK G-SIB scores, especially in the complexity category.

Total assets of European G-SIBs last peaked in the second quarter of 2016. However, since then they have been on a downward path and have fallen close to their 2015 levels. They declined by 0.8 % year-on-year in 2016, and their negative growth rate reached 5.2 % at the end of the first half of 2017 (see Figure 25). However, total assets of G-SIBs[35] in the other world regions continued to grow until the second quarter of 2017, when they recorded marginal declines of 0.3 % year-on-year for US G-SIBs and 0.2 % for the rest of the world's G-SIBs respectively.

[33] http://www.fsb.org/wp-content/uploads/P211117-1.pdf.

[34] For comparison purposes, the European G-SIBs are the stable sample over the observed period (as shown in the 2016 G-SII data disclosure tool) of 33 EEA banks identified by the EBA as global systemically important or potentially systemically important banks. The 33 EBA banks with enhanced disclosure requirements are those exceeding the leverage ratio exposure measure of EUR 200 bn (and so are deemed potentially systemically important). Out of them, 12 banks feature in the G-SIB list of the FSB as per November 2016 and have been identified as globally systemically important banks.

[35] The list of G-SIBs reflects the November 2016 update by the FSB. It consists of 30 banks: 13 from the EEA, 8 from the United States, 2 from Switzerland, 3 from Japan and 4 from China. The sample includes 15 US banks: the 8 G-SIBs in the FSB list and 7 other banks identified as domestically SIBs by the Federal Reserve in the BASEL consistency assessment exercise.

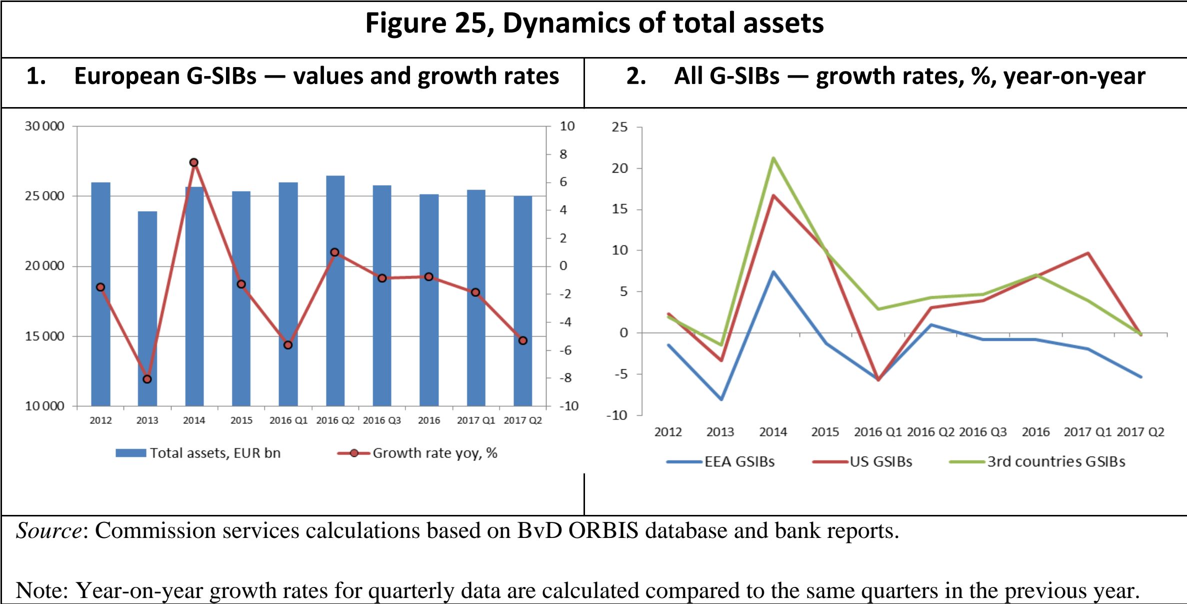


Figure 25, Dynamics of total assets

Source: Commission services calculations based on BvD ORBIS database and bank reports.

Note: Year-on-year growth rates for quarterly data are calculated compared to the same quarters in the previous year.

Gross lending of European G-SIBs has changed relatively little since 2015 in nominal terms; however, on an annual basis there have been negative growth rates from the third quarter of 2016 up to the second quarter of 2017 (see Figure 26). By contrast, G-SIBs in the United States and in other non-EU countries have continued to expand their gross loans[36]. Growth rates have declined since the beginning of 2017 and, in the case of US banks, even turned slightly negative in the second quarter, but still remain well above those of European G-SIBs.

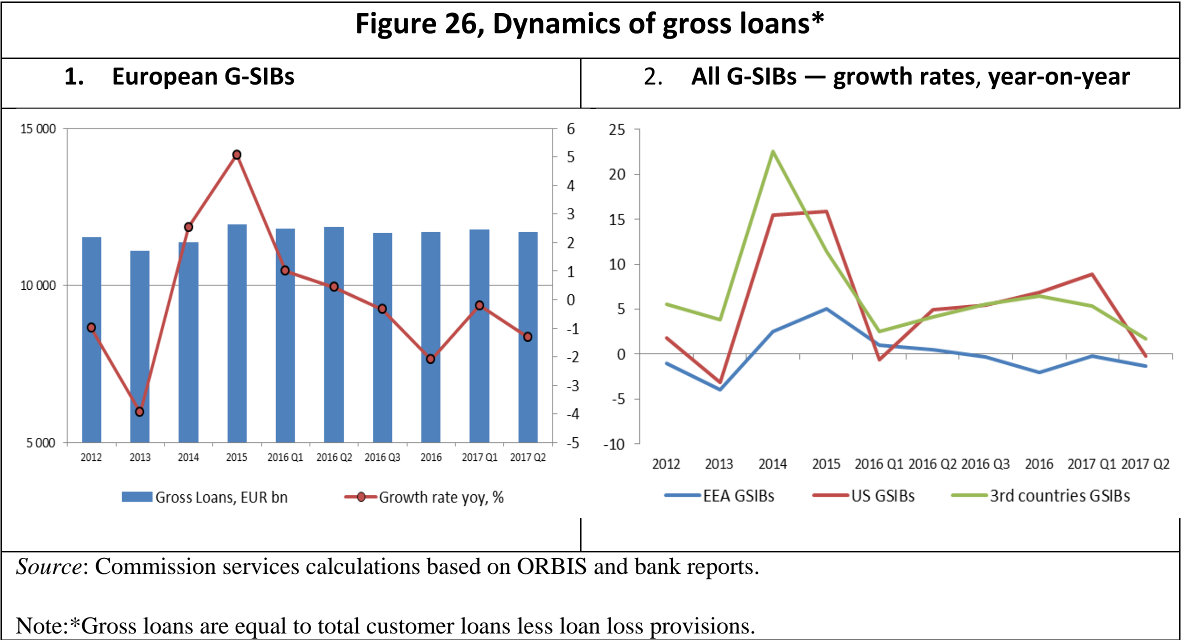


Figure 26, Dynamics of gross loans*

Source: Commission services calculations based on ORBIS and bank reports.

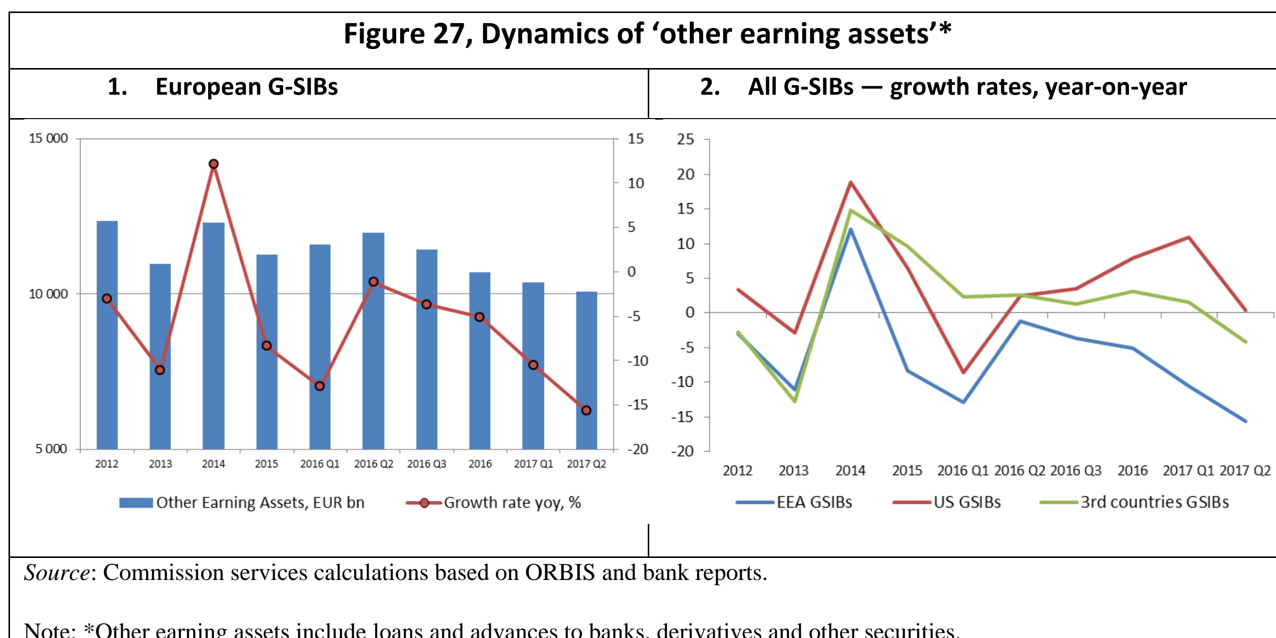
Note:*Gross loans are equal to total customer loans less loan loss provisions.

The stock of *other earning assets* on European G-SIBs' balance sheets increased in nominal terms in the first half of 2016 (see Figure 27). However, their holdings of

[36] Gross loans include the reserves for impaired and non-performing loans.

securities started to decline steadily after June 2016. This led to a reduction in the level of other earning assets and seems to have been one of the drivers behind the decrease in European G-SIBs' total assets. On the contrary, other countries' G-SIBs (especially those in the United States) mostly increased their securities until the first quarter of 2017.

Figure 27, Dynamics of 'other earning assets'*



Source: Commission services calculations based on ORBIS and bank reports.

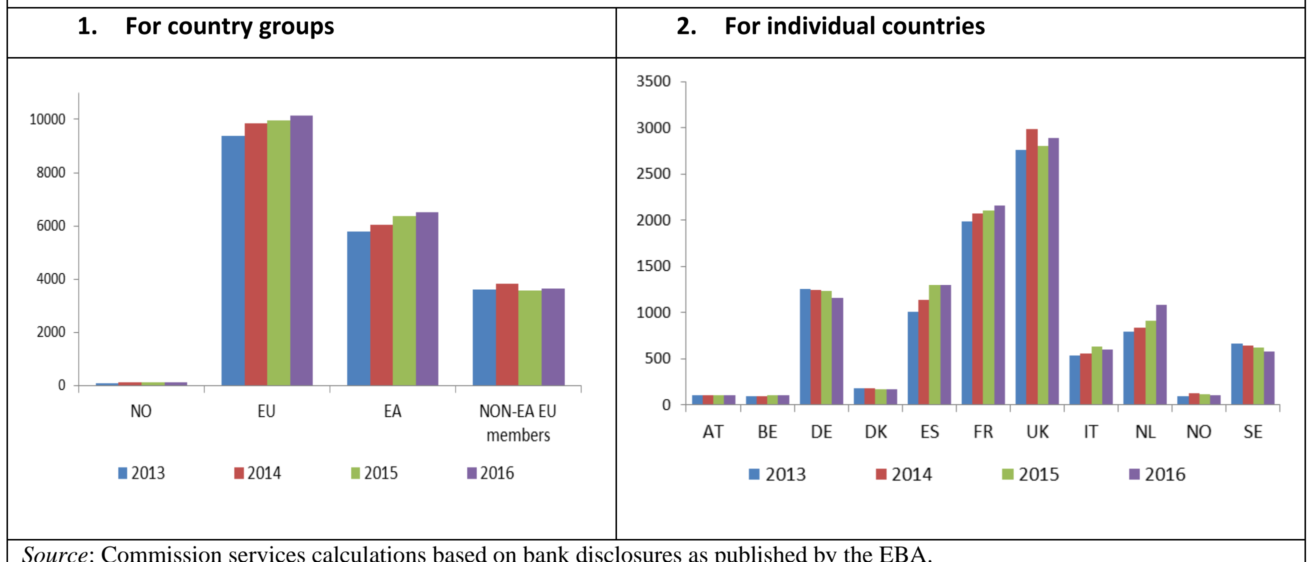
Note: *Other earning assets include loans and advances to banks, derivatives and other securities.

