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COMMISSION STAFF WORKING DOCUMENT

ON THE MOVEMENT OF CAPITAL AND THE FREEDOM OF PAYMENTS

Contents

COMMISSION STAFF WORKING DOCUMENT ON THE MOVEMENT OF CAPITAL AND THE FREEDOM OF PAYMENTS[1]

1. INTRODUCTION

In 2014-2015, the post-crisis recovery of capital flows was still uneven across world regions. Net capital flows were lower in the EU than in non-European emerging and developing countries and, to a lesser extent, in some other advanced economies.

However, in the first three quarters of 2015 taken cumulatively, the net financial account balance for the EU showed a ‘net inflows’ position. In the first two quarters of 2015, capital flows from other countries to the EU increased by more than capital outflows from the EU. This trend was reversed in the third quarter of 2015, as inflows from other countries declined, in line with global developments[2]. Nevertheless, the EU could become a net importer of capital if the trend of the first half of 2015 would be confirmed.

The next question, then, is whether the funds that are available are efficiently allocated across Europe, in a context where boosting European cross-border financial integration continues to be a major challenge. There is still less financial integration today than there was in the pre-crisis period. Despite some normalisation of financial markets, integration was still hampered by cross-border bank deleveraging. The fall in cross-border bank flows was not fully compensated by intra-EU foreign direct investment (FDI) and portfolio investment, which remained below pre-crisis levels.

Addressing this suboptimal investment situation is the objective of the Investment Plan for Europe, which is currently taking off. The European Fund for Strategic Investments (EFSI) is now operational. It should help mobilise at least EUR 315 billion in additional investment by the end of 2017 and channel funding to viable projects with a real added value for the European economy, such as broadband and energy networks and innovations by small and medium-sized enterprises (SMEs) and mid-cap companies[3].

The success of the Investment Plan in mobilising investment finance without creating public debt and supporting projects and investment in key areas partly depends on Europe’s capacity to remove remaining barriers to investment. Investors must be able to operate in a clear, predictable and stable investment environment. They also need to be in a position to seize investment opportunities in a genuine single market where nothing should impede liquidity to match investment needs.

To achieve this objective, a number of regulatory and non-regulatory barriers need to be lifted across all the major infrastructure sectors, including energy, information and communication technology, and transport, and across the single market in services.

1 This report is part of annual stocktaking used by the Economic and Financial Committee (EFC) in its examination of capital movements and freedom of payments under Article 134 of the Treaty on the Functioning of the European Union. The cut-off date for this Staff Working Document is 8 March 2015.

2 Most jurisdictions experienced capital outflows in the recent period, in particular some emerging countries, partly reflecting expectations of tighter monetary policies in the United States.

3 http://ec.europa.eu/priorities/sites/beta-political/files/ip-eu-state-of-play-jan-2016_en.pdf

Whatever the sector, it is essential to ensure that free movement of capital is not hampered and effectively underpins the objective of the capital markets union initiative to build truly integrated, open, competitive and efficient European financial markets.

Well implemented and properly regulated free movement of capital should allow people to perform a wide variety of operations abroad: opening bank accounts, buying shares in non-domestic companies, investing where the best return is, buying real estate, etc. It should also enable companies to invest in and own other European or 'overseas' companies.

This report describes trends in EU capital flows in the global context in 2014 (and 2015, where data are available) and gives an overview of the legal framework. It sets out the main initiatives taken in 2015 to support the free movement of capital and freedom of payments. It then highlights other important challenges requiring continued attention and reports on the main international developments.

2. TRENDS IN EU CAPITAL FLOWS IN 2014-2015, SEEN IN THE GLOBAL CONTEXT

2.1. Main trends and drivers of capital flows[4]

Against a backdrop of declining oil prices, accommodative monetary policy and a relative weakening of the euro against other international currencies, the economic recovery in 2015 has been resilient and widespread across Member States. It has, however, remained slow.