Despite the benefits of diversification, international exposure of G-SIBs[37] is an important source of risk for the financial system from the standpoint of possible contagion between countries. Given the importance of European G-SIBs for cross-border activity and flows due to their vast reach by way of subsidiaries and branches, the dynamics of their international activity can point to the aforementioned risks, but also give an idea about the direction and size of capital flows.

As shown by Figure 28, EU-28 G-SIBs increased their international exposure as both euro area and non-euro area countries finished 2016 with higher stocks of cross-jurisdictional claims than in 2015. Among the euro area countries, the Netherlands and France were the main contributors to the increase, while German and Italian banks reduced their cross-border exposures. For non-euro area countries, the UK G-SIBs and other potentially systemically important institutions were almost exclusively responsible for the growth in cross-jurisdictional claims, whereas banks in Sweden had negative contribution.

[37] To explore the international exposure and activity of European G-SIBs, we use some of the indicators that were defined by the FSB and publicly disclosed by banks as they were published by the EBA.

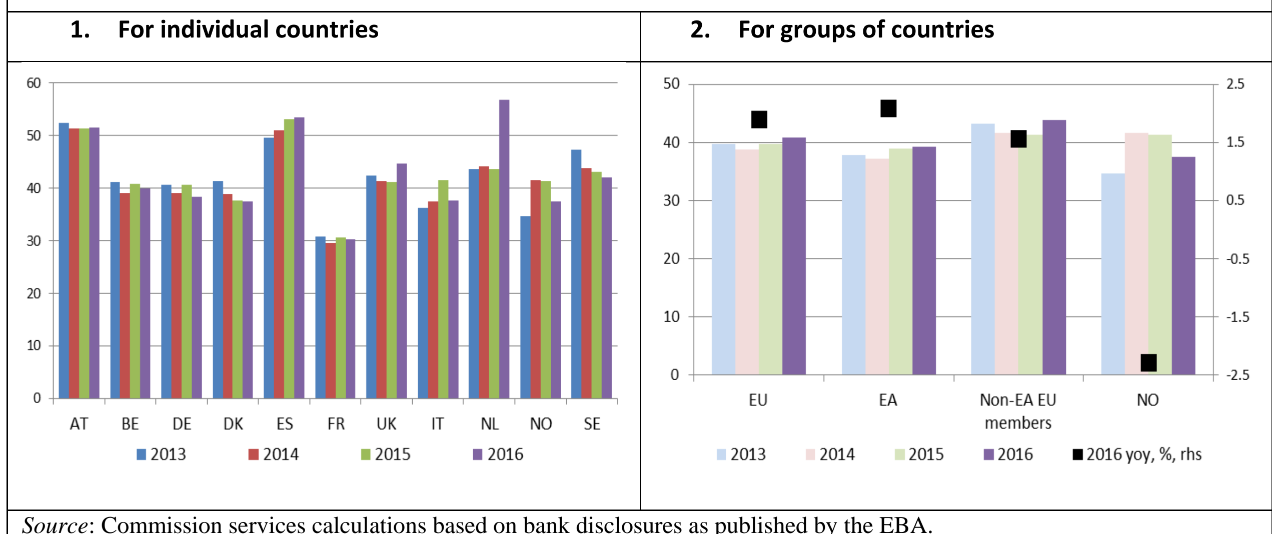
Figure 28, Cross-jurisdictional claims indicators of European G-SIBs, 2013-16



Source: Commission services calculations based on bank disclosures as published by the EBA.

As a share of total assets, the picture remains the same in relative terms for the groups of countries (see Figure 29). Both euro area and non-euro area countries increased the share of their international exposures; subsequently, the same can be said for the EU as a whole. Dutch and UK banks were mainly responsible for the higher overall share of cross-jurisdictional claims after the latter increased significantly in 2016 in both countries (see Figure 27). At the same time, total assets shrank, doubling the effect (see Figure 28). In the case of Austria, Belgium, Denmark and France, there was an increase in cross-border assets. However, their total assets grew more in absolute terms; as a result, there was a reduction in the share of foreign claims. G-SIBs and other potentially systemically important institutions in Norway, Italy and Germany took a more active approach towards limiting their exposures across jurisdictions by reducing their claims while increasing their assets.

Figure 29, Cross-jurisdictional claims as % of total assets, 2013-16



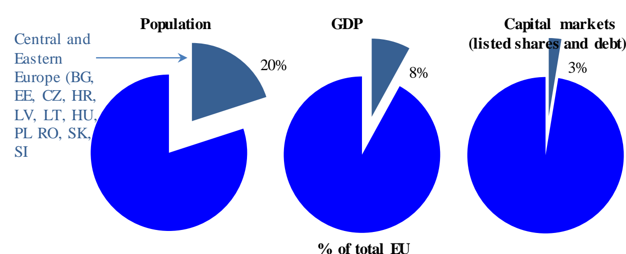
Source: Commission services calculations based on bank disclosures as published by the EBA.

2.8. The growth potential of capital markets in Central and Eastern Europe

The Member States from Central and Eastern Europe (CEE) have the potential to reap significant benefits from the Capital Markets Union. Their capital markets are still structurally less developed than in other Member States. In several of these countries with relatively low per capita income and a less developed financial sector, there is a considerable need for investment, in particular in infrastructure. Although state-owned enterprises started to be privatised in the early 1990s, this process has still not been completed. Capital inflows and FDI are necessary to continue structural reforms, support productivity improvements and boost growth in per capita income. To improve the growth potential of these economies, further investments are needed in education and innovation as well as regulatory and institutional reforms. To support this process, better developed capital markets are essential to finance investments from both domestic and foreign sources.

The CEE countries have high economic growth potential, and better capital markets may help realise this potential. These countries account for 20 % of the EU-28 in terms of population, 8 % in terms of GDP and only 3 % in terms of capital markets (see Figure 30). At the end of 2015, debt market capitalisation[38] in the EU-11 countries stood at 52 % of GDP compared to 159 % of GDP in the EU-28. Stock market capitalisation accounted for 18 % of GDP compared to 66 % of GDP in the EU-28. More developed capital markets can support these economies with more diversified sources to finance growth and development.

Figure 30, The underdevelopment of capital markets in Central and Eastern Europe

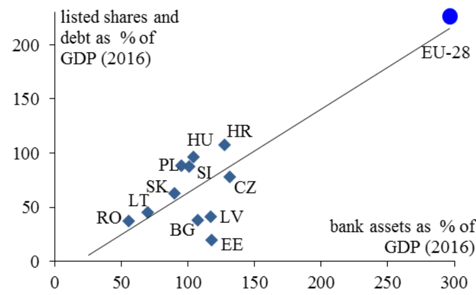


Source: ECB.

Financial intermediation in the CEE countries has remained largely bank based. While still below the EU-28 average (see Figure 31), the banking sector is more important than the capital markets for the CEE countries. While the same also holds for other Member States, the discrepancy appears bigger in the CEE countries; the banking sector as a % of GDP is almost twice as large as the market capitalisation of listed shares and bonds, compared to around 1.3 for the EU as a whole (see Figure 31). Market sources of financing could help unlock the growth potential of these emerging economies, and this can go hand in band with a further development of the banking sector.

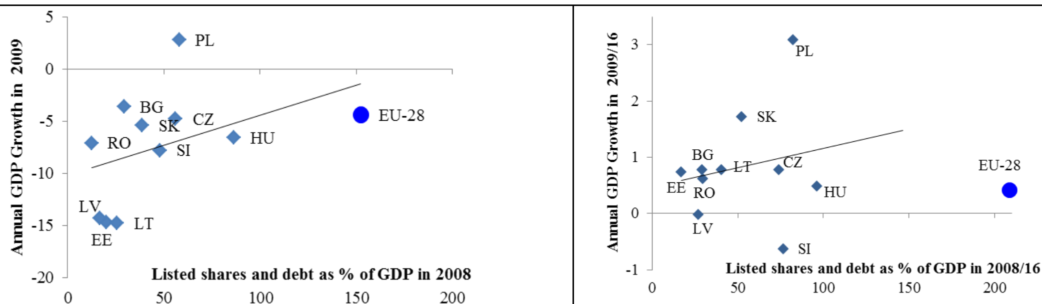
[38] Including bills, bonds, certificates of deposit, commercial paper, debentures.

Figure 31, Capital market depth and the banking sector in CEE countries



Source: ECB.

Figure 32, Capital market depth in CEE: resilience to shocks and GDP growth



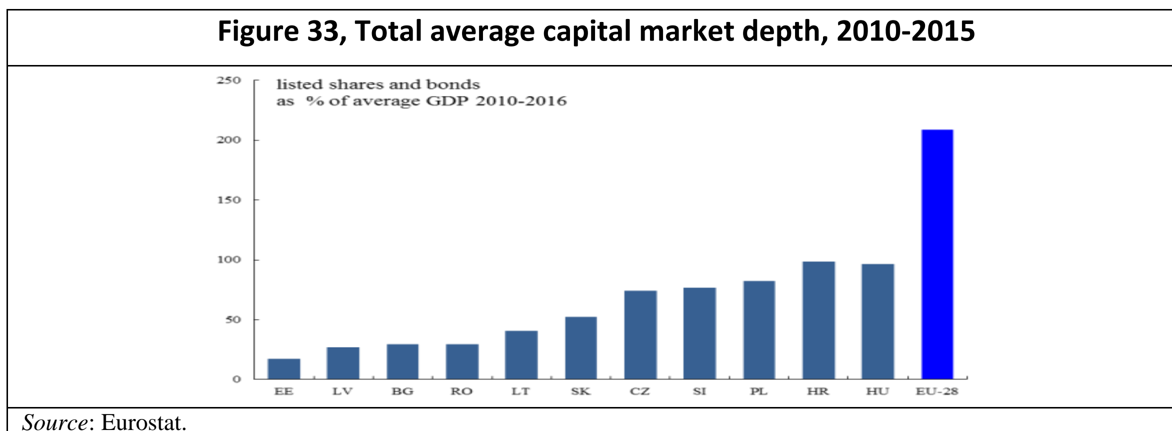
Source: ECB.

Capital markets have the potential to improve resilience to shocks and foster growth. While economic resistance is a complex issue, CEE countries with deeper capital markets at the onset of the crisis appear to be less affected in terms of GDP contraction than some of their peers with less developed capital markets (see Figure 32). The region has picked up since the crisis, with economic growth of 3 % on average, down from around 7 % before the crisis. CEE countries with deeper capital markets seem to post stronger growth rates, although generalisations are difficult as there are many drivers of economic growth.

Capital markets can play a pivotal role in helping restore rapid and sustainable economic growth. Taking listed shares and bonds as a proxy, capital market depth is far below the EU-28 average and varies greatly between the EU-11 countries (see Figure 33). The Baltic countries, Romania and Bulgaria are among the countries with the lowest total stock market capitalisation. Catching up with the deeper capital markets of peers could unleash ‘more than EUR 200 billion in long-term capital, deliver more than EUR 40 billion a year in extra funding for companies’ in the CEE region[39].

[39] AFME and New Financial 2016.

Figure 33, Total average capital market depth, 2010-2015



Source: Eurostat.

3. Legal framework underlying the free movement of capital and payments

3.1. Legal framework at EU level

The principle of free movement of capital lies at the heart of the single market and is one of its four fundamental freedoms. The Treaty on the Functioning of the European Union (TFEU) does not contain an explicit definition of capital movements. However, in its jurisprudence the Court of Justice of the European Union (CJEU) has consistently established a broad definition of capital movements[40]. According to this jurisprudence, capital movements cover many operations, including:

- FDI, real estate investments or purchases;
- securities investments (for instance in shares, bonds, bills and unit trusts);
- transactions in securities on the capital market, admission of securities to the capital market;
- operations in units of collective investment undertakings;
- premiums and payments in respect of life and credit assurance; and
- granting of loans and credits and other operations, including personal capital operations such as dowries, inheritances and legacies, gifts and endowments.

As a rule, all restrictions on the movement of capital between Member States but also between Member States and non-EU countries are prohibited (Article 63 of the TFEU). The CJEU has interpreted the term restriction to mean all measures which are liable to prohibit, limit or deter the free movement[41]. However, the TFEU provides for the possibility to restrict capital movements, for the reasons referred to in Article 65 TFEU and, for non-discriminatory restrictions, for overriding reasons in the public interest. Article 65 TFEU provides in particular that the free movement of capital is without prejudice to certain powers of Member States. These include the power a) to apply the relevant privisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to the place of residence or the place where the capital is

[40] On the basis of the nomenclature annexed to Council Directive 88/361/EEC.

[41] CJEU, Joint cases C‑52/16 and C‑113/16, ECLI:EU:C:2018:157 n. 65 – SEGRO und Horváth

invested, and b) to take precautions and supervisory measures especially in the fields of taxation and the prudential supervision of financial institutions. Moreover, Article 65 (1)(b) TFEU preserves the power of Member States "to take measures which are justified on grounds of public policy or public security".

In any case, restrictive measures must respect the principle of proportionality, hence they must be suited to attain the objective sought, they must not go beyond what is necessary to achieve that objective and cannot be replaced by less restrictive alternative means. Moreover, national measures must comply with other general principles of EU law such as legal certainty and with the fundamental rights[42]. Furthermore, the exceptions provided in the TFEU must not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments (Art. 65(3) TFEU).

Different considerations apply to the movement of capital to and from non-EU countries. The CJEU stressed that it "takes place in a different legal context" from that which occurs within the Union. Consequently, under the Treaty additional justifications may be acceptable in the case of third country restrictions[43]. Justifications may also be interpreted more broadly.[44] Moreover, and in practice more importantly, any restrictions existing before the liberalisation of capital movements are grandfathered under Article 64 (1) TFEU. The relevant date is 31 December 1993 for all Member States except Bulgaria, Estonia and Hungary (31 December 1999) and Croatia (31 December 2002). This means that restrictions in place before these dates affecting third country nationals cannot be challenged on the basis of the principle of the free movement of capital under the Treaty.

The Treaty also makes provision for certain restrictions that can be adopted by the EU under certain conditions. The Council may, by means of a Regulation, interrupt or reduce, in part or completely, the economic and financial relations with one or more non-EU countries if deemed necessary to achieve the objectives of the Common Foreign and Security Policy (Article 215(1)). The restrictive measures or sanctions may affect in particular exports, imports, transfers of funds, investment and access to the EU's capital markets.

3.2. Framework for investment in the Member States

Almost half of the Member States have set up mechanisms to screen investment in order to safeguard public security or public policy interests (Denmark, Germany, Spain, France, Italy, Latvia, Lithuania, Austria, Poland, Portugal, Finland and the United Kingdom). Most of these mechanisms apply to both intra-EU/EEA and extra-EU/EEA investors. Some distinguish between these categories and treat them differently. A small number focus on extra-EU/EEA investors only, though some of these may also apply to

[42] C-163/94 Sanz de Lera and Others, para. 23.

[43] CJEU, cases C-101/05, Skatteverket, n 36; C-446/04, Test Claimants in the FII Group Litigation, n 171.

[44] See, for example, Case C-446/04, FII Group.

intra-EU/EEA investors to deal with cases of possible circumvention of the rules by extra-EU investors[45].

In 2017, new developments were observed on national frameworks for investment screening:

- On 29 March 2017, Latvia adopted amendments to its national security law and commercial code to introduce an investment screening mechanism for reasons of national security. The new law creates a new category of companies: 'commercial enterprises of national security significance'. This would require prior approval from the Cabinet of Ministers to change their shareholdings, which would amount to decisive influence or qualifying holdings. These restrictions apply to certain companies active in the telecommunications sector, electronic mass medium sector and energy (gas, electricity and heat) sector.
- On 17 October 2017, the UK launched a public consultation on the Green Paper *National security and infrastructure investment review: the government's review of the national security implications of foreign ownership or control and the mergers regime*[46]. The Green Paper sets out the approach the UK Government proposes to take in both the short and long term in terms of ensuring that investments and takeovers do not raise national security concerns.

3.3. Infringement proceedings

The infringement procedure is a tool used as a last resort to preserve the integrity of the single market for capital. Most of the barriers to capital movements are overcome at the pre-litigation stage by collaborating with Member States; this is either through formal dialogue as a way of problem-solving before starting infringement procedures, or through other informal contacts.

During the reporting period, the Commission closed one infringement case concerning the special rights in the Hellenic Telecommunication Organisation (OTE) as a result of sufficiently satisfactory measures taken by the Member State.

Another area where the Commission has taken action as a guardian of the Treaties to ensure free movement of capital is direct taxation. Although direct taxation is primarily the responsibility of Member States, they must act in compliance with EU law, including the laws on free movement of capital and the freedom of establishment. During the reporting period[47], the Commission launched two infringement proceedings under Article 63 of the TFEU and Article 40 of the European Economic Area Agreement against Germany and Portugal by sending letters of formal notice.

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[45] For more details on the different features of Member States' screening laws, see the Commission Staff Working Document accompanying the Proposal for a Regulation of the European Parliament and of the Council establishing a framework for screening of foreign direct investments into the European Union, COM(2017) 487 final, p. 7-8.

[46] Available at: https://www.gov.uk/government/consultations/national-security-and-infrastructure-investment-review.

[47] The reporting period is from 1 January 2016 to 1 October 2017.

During the same period, the Commission closed 13 proceedings on tax restrictions on the free movement of capital. By 1 October 2017, there were 31 open infringement proceedings against the Member States for violations in the field of direct taxation in relation to free movement of capital.

In 2017, the Commission brought a case against France to the CJEU for maintaining the effects of the provisions that allow a parent company to set off against the advance payment, for which it is liable when it redistributes to its shareholders dividends paid by its subsidiaries, the tax credit applied to the distribution of those dividends if they come from a subsidiary established in France, but do not offer that option if those dividends come from a subsidiary established in another Member State[48].

In the same year, the Commission also brought an action in the CJEU against Belgium for retaining provisions under which the rental income of Belgian taxpayers from the property on the national territory is estimated on the basis of outdated cadastral values, but the rental income from the property abroad is calculated on its actual rental value[49].

As regards judgments on tax restrictions on the free movement of capital following infringement proceedings, the CJEU considered that Greece failed to fulfil its obligations by enacting and maintaining in force legislation which provides for an exemption from inheritance tax relating to the primary residence, which applies solely to nationals of EU Member States who are resident in Greece[50].

4. MAIN DEVELOPMENTS SUPPORTING THE FREE MOVEMENT OF CAPITAL AND THE FREEDOM OF PAYMENTS

4.1. Capital Markets Union — mid-term review and priorities

As part of the third pillar of the Investment Plan for Europe[51], which aims to remove regulatory and non-regulatory barriers to investment through complementary EU and national measures, the Capital Markets Union (CMU) is essential to delivering on the Commission's priority to boost jobs and growth. By supporting economic convergence and helping to cushion economic shocks in the euro area and beyond, the CMU seeks to remove obstacles to the free flow of capital across borders. This will strengthen the Economic and Monetary Union and make the European economy more resilient.

The Commission has delivered more than two thirds of the measures announced in the 2015 CMU Action Plan (25 out of 33), including:

— Adjust Capital Requirements Regulation (CRR) calibrations for banks' infrastructure investments;

— Review of European Venture Capital Fund Regulation (EuVECA);

[48] *Commission v France*, C-416/17.

[49] *Commission v Belgium*, C-110/17.

[50] *Commission v Greece*, C-244/15.

[51] More details are available at: https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en

- Proposal for simple, transparent and standardised securitisation (STS). This new framework agreed by the co-legislators could significantly boost the ability of banks to extend credit to the economy;
- In mid-2019, the new rules on prospectuses will take effect to help companies raise capital on public markets; and
- Proposal on preventive restructuring and second chance for entrepreneurs.

The Commission published a Code of Conduct on withholding taxes on 11 December 2017[52]. The Code of Conduct proposes pragmatic and operational solutions to achieve standardisation and simplification of refund (and existing relief-at-source) procedures (see section 4.7).

In the light of the most recent developments in the EU's political and economic context, the call for strong and competitive capital markets to finance the EU economy, alongside the Banking Union, has become even more relevant. These developments and evolving challenges have called for a reframing of the CMU Action Plan that could provide strong answers. The mid-term review adopted by the Commission on 8 June 2017 has thus been built around a set of nine new priority measures that complement the original CMU Action Plan. These measures aim to properly address the hurdles of cross-border investments, financial innovations tools, long-term sustainability goals and the need to further integrate EU supervision to face the future challenges of the EU financial markets.

Given the fundamental role of supervision and its role in accelerating market integration, reviewing the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB) has been at the heart of building a CMU. The Commission proposal on targeted amendments to the functioning of the European Supervisory Authorities aims at ensuring that the ESA, ESMA in particular, are equipped to address new challenges and risks, while contributing more effectively to supervisory convergence. The Commission has therefore proposed to expand ESMA's direct EU-supervisory powers in certain targeted cases in sectors that are highly integrated, have important cross-border activities or are regulated by directly applicable EU law, in line with the principle of subsidiarity.

The proposal for a Pan-European Personal Pension Product adopted on 29 June 2017[53] should unlock savings currently idling on low-interest rate accounts, and put them to more productive use, while ensuring strong consumer protection.

In the context of the EU's ongoing work to tackle non-performing loans, the Commission has adopted on 14 March 2018[54] a package of measures, including measures to prevent the build-up of non-performing loans on banks' balance sheets in the future. It was announced on 11 October 2017 in the Commission Communication on Completing the

[52] For more information, see section 4.7 or the press release: http://europa.eu/rapid/press-release_IP-17-5193_en.htm.

[53] http://europa.eu/rapid/press-release_IP-17-1800_en.htm

[54] http://europa.eu/rapid/press-release_IP-18-1802_en.htm

Banking Union and was also stressed by the Economic and Monetary Union (EMU) package of proposals adopted by the Commission on 6 December 2017.

Moreover, the Commission presented legislative proposals to review the prudential treatment of investment firms in December 2017. The objective is to ensure that investment firms are subject to capital, liquidity and other key prudential requirements and corresponding supervisory arrangements that are adapted to their business yet sufficiently robust to capture the risks of investment firms in a prudentially sound manner in order to protect the stability of the EU's financial markets.

Among the CMU initiatives, a legislative proposal on an EU framework for covered bonds was published on 12 March 2018[55], building on well-functioning features of successful national labels.

The Commission also published an Action Plan on Fintech on 8 March 2018[56], in order to explore EU-wide enabling legislation for crowdfunding to increase the scale and facilitate cross-border activity in this rapidly growing sector.

Notably, the Commission developed its communication and Action Plan on sustainable finance following the publication of the recommendations from the High-Level Expert Group on Sustainable Finance, which was adopted on 8 March 2018[57].

Measures were prepared on how to facilitate the cross-border distribution and supervision of Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds, together with guidance on existing EU rules for the treatment of cross-border EU investments and a comprehensive EU strategy on steps that can be taken at EU level to support local and regional capital market development across the EU. They were published on 12 March 2018[58].

Finally, the Commission has committed to conducting an impact assessment that will explore whether targeted amendments to relevant EU legislation (MiFID II and Market Abuse) could deliver a more proportionate regulatory environment to support SME listing on public markets. The objective of this work is to further alleviate the administrative burden on listed SMEs and revive the local ecosystems surrounding SME-dedicated markets, while keeping investor protection and market integrity unharmed. This work stream also aims to enhance the SME Growth Markets' prospects of success.

4.2. Investment Plan for Europe – further deployment

The Investment Plan for Europe comprises three pillars. First, the European Fund for Strategic Investments (EFSI) allows, by means of an EU guarantee, for the mobilisation of additional, mainly private finance to support projects in Europe that deliver tangible results for jobs and growth. Second, the European Investment Advisory Hub and the

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[55] https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-94_en

[56] http://europa.eu/rapid/press-release_IP-18-1403_en.htm

[57] http://europa.eu/rapid/press-release_IP-18-1404_en.htm

[58] http://europa.eu/rapid/press-release_IP-18-1364_en.htm?locale=en

European Investment Project Portal help investment projects reach the real economy by providing technical assistance and greater visibility of investment opportunities. Third, structural reform measures remove regulatory barriers to investment both nationally and at EU level, such as the CMU and its Action Plan. The combination of these measures under the Investment Plan for Europe has already helped substantially increase investments and raise additional finance since its inception in 2015.