EU real gross domestic product (GDP) is expected to have increased by 1.8 % in 2015 and its growth is forecast to accelerate to 2.1 % in 2016. GDP growth in the euro area, which is expected to have been 1.5 % in 2015, is projected to increase to 1.9 % in 2016.[5]

As a consequence of the relatively slow economic recovery, the recovery in capital flows has been weaker in the EU than in other world regions (Annex II).

Against the backdrop of turmoil in global capital markets, slowing down of economic growth in China and normalisation of monetary policy conditions in the US, emerging market economies[6] witnessed a collapse in the scale of both gross inflows and outflows in the third quarter of 2015 compared to the same period in 2014 (down by almost 92 % and 98 %, respectively) and outflows exceeded inflows.[7]

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4 The analysis in this section incorporates the results of a study carried out for the European Commission by Bruegel: '*Analysis of developments in EU capital flows in the global context*'.

5 European Economic Forecast, Spring 2016.

6 Comprising 22 of the 23 emerging market economies included in the MSCI emerging market index except the United Arab Emirates.

7 The external financial account position of emerging markets has had a positive balance with foreign assets exceeding foreign liabilities relatively rarely in the post crisis-period. More specifically, this occurred in the first and second quarters of 2009 in the context of the global economic and financial crisis, in the third quarter of 2012 and more recently in the first and second quarters of 2015 (see Annex I for more details). As of the cut-off date for this report, data for the third quarter of 2015 was still not available for the following emerging economies: Malaysia, Peru, Qatar, India and Egypt.

Furthermore, the world-wide net financial account balance[8] registered in the third quarter of 2015 a large net outflows external position surpassing the levels reached during the 2008-2009 financial and economic crisis (Chart 1, Panel B).

By the first quarter of 2010, gross capital flows reached nearly pre-crisis levels in Latin America, the ASEAN-5[9] and Sub-Saharan Africa[10] Capital inflows to Latin America and Sub-Saharan Africa especially have been increasing in the most recent period, while ASEAN-5 has seen more overall volatility. A similar return to pre-crisis levels, albeit less pronounced, can be observed for the BRICS[11]

This contrasts with the situation in the euro area and non-EU advanced economies (Annex II) where the net international investment positions (NIIP) have been persistently negative in recent years, mainly on the back of negative portfolio investment and positive FDI stocks. Looking forward, the following factors are likely to impact capital flows, in addition to geopolitical tensions:

- *Divergent and asymmetric monetary policy conditions across the globe* are likely to continue influencing capital flow movements, given the likely monetary policy re-normalisation in the US and the continuing quantitative easing in the EU and Japan.

- *Growth patterns and adjustments in emerging economies* might be further accelerated by changing monetary policy conditions and in turn impact capital flows in and out of those regions. For instance, the effects of the growth adjustment policies in China might be further reinforced by a rise in interest rates in the US.

- *Changes in commodity prices* are likely to remain important drivers of capital flows, as sharp adjustments might trigger shifts in economic growth and trade patterns that could in turn affect cross-border lending and investment.

- *Cross-border bank deleveraging* is expected to continue weighing on international financial integration in Europe, despite some signs of its slowing down.

- *Declining market liquidity* in a number of market segments increases the probability of a sharper adjustment if some of the downside risks materialise.

2.2. Capital flow developments in the EU

As shown in Panel A of Chart 1, net capital outflows, which were a feature of the EU financial account balance in 2009-2011 and again from early 2013, have gradually been

[8] Approximated by the sum of the net financial account balances of 75 countries, see the note to Chart 1 for more details.

[9] Indonesia, Malaysia, the Philippines, Singapore and Thailand.

[10] Cabo Verde, Lesotho, Mozambique and Namibia.

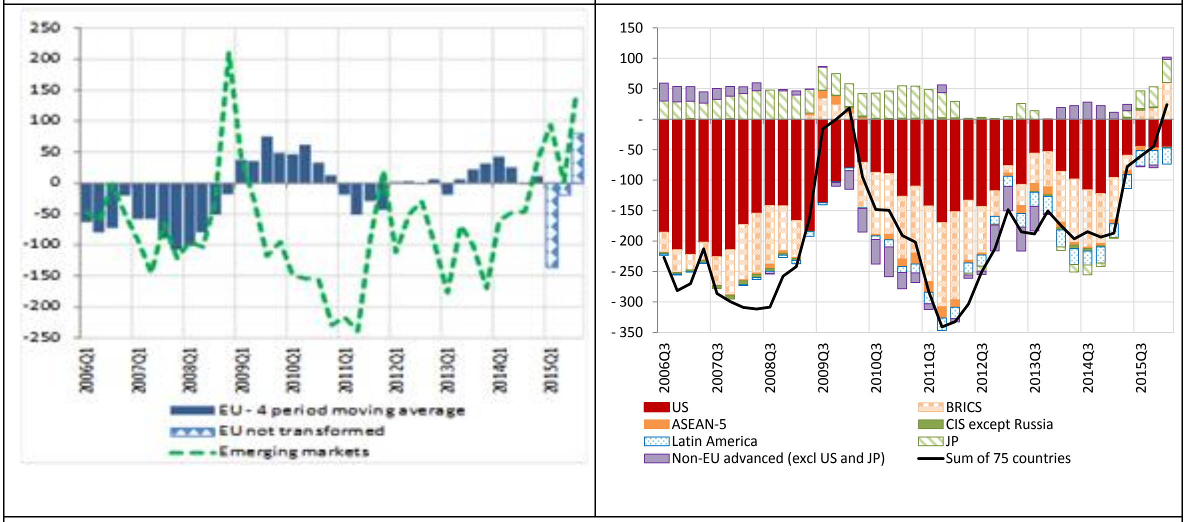
[11] Brazil, Russia, India, China and South Africa.

reduced since early 2014. At the beginning of 2015 there were even net extra-EU inflows of EUR 120 billion and EUR 17 billion for the first and second quarter, respectively. This situation seems to have been related to a decline in outflows from the EU[12]. In the third quarter of 2015, however, the EU financial account balance[13] switched again to a 'net outflows' external position amounting to EUR 70 billion. The reversal to a 'net outflows' position in the third quarter of 2015 was in line with recent developments in most other regions in the world (Panel B of Chart 1).

The general trends masked heterogenous developments across groups of EU Member States. The euro area, for example, stands out as being an increasing net capital exporter since the end of 2010, on the back of net outflows of banking-related investment (mainly deposits and loans), but the increase slowed in 2014. Euro area banks slowed the pace of their expansion of holdings and FDI abroad, contributing to a reduction in capital outflows in the first and second quarters of 2015. At the same time, portfolio investment in the euro area became less attractive to foreign investors, possibly due to the European Central Bank’s large-scale asset purchases, which compressed government and corporate bond yields in the euro area, while slower growth might have weighed on investment in equity.

Chart 1, Net financial account, USD billions

A. Extra-EU* | **B. Rest of the world****



Source: IMF Balance of Payments Statistics and Eurostat for the EU-28 (EU-28 vis-à-vis extra-EU-28, excluding intra-EU flows). *Note*: *Four-quarter moving averages up to the latest quarters, not transformed since Q1-2015; **Four-quarter moving averages; ***The sum of 75 countries is the balance of net assets minus net liabilities, where a positive sign denotes net lending to the rest of the world and a negative sign net borrowing. ****The 75 countries included in our country groups account for around 90 per cent of GDP of the countries included in the IMF World Economic Outlook. *****Excluding reserves and related items as well as financial derivatives. ******Emeging markets – 22 of the 23 countries included in the MSCI emerging market index excluding the United Arab Emirates, data for Malaysia and India – as of Q2 2015, data for Peru – as of Q1 2015, data for Egypt – as of Q4 2014.

12 For instance, EU outflows to China were down by almost 93 % in the first half of 2015 compared with the same period in 2014 due to a reversal of portfolio and bank investment.