The recently agreed EFSI ('EFSI 2.0') will help mobilise further finance in strategic sectors of the EU economy[59]. EFSI 2.0 extends the lifespan of the EFSI to 31 December 2020, raising the investment target from EUR 315 billion to EUR 500 billion.

EFSI 2.0 will also allow investments in new sectors and strengthen climate-related investments in light of ambitious goals that the EU agreed to at the Paris Climate Conference. Technical assistance to project promoters (private or public) to accelerate developing investment projects will also be strengthened.

Synergies between the different pillars — EFSI finance and CMU measures — have been achieved, for instance in the field of mobilising start-up and expansion finance for SMEs. The Commission reformed relevant regulatory frameworks to raise capital — EuVECA for European venture capital funds and EuSEF for European social entrepreneurship funds — making them more attractive for fund managers. The new legislation extended the range of managers eligible to market and manage EuVECA and EuSEF funds to include larger fund managers, i.e. those with assets under management of more than €500 million. For EuVECA, alternative investment fund managers can also now operate EuVECA funds and invest in SMEs listed on SME growth markets and companies other than SMEs (small midcaps with up to 499 employees). Under the Pan-European Venture Capital Fund-of-Funds programme, EU budget support of EUR 410 million to one or several privately managed Funds-of-Funds is also expected to generate total investments of up to EUR 1.6 billion in support of venture capital investment in early- and expansion stage companies.

4.3. Addressing national barriers to the free movement of capital

The Commission continued to work with an expert group of Member State representatives to address national barriers to the free movement of capital in support of the CMU project and to complement the European Semester initiatives in order to tackle obstacles to investment.

The Commission published a report[60] taking stock of the results of the mapping and inviting Member States to proactively tackle unjustified barriers stemming from national legislation or administrative practices that either go beyond EU rules ('gold-plating') or are in areas mainly of national competence.

The report contained a proposed roadmap of measures, which the Member States then endorsed in the ECOFIN meeting of 23 May 2017[61]. The roadmap needs to be

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[59] Regulation (EU) 2017/2396.

[60] https://ec.europa.eu/info/files/170227-report-capital-barriers_en.

[61] https://ec.europa.eu/info/files/170519-roadmap-national-capital-barriers_en.

implemented by means of individual national measures supported by joint work to be carried out in the Expert Group[62].

Here is the state of play for the implementation of the measures included in the Joint Roadmap:

- burdensome withholding tax relief ('WHT') procedures: a code of conduct was published in December 2017 (see section 4.7 for more details);
- barriers to the cross-border distribution of investment funds: legislative proposals addressing cross-border barriers to the distribution of investment funds were adopted by the Commission on 12 March 2018 ;
- removing residence requirements for the managers of financial institutions when unjustified and disproportionate: the issue was thoroughly discussed and one Member State reported plans to change their legislation;
- working to identify drivers for cross-border investment by pension funds and promote opportunities under the Investment Plan for Europe: the Commission services will present the result of a study on insurance/pension funds investment in equity by the end of 2018; and
- continue working on the financial literacy of consumers and SMEs: a report summarising the work of the subgroup will be published in April 2018.

In addition, the Expert Group decided to engage in discussing other issues that might pose difficulties to cross-border capital flows, such as specific national consumer protection and conduct rules that might hinder the cross-border access or distribution of specific retail products (for example savings accounts or consumer credit).

To ensure that pension funds are able to fully play their role as major investors in the EU economy, the Expert Group also looked into restrictions imposed on cross-border investment by pension funds; they found them to be generally in line with prudential rules. Moreover, these rules do not seem to be the main factor limiting cross-border investment in the EU. Pension fund investments are to a large extent influenced by the overall business environment, project-related guarantees and administrative and tax obstacles. The Commission Services proposed to work with the Member States through the expert group to identify the main drivers of cross-border investment by pension funds and to promote the existing opportunities under the Investment Plan for Europe.

4.4. Intra-EU investment protection

The Communication on the mid-term review of the CMU Action Plan adopted in June 2017[63] envisages in priority action 8 that the Commission will publish an interpretative communication in 2018 to provide guidance on existing EU rules for the treatment of

[62] Expert Group on barriers to free movement of capital:

http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3388&NewSearch=1&NewSearch=1.

[63] COM(2017) 292 final, https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017_en.pdf.

cross-border EU investments. In addition, it envisages that the Commission will launch an impact assessment with a view to setting out an adequate framework for the amicable resolution of investment disputes between investors and public authorities.

Accordingly, the Commission published an inception impact assessment on a potential framework for the prevention and amicable resolution of investment disputes between investors and public authorities in July 2017, together with a roadmap on an interpretative communication clarifying the existing EU standards for the treatment of cross-border intra-EU investments. To feed into these initiatives, the Commission launched a public consultation on i) the prevention and amicable resolution of disputes between investors and public authorities within the single market; and ii) areas where more clarity about EU investors' rights may be needed.

4.4.1. Existing EU standards for the treatment of cross-border intra-EU investments

The single market contains clear and detailed safeguards for protecting investments in all stages of their life cycles in the EU. The rights to establish, to provide services or to transfer capital all apply to foreign investors. The principle of non-discrimination on grounds of nationality ensures, as far as is possible, the same treatment for foreign and local investments. However, there is some degree of complexity and an apparent lack of awareness amongst a number of market participants and other stakeholders about the level of protection afforded to cross-border EU investors by EU law. Investors may lack clarity about the extent to which EU law grants investment protection, for example when they are faced with indirectly discriminatory treatment, maladministration or otherwise adverse national measures. With its planned communication on the treatment of cross-border EU investments, the Commission aims to help investors exercise their rights and help ensure that EU law is applied consistently.

4.4.2. Prevention and amicable resolution of disputes between investors and public authorities

The Commission is exploring whether mediation could offer a way to ensure a cost-effective, flexible and quick resolution of some disputes between investors and public authorities. It may not be suitable for all disputes, in particular those concerning the legality of generally applicable rules such as legislation. However, in a number of cases, in particular those concerning individual administrative decisions, acts or contracts, all parties concerned may have legal and economic incentives to find an amicable solution. In general, involving an independent third party such as a mediator in an amicable dispute resolution procedure has widely recognised benefits. Another option would be to establish a network of national contact points responsible for providing advice and information to investors about the legal environment relevant to their investment. These contact points could also intervene on their behalf in complex legal or factual situations with public authorities. Any potential initiative would be a voluntary option for the parties involved and would not jeopardise their right to have access to a court.

4.4.3. Towards termination of intra-EU bilateral investment treaties

In parallel to the two policy measures described above, the Commission is taking legal action against Member States that maintain bilateral investment treaties (intra-EU BITs). The Commission considers the intra-EU BITs to be incompatible with EU law, in particular with articles 3(2), 49, 56 63, 107, 344 TFEU and with the general principles of effectiveness, autonomy, coherence and unity of EU law and legal certainty. In 2018, an

important development was the preliminary ruling of 6 March 2018[64] by the CJEU in a preliminary reference case sent by the German Supreme Court concerning the compatibility of an arbitration provided for in an intra-EU BIT (case C-284/16 *Achmea*). The judgement confirms the Commission's view that investor-State arbitration between a Member State and an investor situated in another Member State is incompatible with EU law. The Commission will study in detail the consequences that follow from the ruling.

4.5. Vienna Initiative — Working Group on Capital Markets Union

Rationale for creating the Working Group

The Capital Markets Union aims to mobilise capital in Europe and channel it to companies, including SMEs, and infrastructure projects in order to help them expand and create jobs. Development and integration of capital markets will bring benefits to investors and issuers across EU. However, economic analysis shows that some Member States, especially those countries from Central, Eastern and South Eastern Europe lag behind in terms of capital market development, leading to a limited choice of options for financing start-ups and expanding businesses.

The CMU Action Plan[65] emphasised the need to take measures to allow for further development of capital markets in the countries with high catch-up potential. On 6 March 2017, the Vienna Initiative Full Forum decided to set up the Working Group on Capital Markets Union following a proposal by the Commission. The objective was to provide a more coherent picture of how capital markets develop and their main features in CEE countries. It aims to identify the conditions required to create more diversified financial markets in the region, where bank funding would be complemented by strong capital markets. It also examined the comparative advantages of and obstacles to developing national capital markets, both within the region and beyond.

All interested Vienna Initiative members, i.e. representatives of both public and private institutions from the CEE countries, including both Member States and non-EU countries as well as international institutions such as the European Investment Bank, the European Bank for Reconstruction and Development, the IMF and World Bank were invited to take part in this Working Group. The Commission was tasked with coordinating the work, chairing the meetings and providing Secretariat services. Three one-day meetings were held on 4 April, 30 June and 3 October 2017 in Brussels. More than 30 different public and private institutions and organisations participated and contributed to the discussions and to the report produced by the Working Group.

This work will help identify further initiatives necessary to enhance local capital markets, to be implemented at national or EU level. The report from the Working Group on CMU was adopted by the Vienna Initiative Full Forum in London on 12 March 2018. Some proposals and best practices identified in the report will feed into the Commission's communication on EU support for local capital markets, planned for Q2 2018. This initiative was announced in the CMU mid-term review published in June 2017 as a new priority action. Apart from the Vienna Initiative report, the communication will take into

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[64] https://curia.europa.eu/jcms/jcms/p1_862700/en/

[65] http://ec.europa.eu/finance/capital-markets-union/docs/building-cmu-action-plan_en.pdf

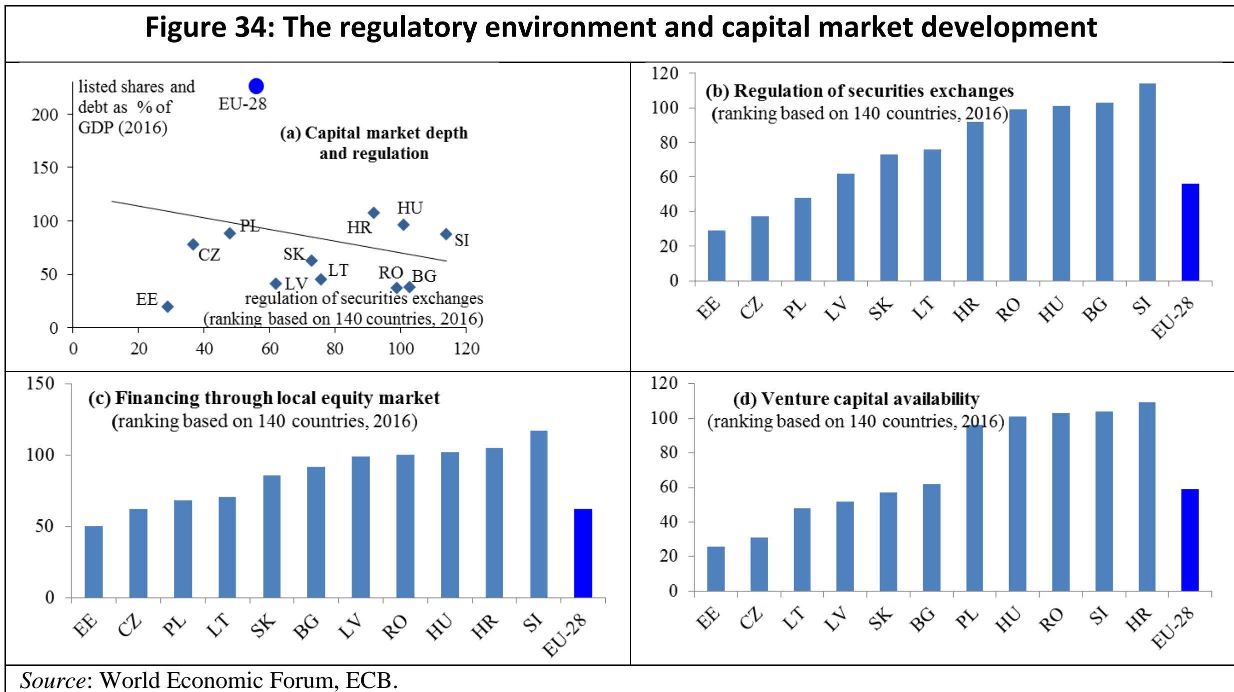
account the experience of the Commission's Structural Reform Support Service in providing technical support for capital market development in several Member States.