13 Excluding reserves and financial derivatives.

The UK, Sweden and Denmark experienced increasing net capital inflows in 2014, on the back of strong portfolio and FDI inflows, while net capital inflows decreased somewhat during 2014 in non-EU advanced countries[14].

The Central and Eastern European countries' net financial account did not return to pre-crisis levels, and net capital inflows started receding in Q4-2011 amid an outright reduction in cross-border lending on the part of foreign banks operating in the region. This trend seems to have lessened by the end of 2013 to early 2014. Moreover, outflows seem to be more than offset by domestic deposit growth in most countries, pointing to a more balanced post-crisis economic model in the region.

2.3. Capital flows by financial instrument

2.3.1. Global trends in the banking sector

Cross-border bank loans (which account for most of the 'other investment' category in Annex II) continued to dominate cross-border capital flows in the EU, especially in the euro area, reflecting the bank-based nature of finance in Europe.

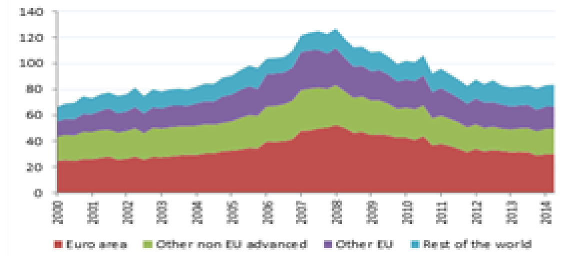
Given the importance of the banking system for financial integration in Europe,[15] this report looks at capital flows from the perspective of the banking sector via international banking investments as reported by the Bank for International Settlements (BIS) banking statistics.[16]

Chart 2 shows the consolidated foreign claims on the rest of the world by country group, quarterly, to the end of 2014.

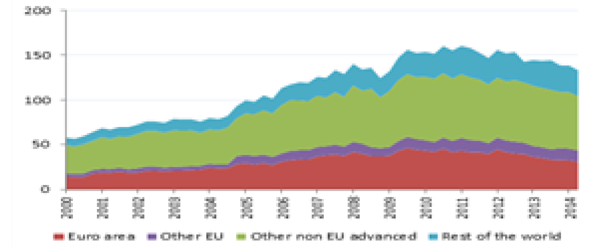
Chart 2, Gross foreign claims of domestically owned banks on the rest of the world

Percentage of the sum of GDP for each group of countries*

A. Euro area 10**



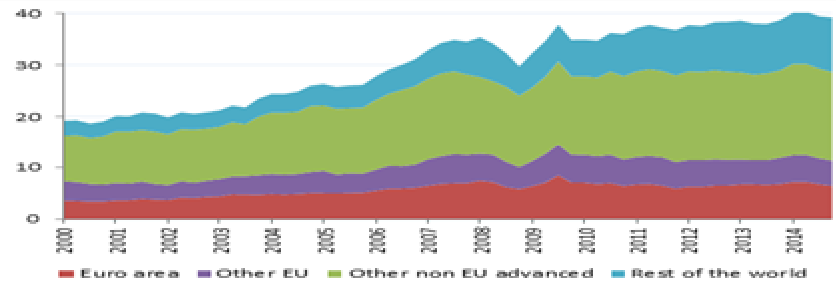
B. Non-EA-3: Denmark, Sweden, and UK



14 Canada, Japan, United States, Australia, Hong Kong SAR, Iceland, Israel, Korea, New Zealand, Norway, Switzerland

15 As reported in the 2015 staff working document on the movement of capital and the freedom of payments, bank-intermediated claims represented a declining share of total external liabilities in the post-crisis period. Nevertheless, in 2014 it stood at almost 35 % for the CEE 9, 30 % for the euro area 17, and 45 % for the UK, Denmark and Sweden.

16 Not all countries are BIS reporting countries, even in Europe.

C. Non-EU Advanced 6: Australia, Canada, Japan, South Korea, Switzerland, US

Source: BIS consolidated banking statistics (series: immediate borrowing basis, domestically owned banks, Foreign claims) Federal Reserve Economic Data and Bruegel calculations; *Note*: *Group GDP is equal to the sum of GDP for all the countries in the respective group;**On the reporting country side, euro area10 is made up of AT, BE, DE, ES, FR, IT, IE, NL, PT, FI. On the counterparty side, the euro area is all 19 member states of the single currency. **Among the non-euro area EU countries, only Denmark, the United Kingdom and Sweden are BIS reporting countries.

Euro area banks (Panel A in Chart 2) account for the largest claims on other euro area countries (30 % of group GDP in Q4-2014), followed by claims on other non-EU advanced countries (20 % of group GDP). The deleveraging of euro area banks relative to all other country groups which has been evident since the financial crisis in 2008/09 seems to have plateaued at a lower level as of mid-2012, staying at that level throughout 2013 and into the second half of 2014.

The non-euro area countries Denmark, Sweden and the United Kingdom (the non-EA-3 in Panel B in Chart 2) report the most claims on other non-EU advanced countries. A deleveraging process is ongoing, and claims on the euro area have fallen from highs of over 46 % of group GDP in 2012 to 26.25 % of GDP currently. This shows the importance of the stronger and more uniform prudential framework which is being implemented in the EU. This should help achieve a sounder and safer common banking market, as will the banking union in the euro area (see Section 5.4). In contrast to the European regions, banks located in the six non-EU advanced economies of Australia, Canada, Japan, South Korea, Switzerland, and the US (Panel C in Chart 2) continued to increase their exposure to banks within the same country group until the end of 2013. However, claims on both European groups have been falling or increasing only slightly since the end of 2013 (at rates of -0.35 and 0.22 percentage points inside and outside the euro area, respectively). Claims on all EU banks amount to about 11.3 per cent of group GDP, or 29 % of total cross-border claims, compared to 44 per cent of claims within-group.

The deleveraging process seems to have stalled for euro area banks after a significant adjustment in 2008-2013, however, it is still ongoing in Denmark, Sweden and the United Kingdom, although at a slower pace.

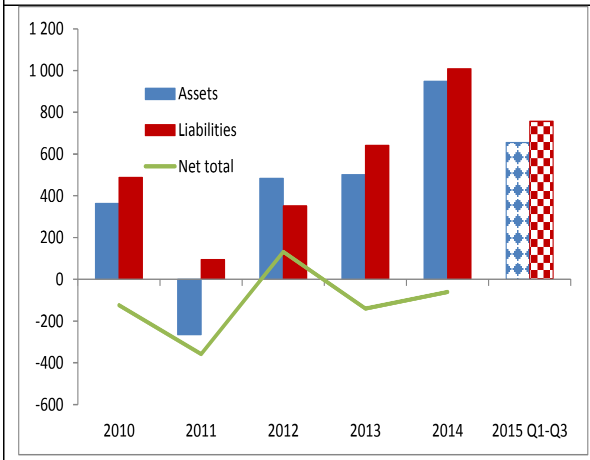
The next sub-sections illustrate the importance that FDI and portfolio flows could have in partly compensating for the decrease in cross-border banking flows. This points to the need to build a capital markets union alongside the banking union, as proposed by the Commission on 30 September 2015 (see Section 4.1).

2.3.2. *Portfolio investment*

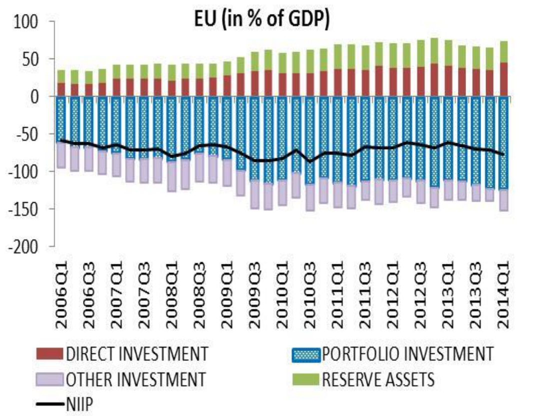
Cross-border investment in debt and equity played a major role in the euro area and the non-EA-3 Member States before the financial crisis. Net portfolio investment flows were volatile and turned negative in the euro area in the second quarter of 2014 and in the first quarter of 2015. Gross portfolio investment assets and liabilities have been increasing since 2011 and grew by 89 % and 57 % in 2014 compared to 2013, respectively (Panel A of Chart 3)