The regulatory environment and supply of capital

The regulatory environment plays a key role in capital market development. While not the only determinant, the better the ranking of countries in terms of effectiveness of regulation and supervision of securities exchanges, the deeper the capital markets are (see Figure 34.a). On equity markets in CEE countries[66], market-specific laws and reforms, in particular the implementation of insider trading laws as well as institutional and political reforms and economic and financial openness, support their development. In this respect, there are wide variations between countries, although most of the CEE countries are ranked below the EU average (see Figure 34.b). As a result, issuing shares on the local equity market is also more difficult (see Figure 34.c). In response to the high transaction costs involved in issuances, junior markets have been set up by some stock exchanges to offer lighter listing requirements and lower compliance costs. One example is Polish New Connect, which allows companies to raise capital more cheaply through IPOs and benefit from lower listing fees afterwards. On the availability of venture capital, some CESEE countries (the Baltic states, Czech Republic, Slovakia, Bulgaria) seem to score rather well (see Figure 34.d), which is encouraging given the importance of this financing channel for start-ups and innovative companies.

[66] L. Baele, G. Bekaert and L. Schäfer (2015). An anatomy of Central and Eastern European equity markets', EBRD Working Paper No 181, December 2015.

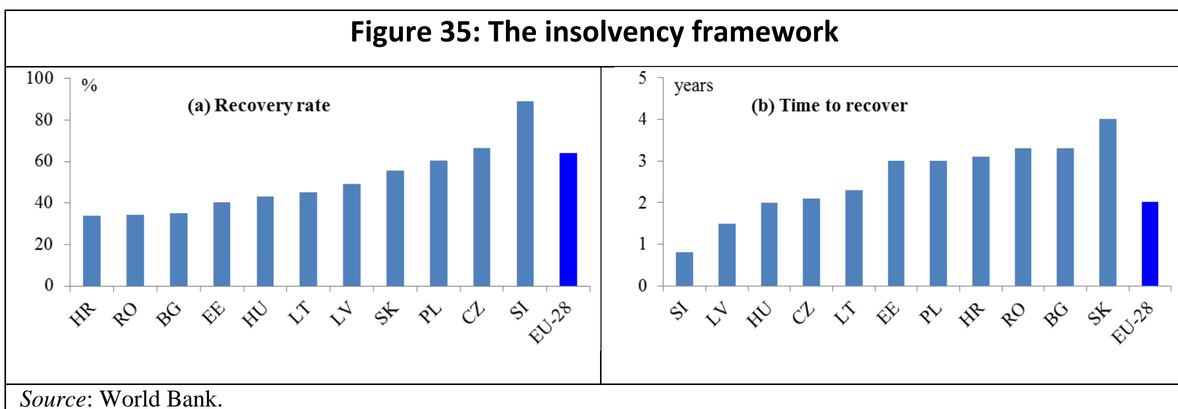
Figure 34: The regulatory environment and capital market development



Source: World Economic Forum, ECB.

A strong insolvency framework is necessary for cross-border investment and to facilitate more predictable and orderly outcomes for corporate restructurings. While Member States in the region have reformed and improved their insolvency procedures in general, most countries still lag behind. The average recovery rate from a liquidation of assets in the EU is around 65 %, although it is lower in several CEE countries (see Figure 35.a). The time it takes to finalise an insolvency procedure is also often longer in the CEE countries compared to an average of around 2 years in the EU (see Figure 35.b). The Commission monitors the national corporate insolvency frameworks under the European Semester. They were analysed in several Country Reports and the related country specific recommendations were adopted for a dozen Member States in last five years. In November 2016, the Commission proposed a directive on insolvency, restructuring and second chance that includes the first set of European rules on corporate insolvency.

Figure 35: The insolvency framework



Source: World Bank.

4.6. Direct taxation and free movement of capital

The Commission's agenda to tackle tax evasion and avoidance has achieved notable success. This work on fairer taxation is important to remove distortions that many companies face due to the aggressive tax planning of their competitors. A coordinated EU approach also helps to prevent a mixture of national anti-abuse measures from creating new obstacles for businesses in the single market. Recent policy initiatives in the field of taxation are therefore essential for more integrated capital markets in the EU.
All of the initiatives announced in the 2015 Action Plan for a fair and efficient corporate taxation in the EU have now been launched with the aim of ensuring that every company pays tax where it makes its profits.

In May 2017, Member States adopted legislation to counteract hybrid mismatches, including rules that involve non-EU countries. This initiative consisted of an amendment to the Anti-Tax Avoidance Directive[67] (ATAD), which had been adopted in July 2016. This framework aims to reinforce EU anti-abuse provisions in the ATAD and address external risks of base erosion and profit shifting.

Following a proposal by the Commission in October 2016, Member States adopted a Directive on tax dispute resolution mechanisms[68] in July 2017. This instrument lays down rules for resolving disputes more swiftly and efficiently between Member States that arise from the interpretation and application of tax treaties on the elimination of double taxation for citizens and businesses. The Directive creates an obligation to resolve the dispute within a defined period of time and delivers an important innovation as it offers guarantees for the rights of the taxpayer to trigger several stages of the dispute resolution procedure(s).

In October 2016, the Commission re-launched the Common Consolidated Corporate Tax Base (CCCTB)[69], to be implemented in two phases in the coming years. The common base should be implemented first, to be swiftly followed by consolidation. The CCCTB would provide Member States with a growth-friendly, efficient and fair corporate tax system, while ensuring that businesses in the single market have a simple, less costly and more stable tax environment. The re-launched CCCTB would directly contribute to the goals of the Capital Markets Union. It would redress the current debt bias in taxation, which can make companies more fragile and de-stabilise the economy. An allowance for growth and investment will be offered to companies within the CCCTB to give them equivalent tax benefits for equity as they get for debt. This will create a more neutral and investment-friendly tax environment. Negotiations on the re-launched CCCTB are ongoing in the Council.

In June 2017, the Commission proposed legislation to further strengthen the transparency framework in the EU and support national administrations in their efforts to tackle abusive tax practices. The recently proposed rules make intermediaries (e.g. advisers, consultants, lawyers, accountants) liable to report to tax authorities on cross-border schemes that include at least one of the risk indicators ('hallmarks') laid down by law.

[67] Council Directive (EU) 2016/1164.
[68] http://europa.eu/rapid/press-release_IP-17-3727_en.htm

[69] For more details, see: http://europa.eu/rapid/press-release_IP-16-3471_en.htm.

This recent proposal is an amendment to the Directive on administrative cooperation and is currently being negotiated in the Council.

Considerable progress has been made in the area of administrative cooperation in the EU. From 2016, financial institutions started customer due diligence of their account holders in compliance with the national measures implementing Directive 2014/107/EU on the mandatory automatic exchange of information in the field of taxation. The purpose is to collect information to be exchanged in accordance with the OECD's Standard for Automatic Exchange of Financial Account Information. The first automatic exchanges of information between tax administrations of the Member States took place in September 2017. This closer cooperation will allow tax administrations in the EU to ensure that taxpayers of each Member State comply with their national tax obligations for accounts held in other Member States. Improved tax compliance rules, in particular the self-certification procedures for tax residence included in the due diligence to be applied by financial institutions under the Directive, may help address the concerns of some Member States about the application of withholding tax relief and refund procedures.

The existing savings taxation agreements between the EU and five non-EU European countries[70] (the Principality of Andorra, the Principality of Liechtenstein, the Principality of Monaco, the Republic of San Marino and the Swiss Confederation) have been updated to take into account the automatic exchange of financial account information based on the aforementioned OECD Global Standard. The revised agreements (Liechtenstein and San Marino) entered into force on 1 January 2016 and the first automatic exchanges took place in September 2017. The three other revised agreements apply from 1 January 2017 for first exchanges to take place by September 2018.

Against the background of the Capital Markets Union, the Commission is also taking action to encourage Member States to speed up and simplify withholding tax refund procedures (see Section 4.7) and encourage best tax practices in promoting venture capital and business angel investment in start-ups and innovative companies. A study was published in June 2017 on tax incentives for venture capital and business angels, together with the mid-term review of the Capital Markets Union. It found that taxation plays a role in supporting or hampering venture capital and business angel investment. The way in which tax incentives are designed could help lower the risk (upside and downside) of investments in SMEs and start-ups. The study observed 47 tax incentives designed to promote venture capital and business angel investment in the 36 countries sampled.

Taxation is one of the policy areas monitored by the European Semester, the EU's annual cycle of economic policy coordination. The main taxation priorities of the 2017 European Semester cycle are to stimulate productive investment, support employment, improve tax compliance and promote social fairness. In 2017, the Commission provided country-specific recommendations in the area of taxation to 15 Member States.

[70] https://ec.europa.eu/taxation_customs/individuals/personal-taxation/taxation-savings-income/2004-ec-agreements_en

4.7. Withholding tax procedures and free movement of capital

The Code of Conduct on withholding tax is one of the main deliverables of the CMU Action Plan in the area of taxation. It seeks to address the long-standing problem of long delays and costs in recovering taxes withheld in the country of investment. As envisaged in the CMU mid-term review, the Code of Conduct was published on 11 December 2017. Burdensome procedures for recovering tax withheld on portfolio investments have long been identified by Member States as a barrier to a true EU capital market: they penalise cross-border investment, disrupt financial processes such as clearing and settlement, and increase the cost of cross-border trading. The resulting misallocation of financial resources undermines cross-border investments, which are *de facto* taxed twice (despite bilateral taxation treaties). Antiquated or inefficient procedures to recover withholding tax are also at risk of tax abuse (as witnessed recently in Denmark, Germany, Belgium and Poland).

Following detailed debates in the Expert Group on barriers to free movement of capital[71], the group identified a list of nine best practices on withholding tax. These best practices have been confirmed in the Commission report on national barriers to capital flows[72], which was adopted in March 2017 and endorsed by ECOFIN in a Joint Roadmap of actions to address national barriers to capital flows[73] in May 2017.

Faced with this complex situation, the Code of Conduct envisages a set of pragmatic approaches to improve the efficiency of current withholding tax procedures. The emphasis is on improving the refund proceedings rather than pursuing the more straightforward approach of relief-at-source. A section on relief-at-source has nevertheless been kept, especially for Member States that are already equipped with such a system. The provisions of the Code of Conduct are designed to apply to withholding tax on cross-border passive income (mainly dividends, interests and royalties).

The Code of Conduct is a non-binding document in legal terms. Member States are asked to voluntarily commit themselves to implementing good practices listed in it. Given its nature, a process of monitoring and reporting on Member State measures to implement the Code of Conduct is envisaged in the text.

4.8. Macroprudential measures

Macroprudential measures are a useful tool to address systemic risks. The financial crisis highlighted the need for system-wide oversight. It led to macroprudential policy being developed as a new EU policy area with the objective to prevent or mitigate systemic risk.

However, there is a close relationship between macroprudential measures and capital movements. On the one hand, capital movements may at times be a source of systemic risks or may interact with them. Macroprudential measures may in certain cases overlap with capital flow management measures. On the other hand, the adoption of

[71] http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3388.

[72] https://ec.europa.eu/info/files/170227-report-capital-barriers_en.

[73] https://ec.europa.eu/info/files/170519-roadmap-national-capital-barriers_en.

macroprudential measures may at times have as objective to limit effects on capital movements (e.g. reciprocation measures are designed to avoid that a macroprudential measure in a country to address an overheating housing market would be made ineffective via offsetting increases in foreign bank cross-border lending into that country).

In this vein, the Capital Requirements Directive[74] and the Capital Requirements Regulation[75] provide for a number of instruments for macroprudential use in the banking sector. Given that macroprudential risks are often national in nature, the framework aims to provide Member States with the necessary national flexibility to act, while providing appropriate safeguards to ensure that the single market and the free flow of capital are not unduly undermined. These safeguards come in the form of EU coordination requirements in advance of the activation of selected measures (e.g. tightening measures under Article 458 CRR or when a systemic risk buffer measures exceeds an intensity that may have a relevant impact on the single market).

Several Member States have supplemented the macroprudential toolset for the banking sector in EU law with macroprudential instruments in national law. Most of these instruments relate to mortgage transactions. They include instruments such as caps to the loan-to-value ratio, loan-to-income/debt-to-income ratios, debt-service-to-income ratios and maturity limits.

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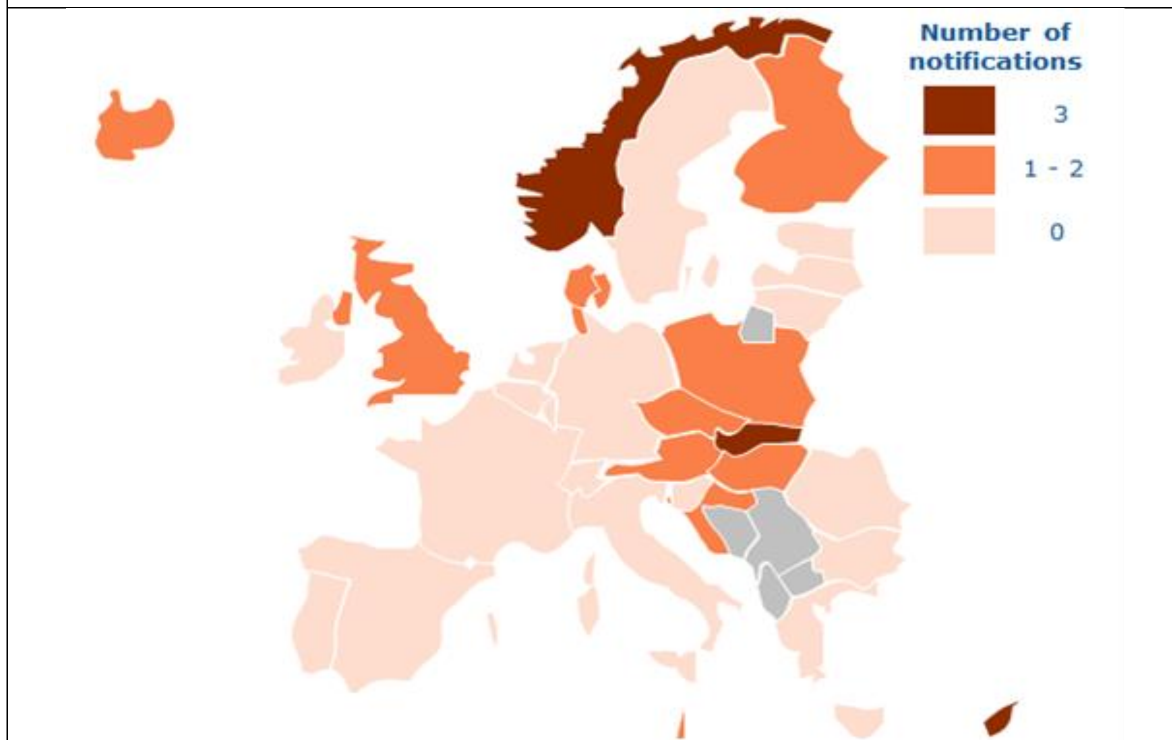
[74] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institution and the prudential supervision of credit institution and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

[75] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Figure 36, Number of notified macroprudential measures by Member State in 2017 (up to end of September) with economic significance



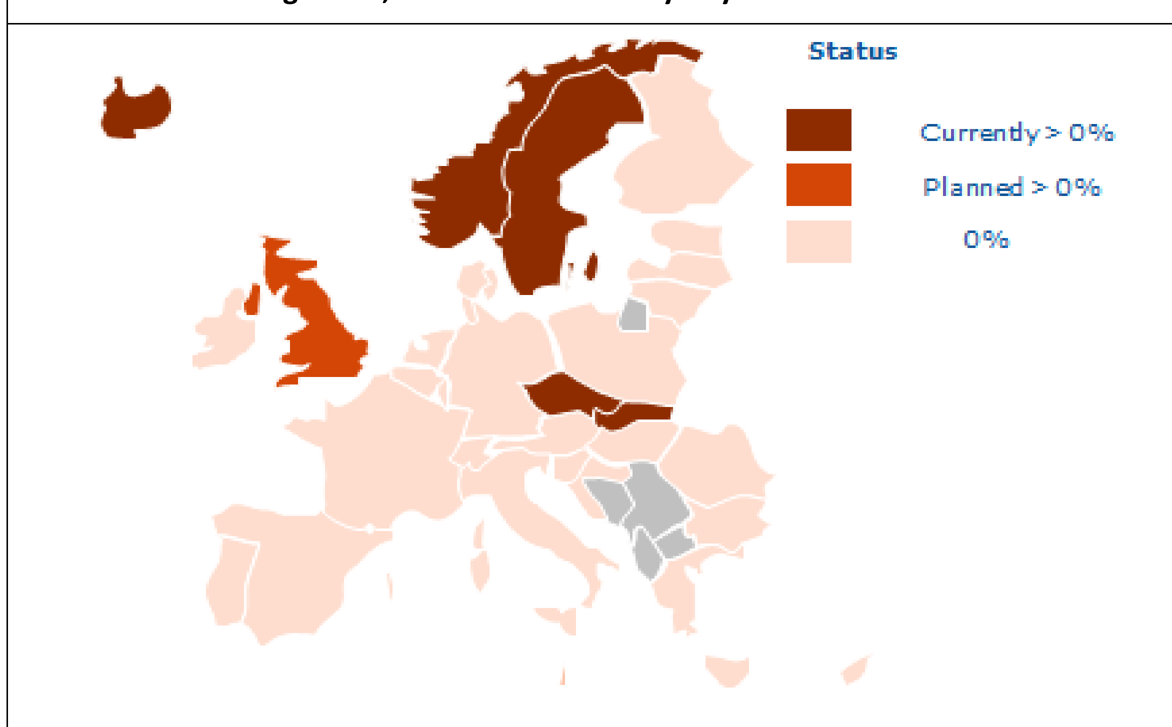
Source: Commission services calculations based on ESRB data.
Note: The figure takes into account, from all the measures notified to the ESRB, only those with economic significance and indicating a change with respect to the status quo. Measures of a more procedural or administrative nature, such as setting the countercyclical capital buffer rate at 0 %, are not taken into consideration. Other measures that have to be notified periodically, like the yearly identification of O-SIIs and the relative buffer rate setting, are not reported if they merely serve to confirm the measures notified the year before.

Since 2016, the countercyclical capital buffer (CCyB) and the buffer for global systemically important institutions (G-SIIs) have become mandatory, and the buffer for other systemically important institutions (O-SIIs) has become available. The number of measures notified by Member States in 2017 (up to the end of September) declined compared to the same period in 2016, to a large extent due to the number of reciprocation measures in 2016 following the Belgian residential real estate measure under Article 458 CRR and the Estonian systemic risk buffer. Some notifications are not of 'economic significance' and have a more administrative nature or confirm measures already taken. Figure 36 provides an overview of the measures with economic significance notified so far in 2017.

As macroprudential risks and vulnerabilities evolve only gradually over time, the more prudent activation of macroprudential measures detected in 2017 should not be interpreted as Member States becoming complacent about risks. It could be taken to mean that Member States already put in place the necessary measures in previous years, which then required only targeted adjustments in 2017. Macroprudential measures can be either tightening or accommodative.

Looking at the measures notified more often, the CCyB clearly dominates; its rate has to be set and notified on a quarterly basis, even if no changes are envisaged. At this stage, a buffer rate higher than zero applies to the Czech Republic (0.5 %), Slovakia (0.5 %) and Sweden (2 %). Further increases in the CCyB are scheduled in the Czech Republic, Slovakia and the United Kingdom as of 2018. Figure 37 summarises the activation of the CCyB.

Figure 37, Activation of the CCyB by Member State



Source: Commission services calculations based on ESRB data.
Note: Czech Republic has had a 0.5 % CCyB since April 2017, which is scheduled to increase to 1 % from July 2018. Slovakia has had a 0.5 % CCyB since August 2017, which is scheduled to increase to 1.25 % from August 2018. Sweden has had a 2 % CCyB since March 2017. The United Kingdom has announced an increase of the CCyB from 0 % to 0.5 % from June 2018. In the EEA, Iceland has had a CCyB of 1.25 % since November 2017, and Norway has had a CCyB of 1.5 % since June 2016.

Two main risks have been addressed so far: the systemic importance of financial institutions and the risks stemming from the real estate sector. On the former, around 200 G-SIIs and O-SIIs have been identified in the EU. The additional capital buffer requirements for such institutions vary from 0 % to 2 % (subject to phasing-in). The systemic risk buffer is currently used in 11 Member States for a wide range of purposes. The ESRB has also recommended two measures for voluntary reciprocation[76]. Furthermore, three Member States (BE, FI and CY) notified draft national measures under Article 458 CRR in 2017. In each case, the Commission decided, after giving due consideration to the EBA and ESRB opinions, not to propose to the Council to adopt an implementing act to reject the draft national measures.

On the real estate sector, the ESRB addressed public warnings to eight EU Member States in November 2016 (Austria, Belgium, Denmark, Finland, Luxembourg, Netherlands, Sweden and the United Kingdom) given the medium-term vulnerabilities in their residential real estate sectors[77]. The number of Member States (17 out of 28) that have in place borrower-based measures based on national law has not changed compared to 2016. These are measures such as loan-to-value caps and debt-service-to-income limits to address the impact of low interest rates on their housing markets. Borrower-based measures appear to be particularly effective due to the strong link between the housing market and credit growth. In practice, borrower-based measures therefore reduce

[76] See Recommendations ESRB/2016/3 and Recommendations ESRB/2016/4, both amending Recommendation ESRB/2015/2.
[77] https://www.esrb.europa.eu/news/pr/date/2016/html/pr161128.en.html.

vulnerabilities on the balance sheets of both banks and households, even if they apply mainly to new mortgage loans. Capital-based measures seem to have had a more indirect, limited effect on cyclical adjustments and the cost of loans.

Overall, the use of macroprudential measures by the Member States has not given rise to major issues in relation to the free movement of capital. The macroprudential toolset is carefully designed to balance the need to address risks with that of preserving the single market. A number of safeguards therefore exist to avoid unintended consequences. However, the Commission continuously monitors the use of macroprudential measures and their compatibility with the free movement of capital.

5. Other important challenges requiring regular monitoring

5.1. Capital controls in Greece and Iceland

Capital controls are one of the most severe exceptions to the principle of free movement of capital. However, they are sometimes needed to prevent disorderly outflows from causing a financial and economic meltdown. The restrictions imposed in Cyprus until April 2015 and those still in force in Greece and Iceland are recent examples of necessary restrictions on the free movement of capital within the EU/EEA.

Capital controls in Greece

Capital controls in Greece have been in force since 28 June 2015. At the time, the Commission found that the temporary restrictions imposed by the Greek authorities were justified because of the need to preserve the stability of the financial and banking system in Greece.

In the reporting period, further to the relaxation measures already implemented, the Greek authorities adopted and published a roadmap in May 2017 on the gradual relaxation of capital controls with a view to abolishing them, while at the same time safeguarding financial and macroeconomic stability. The roadmap is a non-binding document that outlines the strategic considerations envisaged by the competent authorities.

The conclusion of the second review enabled the capital controls implemented in 2015 to be relaxed further. From September 2017, individuals can withdraw lump sums of up to EUR 1 800 per calendar month, compared to the maximum EUR 840 limit every 2 weeks that existed prior to this. New regulations, which became effective on 15 November 2017, contained three main changes:

- Individuals can open new bank accounts provided they do not have one already. Inactive accounts can be reactivated.
- A previous restriction on withdrawing a maximum of 50 % of any cash transferred into the country from abroad has been lifted. Greek residents are able to withdraw 100 percent of money transferred from abroad to newly established accounts (deposited after 15 November 2017).
- The measures also include increasing the limit on international transactions that an enterprise can make per day from EUR 10 000 to EUR 20 000, subject to bank approval.

The Commission will continue monitoring and assessing the relaxation process through its participation in the Third Economic Adjustment Programme for Greece.

Capital controls in Iceland

Article 40 of the EEA Agreement establishes the principle of free movement of capital in the EEA. However, Article 43 expressly permits a contracting party to take 'protective measures' if there are disturbances in the functioning of its capital market, or if it is having difficulties with its balance of payments. Capital and foreign exchange controls were introduced in Iceland in 2008 in response to a severe banking crisis and sudden pressure on the country's balance of payments.

Since then, the Commission has been monitoring the situation and discussing the best way forward with the Icelandic authorities and with the European Free Trade Area Surveillance Authority. The Icelandic authorities aim to remove restrictions on the free movement of capital in the EEA while safeguarding Iceland's financial and economic stability.