Chart 3, Portfolio investment

A. Gross and net flows, bn EUR



B. Stocks, % of GDP



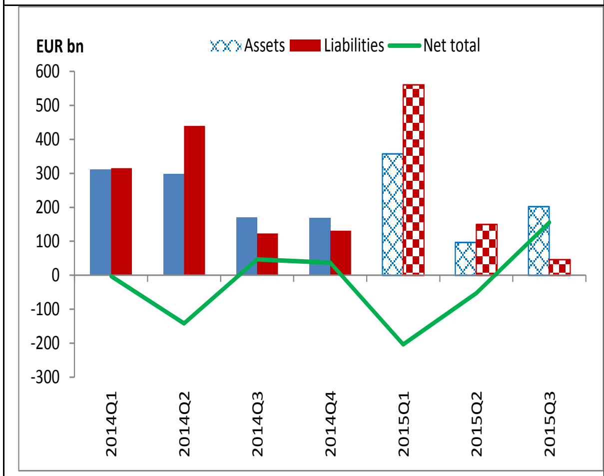
Source: Eurostat, Net figures equal to assets minus liabilities.

In the first two quarters of 2015 the increase in the incurrence of liabilities held by foreigners (inflows) exceeded the increase in the acquisition of foreign assets (outflows) due to extra-EU portfolio investment into the EU (Panel B of Chart 4). In the third quarter of 2015, however, extra-EU portfolio liabilities declined. As this decline was only partially compensated by an increase in intra-EU cross-border portfolio investment, this resulted in overall net outflows as the net portfolio acquisition of foreign assets abroad exceeded foreign portfolio investment into the EU for this reporting period.

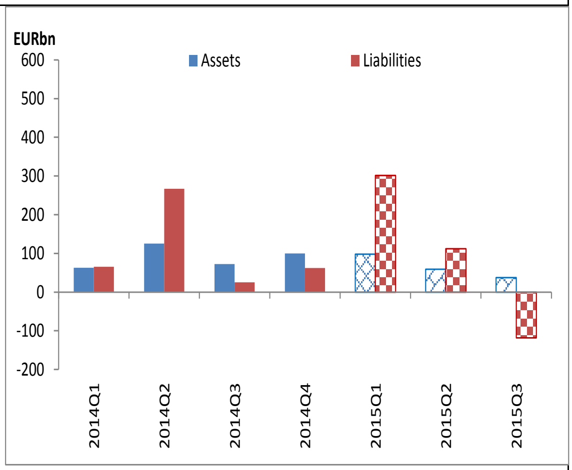
Portfolio investment trends differed across groups of EU Member States. In the UK, Denmark and Sweden, there have been net portfolio inflows since the first quarter of 2015 (see Annex II).

Chart 4, Portfolio investment - latest quarterly developments

A. Total EU



B. Extra- EU



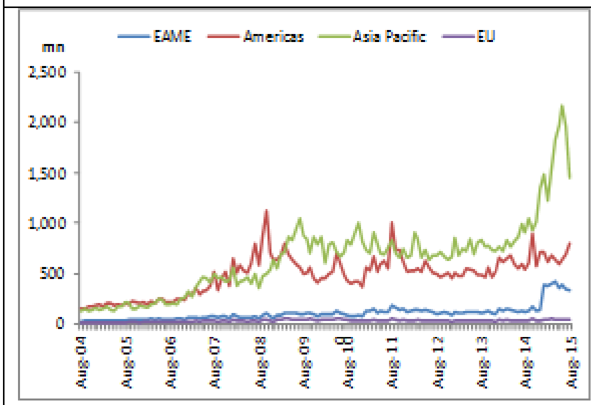
Source: Eurostat.