In 2016, the Icelandic authorities adopted decisive measures to move away from capital controls. On 11 October 2016, the Icelandic Parliament adopted a law to ease capital controls in two stages. It based this law on the composition agreements signed with creditors of the estates of failed banks and on a series of currency auctions to reduce the stock of offshore króna. The first stage, from September 2016, involved outward FDI becoming unrestricted subject to confirmation by the Central Bank of Iceland. Investment in financial instruments issued in foreign currency, other monetary claims in a foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans were allowed up to a given amount (ceiling), to be increased in stages.

The second stage, from 1 January 2017, involved transfers of deposits abroad becoming permissible but subject to the same ceiling as financial instruments issued in foreign currency. The domestic custodianship requirement for foreign securities investments was revoked, and foreign currency purchases in cash were limited by the ceiling.

On 14 March 2017, Iceland granted full exemptions from nearly all restrictions. Some minor controls remain in place, in particular to prevent carry trade[78].

In general, households and businesses are no longer subject to the restrictions that the Icelandic Foreign Exchange Act imposed on foreign exchange transactions, foreign investment, hedging and lending activity in Iceland. The requirement that residents repatriate foreign currency has also been lifted. Foreign investment by pension funds, collective investment funds (UCITS) as well as cross-border transactions with Icelandic króna have been authorised. Foreign financial undertakings have been authorised to transfer króna and financial instruments issued in domestic currency to and from Iceland.

[78] A carry trade is a strategy in which an investor borrows money at a low interest rate in order to invest in an asset that is likely to provide a higher return. This strategy is very common in the foreign exchange market.

However, the status of króna-denominated assets subject to special restrictions — *offshore króna assets* — remains unchanged.

An agreement was reached in March 2017 with some owners of offshore Icelandic króna, whereby they would sell approximately ISK 90 billion to the Central Bank of Iceland at ISK 137.5 per EUR.

The Commission welcomes the progress made by the Icelandic Government on removing capital controls without threatening the country's economic and financial stability, in particular the most recent steps taken in 2017 to lift capital controls on individuals, companies and pension funds.

5.2. Lending in foreign currencies and cross-border mortgage lending

The Commission is closely monitoring regulatory developments in Member States related to lending in foreign currencies and the cross-border provision of mortgage loans.

Following the entry into force of the Mortgage Credit Directive[79], the Commission has assessed national measures that transpose the new provisions and has launched infringement procedures where transposition was incomplete or completely missing. The entry into force of the new EU regulatory framework can lend momentum to cross-border mortgage lending and help develop an integrated EU market. The Commission will continue to observe market developments in this area.

While the Mortgage Credit Directive should help ensure that risks associated with foreign currency loans are better managed, it is only applicable to credit agreements signed after 21 March 2016. The loan agreements concluded earlier, which sometimes resulted in serious problems following the global financial crisis and unfavourable exchange rate movements, were governed by national measures and generally applicable EU consumer protection rules. The question as to whether these contracts violated applicable laws is to be decided by the courts. In recent years, the CJEU has been involved in a number of judicial procedures initiated by the borrowers concerned.

At the same time, some Member States have adopted or planned to adopt regulatory measures that often interfere directly with outstanding loan contracts, also in a retroactive manner. The Commission has been closely monitoring these developments to ensure that EU law is fully respected. If a measure is deemed to be restricting the free movement of capital, it is acceptable only if it is duly justified by public interest objectives and if it does not go beyond what is necessary to attain its objectives (in accordance with the principle of proportionality). When assessing a national measure, the Commission takes into account its scope, its consequences for foreign investors, its potential impact on financial stability, evidence proving the need for regulatory steps for consumer protection reasons, as well as compliance with the principle of legal certainty. If the Commission has had doubts about compliance with EU law, a dialogue with the Member State concerned has proved to be useful. An additional tool is the use of infringement; a procedure was opened against Croatia.

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[79] Directive 2014/17/EU of the European Parliament and of the Council on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010, OJ L 60/34, 28.2.2014, p. 34-85.

5.3. Investments in real estate and agricultural land

Within the meaning of Article 63 TFEU, capital movements include cross-border transactions between residents and non-residents. According to the explanatory notes of the Annex to Council Directive 88/361/EEC, investments in real estate include acquisitions, rights of usufruct, easements and building rights.

The national laws on the above-mentioned capital movements, when applied to cross-border situations, must respect EU law, in particular the principle of free movement of capital. The free movement of capital rules allow Member States to impose restrictions on the Treaty freedom provided that these restrictions pursue an objective in the public interest, are proportionate and non-discriminatory. The restrictions may differ from one Member State to another. The Commission services are assessing the national provisions with cross-border impact on capital movements on a case-by-case basis.

On the acquisition of agricultural land, Member States are allowed to maintain, during a transition period, derogations from the free movement of capital rules as envisaged in their Accession Treaties. Croatia is the only country for which the transition period is still ongoing; it is due to expire on 1 July 2020, with the possibility of a 3-year extension. The transitional derogations granted by the Accession Treaties to Bulgaria, Romania, Hungary, Slovakia, Latvia and Lithuania expired in 2014, and for Poland in 2016.

After the transitional derogations expired, these countries adopted new laws to regulate acquisitions of agricultural land. The new land laws pursue policy objectives such as preserving farming on agricultural land, supporting agricultural communities and preventing land speculation, which may justify restrictions on the Treaty freedom. Nevertheless, concerns were raised about the compatibility of certain provisions contained in five new land laws with EU law, in particular in relation to the principle of proportionality. As a result, infringement procedures were started in 2015 against Bulgaria, Hungary, Lithuania, Slovakia and Latvia. In May 2016, the Commission requested them to take the necessary measures to remove these restrictions on the acquisition of agricultural land from their land laws and therefore bring their national laws in line with EU law. To dispel its concerns, the Commission may refer these Member States to the CJEU if their national laws are not amended. In 2017, Latvia and Lithuania changed their national law to address the concerns raised; the Commission is currently assessing the new laws.

During the reporting period, the Commission also adopted an interpretative communication on ‘Acquisition of farmland and European Union law’. It provides guidance based on case law of the CJEU with the aim of helping Member States regulate the acquisition of agricultural land in line with EU law. It acknowledges that agricultural land is a special asset that deserves particular protection. Member States are competent to decide on the measures necessary to address the challenges faced in their national land sales markets, such as fighting against excessive price speculation, undesired land concentration, preserving agricultural communities or supporting sustainable agriculture. It gives guidance on how these objectives can be achieved in terms of EU law, in particular the free movement of capital principle.

6. GLOBAL DEVELOPMENTS IN CAPITAL MOVEMENTS/PAYMENTS AND THE EU

A series of different issues affect the free movement of capital beyond the borders of the EU. First, the legal framework under which cross-border capital movements are organised is complex. It includes bilateral agreements with a specific investment and capital movement dimension that are concluded both at EU and Member State level. It also comprises the multi-party OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations[80]. These are legally binding for the 22 EU Member States, which as OECD Members adhere to the Codes.

In addition, certain measures such as international law enforcement (on anti-money laundering in particular) and international sanctions are directly linked to how freely capital moves globally.

This report is not exhaustive. As a result, it does not cover unilateral measures taken by non-EU countries that affect the free movement of capital, many of which are currently in force or have recently been adopted. Such measures include screening mechanisms, the prohibition of foreign investment in certain sectors, and a series of intermediate steps such as joint venture obligations, foreign equity caps etc[81].

6.1. EU investment policy — non-EU countries

6.1.1. *Free trade agreements and stand-alone investment agreements*

Following the entry into force of the Lisbon Treaty, which gave the EU exclusive competence for FDI (Art. 207 TFEU), the Commission engaged in an ambitious negotiation agenda that covers investment liberalisation and investment protection as well as investment dispute settlement in free trade agreements or stand-alone investment agreements.

The investment protection provisions typically cover a number of standards of treatment to be afforded to investors of a party and their investments in the territory of another party: non-discrimination, fair and equitable treatment, prohibition of expropriation without compensation and free transfer of funds, as well as the possibility for dispute settlement between investors and States. At the same time, some of these provisions have raised concerns in the past about how they might interfere with the right of States to regulate. Against this background, the Commission adopted a reform-based approach, which entails modern and innovative provisions to ensure a balance between investors' rights and the States' right to regulate on legitimate public policy objectives. The Commission applies this approach in all its negotiations.

The Comprehensive Economic and Trade Agreement (CETA) signed by the EU with Canada already includes investment protection rules along the lines of the reformed approach proposed by the EU. It was signed at EU level and its provisional application

[80] http://www.oecd.org/daf/inv/investment-policy/codes.htm

[81] For additional information on measures adopted by non-EU countries, see http://trade.ec.europa.eu/doclib/docs/2015/march/tradoc_153259.pdf. On screening mechanisms or measures adopted by EU Member States, see section 4.1.

started on 21 September 2017. CETA will be fully implemented once it is ratified by the EU and all Member States according to their constitutional requirements. When CETA takes effect, its investment protection and investment dispute settlement provisions will replace the bilateral investment agreements concluded in the past by Member States with Canada.

Following the conclusion of the negotiations on a free trade agreement between EU and Singapore in 2014, the Commission asked the CJEU for an opinion on the EU competence to sign and conclude the agreement. The Court ruled in May 2017, clarifying that the investment-related provisions in the agreement were matters of EU exclusive competence, with the exception of investment protection for non-FDI forms of investment and investment dispute settlement, which fall under shared competence between the EU and its Member States. In light of the Court's opinion, the Commission is now working to identify the best architecture for EU agreements with investment provisions.

The negotiations of the free trade agreement with Vietnam were concluded in December 2015. The Agreement has undergone a legal review, and will be translated into the EU's official languages. The Commission will then present a proposal to the Council of Ministers for signature and conclusion, before which the European Parliament's consent is needed.

On 6 July 2017, political agreement was reached on the EU-Japan Economic Partnership Agreement. The Agreement is expected to be signed by the summer 2018.

Negotiations to modernise the EU-Mexico Global Agreement, which started in 2016 and include investment protection and investment dispute settlement, continued. The eighth round of negotiations took place from 12 to 20 February 2018.

During 2017, negotiations also continued on the stand-alone investment agreements with China (three rounds of negotiations per year) and Myanmar (the latest negotiation round took place in April 2017).

6.1.2. *Member State bilateral investment treaties with non-EU countries*

The agreements on investment protection negotiated at EU level with various non-EU countries will gradually replace the bilateral investment agreements concluded by Member States with the same countries. For countries where no EU-level negotiations are envisaged, the Commission can authorise Member States to negotiate and conclude bilateral investment treaties subject to a number of conditions; these are set out in Regulation (EU) 1219/2012 establishing transitional arrangements for bilateral investment agreements between Member States and non-EU countries.

As part of the Regulation, Member States submit notifications of the opening or conclusion of negotiations with non-EU countries on a continuous basis. The Commission assesses the notified agreements for among other things their compatibility with EU law and consistency with EU investment policy. A comitology procedure is used to authorise them in consultation with Member States.

6.1.3. *Proposal for a Regulation on investment screening for non-EU countries*

The EU has one of the world's most open investment regimes, and collectively Member States have the fewest restrictions on FDI in the world. This is expressly acknowledged in the OECD FDI Regulatory Restrictiveness Index, which measures statutory restrictions on foreign direct investment in 62 countries worldwide and how they have changed since 1997.

However, in some cases foreign investors might seek to acquire strategic assets allowing them to access e.g. critical technologies, infrastructure or sensitive information in a way that may pose risks to security or public order.

In response to such concerns, the Commission proposed a new legal framework for screening foreign direct investments from non-EU countries on 14 September 2017[82].

The Commission's proposal for a Regulation[83] provides for three main features.

First, it sets out a framework for screening of foreign direct investments into the EU. This includes guidance on factors that Member States and the Commission should take into account when screening FDI, such as the effects on critical infrastructure, technologies and inputs, which are essential for security and the maintenance of public order. It also lays down basic procedural elements to ensure non-discrimination between non-EU countries, transparency and the possibility of adequate redress for decisions adopted under the screening mechanisms.

Second, it sets up a cooperation mechanism between Member States and the Commission through contact points and the possibility to exchange views on investments into the EU. This could be used in particular for cases where FDI in one or more Member States may affect the security or public order of another.

Third, the Commission may screen foreign direct investments into the EU on grounds of security or public order if they might affect projects or programmes of EU interest. The proposed Regulation sets out a non-exhaustive list of factors for identifying such projects or programmes. Projects and programmes in the areas of research (Horizon 2020), space (Galileo and EGNOS), transport, energy and telecommunications could be covered.

The Commission's proposal allows Member States to adapt to changing circumstances and their specific national context when screening foreign direct investments. It does not oblige Member States to adopt a review mechanism, and they would take the final decision in any screening. This EU-level mechanism aims to be proportionate and transparent while minimising the administrative burden on Member State governments and investors.

[82] See: http://europa.eu/rapid/press-release_IP-17-3183_en.htm.

[83] Proposal for a Regulation of the European Parliament and of the Council establishing a framework for screening of foreign direct investments into the European Union, COM(2017) 487 final.

International organisations and fora

6.1.4. *Free movement of capital and the OECD*

In 2017, the OECD continued its work on the OECD Code of Liberalisation of Capital Movements, assessing the compatibility of regulations introduced by its members with their obligations under the Code. Meanwhile, the organisation actively contributed to ongoing international discussions about the need to reform the international financial architecture.

In parallel, the OECD proceeded with reviewing the Code, which should ensure its continued relevance in an environment that has substantially changed since the last major review in 1992. The first phase of this work, which takes place in the Advisory Task Force on the OECD Codes (ATFC), is open to non-OECD countries and international organisations. Discussions have centred on measures aimed at preserving financial stability. The Commission participates actively in the ATFC and coordinates with Member States to ensure that their positions are consistent, in particular on matters that are covered by a common legal framework in the EU. While the review was initially scheduled to take 2 years, its timeframe has since been extended.

In 2017, the OECD also continued its work to advance implementation of its guidelines on corporate governance of state-owned enterprises (SOEs), which were last updated in 2015. This is being done against the background of SOEs playing a greater role in the global economy. The Commission is taking part in the dialogue launched by the OECD on this issue, which aims to develop a stronger understanding of how to address growing policy concerns about the internationalisation of SOEs.

6.1.5. *International Forum of Sovereign Wealth Funds*

The total assets under management held by sovereign wealth funds (SWFs) worldwide have flattened in the last 2 years, with growth of 3 % in 2016 and just 1 % in 2017. The total assets under management among these investors rose from EUR 5.8 trillion in 2016 to EUR 5.9 trillion in 2017. This pace of growth is in sharp contrast to the historical performance: for example, sovereign wealth fund assets grew by 17 % between December 2011 and December 2012, and by a further 16 % the following year. The recent developments reflect the sustained low oil prices as well as the ongoing rebalancing of China’s economy, with consumption-driven growth and slowing investment.

According to Commission estimates, 20 % to 30 % of the holdings of the largest SWFs account for assets within the EU, while 20 % to 25 % of all listed companies in the EU have SWF shareholders. SWF investments are concentrated in the United Kingdom, France, Italy and Germany, and are mainly in the energy, transport, storage and communications sectors.

The Commission attended the ninth annual meeting of the International Forum of Sovereign Wealth Funds on 5-7 September 2017 as an observer. The meeting was hosted by the Kazakh SWF Samruk-Kazyna in Astana. The meeting focused on (i) the role of SWFs in developing the digital economy; (ii) attracting foreign investment, managing state-owned assets and fostering economic growth; and (iii) the implications of China’s Belt and Road initiative for SWFs.

6.2. Other developments

6.2.1. *Economic and financial sanctions for non-EU countries*

The possibility of applying economic and financial restrictive measures is one of the general exceptions to the free movement of capital and payments in relation to non-EU countries. Pursuant to Article 215 of the TFEU, economic and financial restrictive measures may be taken against non-EU countries, or individuals, groups or non-state entities. Such measures are based on decisions adopted within the framework of the common foreign and security policy.

The most prominent of the EU's existing sanctions regimes during the reporting period were those relating to Russia. These economic sanctions were first introduced on 31 July 2014 in response to the ongoing destabilisation of Ukraine, in addition to targeted individual restrictive measures like asset freezes against certain persons and entities. They include bans targeting Russian interests in the financial, oil and defence sectors. The EU's restrictive financial measures aim to cut off strategic state-owned Russian companies from EU financing sources, thus imposing an indirect financial cost on the Russian state.

These sanctions have been rolled over by a decision of the European Council every half year since their introduction. In March 2015, the European Council linked the lifting of EU sanctions to the implementation of the Minsk peace agreements. On 21 December 2017, the European Council prolonged the EU economic sanctions against Russia until 31 July 2018.

6.2.2. *High-risk countries and transparency — anti-money laundering and countering the financing of terrorism*

Under Directive (EU) 2015/849, the Commission is mandated to adopt a list of high-risk non-EU countries that have strategic deficiencies in their regimes on anti-money laundering and countering the financing of terrorism (AML/CFT). These deficiencies pose significant threats to the EU financial system. The purpose is therefore to protect the proper functioning of the EU financial system from money laundering and terrorist financing risks emanating from such countries. This requirement follows the approach developed at global level by the Financial Action Task Force (FATF) in response to the threat posed by countries that did not implement internationally agreed AML/CFT standards.

The Commission adopted Delegated Regulation (EU) 2016/1675 on 14 July 2016. It lists 11 non-EU country jurisdictions[84] in line with the assessment also made by the FATF. On the consequences, all EU 'obliged entities' (banks and other entities subject to AML/CFT rules) are bound to apply enhanced customer due diligence measures when dealing with natural persons or legal entities established in high-risk third countries. These enhanced measures will lead to extra checks and monitoring of transactions by banks and obliged entities to prevent, detect and disrupt suspicious transactions.

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[84] Countries listed: Afghanistan, Bosnia and Herzegovina, Guyana, Iraq, Lao PDR, Syria, Uganda, Vanuatu, Yemen, Iran, Democratic People's Republic of Korea (DPRK).

'High-risk third countries' identified in Delegated Regulation (EU) 2016/1675 have already been listed by the FATF due to the strategic deficiencies in their AML/CFT regimes. With this Delegated Regulation, the Commission, which is a member of the FATF, joins global efforts to protect the financial system from the risks posed by these countries. The Commission has encouraged these countries to swiftly resolve their strategic deficiencies. As outlined in the Action Plan on terrorist financing, the Commission is committed to helping these countries and to provide technical assistance for supporting implementation of FATF recommendations and relevant UN Security Council Resolutions.

The Commission proposed to amend this list in order to reflect the latest available information from FATF. As part of its scrutiny powers, the European Parliament rejected the Delegated Acts updating the list. It asked the Commission to make a more independent assessment.

On 29 June 2017, the Commission sent a letter to the European Parliament and to the Council, together with a roadmap detailing a new methodology for the assessment of high-risk third countries. The Commission confirmed that it will work towards a new methodology that relies less on external information sources to identify jurisdictions that have strategic deficiencies in tackling money laundering/financing of terrorism. This work will be done in several stages as outlined in the roadmap. The first results are expected by the end of 2018 (i.e. a new EU list will be issued based on the new methodology by this date).

Pending completion of the assessment based on the new methodology, the Commission will continue to adopt Delegated Acts that update Regulation (EU) 1675/2016. This is necessary in order to protect the EU financial system from the risks posed by these jurisdictions, which have been identified as being high-risk. It will also strengthen EU efforts to promote a global approach towards high-risk countries. As a result, the Commission adopted Delegated Regulations at the end of 2017[85][86] in order to add countries that have strategic deficiencies based on a new list created by the FATF.

On 21 December 2017, the co-legislators reached a political agreement on the revision of the Directive (EU) 2015/849[87] ("fourth AML Directive"). This revision brings important changes to the requirements concerning the transparency of beneficial ownership information on legal entities and legal arrangements, i.e. the information about the natural person who stands behind these structures:

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[85] Commission Delegated Regulation (EU) 2018/105 of 27 October 2017 amending Delegated Regulation (EU) 2016/1675, as regards adding Ethiopia to the list of high-risk third countries in the table in point I of the Annex

[86] C(2017)8320 Commission delegated regulation amending Delegated Regulation (EU) 2016/1675 supplementing Directive (EU) 2015/849 of the European Parliament and of the Council, as regards adding Sri Lanka, Trinidad and Tobago and Tunisia to the table in point I of the Annex.

http://eur-lex.europa.eu/legal-content/FR/TXT/?uri=uriserv:OJ.L_.2018.041.01.0004.01.FRA&toc=OJ:L:2018:041:TOC)

[87] http://www.consilium.europa.eu/en/press/press-releases/2017/12/20/money-laundering-and-terrorist-financing-presidency-and-parliament-reach-agreement/

- The registration requirements already included in the 4th AML Directive will be the same for legal entities and legal arrangements (such as trusts), given that the registration requirement is no longer limited to those legal arrangements that generate tax consequences;
- The registers will also include additional information concerning the ownership through shares and voting rights in the legal entity;
- The accuracy of the beneficial ownership information is improved through the establishment of verification's mechanisms that would allow checking the discrepancies between beneficial ownership information collected by the registers and the one collected through other means by competent authorities and by the private sector; and
- The accessibility to the beneficial ownership information by the public is made easier: the register concerning legal entities will be accessible to the general public, while the register concerning legal arrangements will be accessible to any person who can demonstrate a legitimate interest as well as, for certain legal arrangements, to any person who files a written request to access it.

The new Directive will also:

- Enhance the access of Financial Intelligence Units to relevant information, including information which allows the identification of persons owning real estate;
- Require the setting-up of centralised automated mechanisms for bank accounts in each Member State accessible to the Financial Information Units;
- Make more difficult to use pre-paid cards anonymously;
- Add additional criteria, including transparency, for listing high-risk third countries, ensuring a high level of safeguards for financial flows from high-risk third countries;
- Include new sectors in the scope of the AMLD (virtual currencies platforms, tax related services and work of arts);
- Increase the cooperation and facilitates the exchange of information between financial supervisors in the EU.

Member States shall transpose the new Directive within 18 months following the entry into force, and would benefit from additional time to transpose some provisions, in particular those that deserve IT investments (e.g. 20 months for legal arrangements registers and 32 months for centralised automated mechanisms).

7. CONCLUSIONS

The EU has one of the most open investment frameworks in the world and remains committed to strengthening the free movement of capital and freedom of payments.

The implementation of important Commission policy priorities in the field of investment in 2017 should both enhance and be supported by effective free movement of capital and freedom of payments, which underpins a well-functioning single market for capital.

2017 saw a number of major policy initiatives to support this objective. The mid-term review of the Capital Markets Union should ensure that it better connects savings to investment and strengthens the EU financial system by improving private risk sharing, providing alternative sources of financing and increasing options for retail and institutional investors.

Since building a Capital Markets Union is also a national task, the Commission continued its work with Member States in 2017 by adopting a report on mapping and removing national barriers to the free movement of capital (e.g. burdensome procedure for withholding tax relief or barriers to the cross-border distribution of investment funds). The work consisted of implementing the 2017 report and the subsequent Joint Roadmap of actions on national barriers to capital flows as well as discussing other potential barriers to be tackled in the future with the help of Member States.

A number of initiatives were also launched in the field of taxation, contributing to more integrated capital markets and a more level playing field.

The further progress made in lifting capital controls in Greece in 2017 supports the functioning of the Greek financial system and benefits its citizens and companies. It also ensures that the capital control measures adopted in the post-crisis period will not be maintained longer than is strictly necessary in order to abolish them as soon as possible, while at the same time safeguarding financial and macroeconomic stability.

Alongside these key initiatives, the free movement of capital in Europe is ensured through:

- appropriate micro- and macro-surveillance of the financial sector;
- monitoring of national laws in specific sectors;
- launching of infringement proceedings where necessary; and
- working with Member States to ensure a correct and timely transposition of EU rules.

Since the free movement of capital is the only single market freedom that also applies to non-EU countries, it is essential to match the initiatives taken to promote cross-border capital flows in the EU with initiatives aimed at attracting capital from abroad and ensuring a level playing field for European investment in non-EU countries. Investment agreements with these countries and the work carried out by international organisations such as the OECD therefore also have an important contribution to make to growth and jobs in Europe.

Finally, while being open to investment from non-EU countries, the EU and its Member States need to ensure that their legitimate public interests are protected. With this in mind, the Commission proposal for a new EU legal framework on investment screening is an important initiative that would improve transparency and cooperation within the EU

on screening certain investments from non-EU countries on grounds of security and public order.