Market liquidity has been declining recently in several important market segments despite the increase in portfolio flows in the EU and globally, creating a risk of sharp reversals if some downside risks materialise (Chart 5, Panel A). Domestic market capitalisation increased well beyond pre-crisis levels in the rest of the world, while it remains relatively lower in the EU (Chart 5, Panel B).

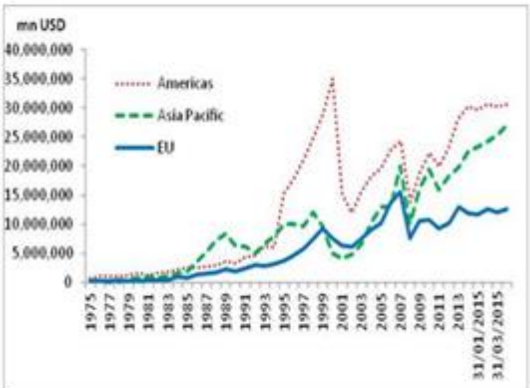
As Chart 5 illustrates the number of trades in equity shares remains subdued in the EU and almost at the same levels as in 2004. In contrast, trading activity has been consistently much higher in the US and increased sharply in 2015 in Asia Pacific, particularly in China. The turmoil in China's stock markets in the summer of 2015 resulted in rapidly declining trading activity in Asia Pacific.

Chart 5, Stock markets developments

A. Number of trades in equity shares*



B. Domestic market capitalisation



Source: World Federation of Exchanges. *Notes*: *Electronic order-book trades and negotiated deals.

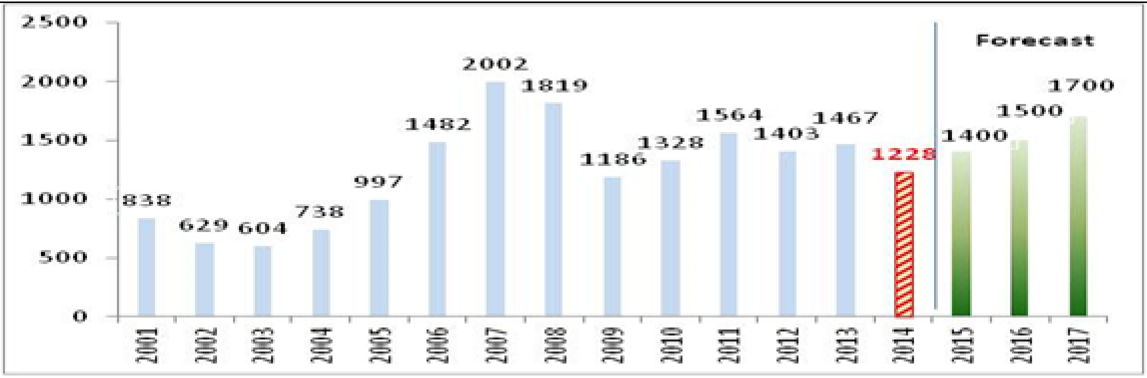
2.3.3. FDI developments[17]

2.3.3.1. Global FDI developments and the EU

Global FDI flows declined by 16 % in 2014 and reached USD 1 228 bn (EUR 1 114 bn), a level only slightly higher than that of 2009 (Chart 6). They are forecast to start rising and to reach USD 1 400 bn (EUR 1 270 bn) in 2015 (an increase of 16 %), according to UNCTAD.[18] FDI flows are expected to surpass the more recent 2011 peak of USD 1 564 bn (EUR 1 418 bn) in 2017 but are not expected to reach their 2007 pre-crisis peak of USD 2002 bn (EUR 1 816 bn) by the end of the forecast period.

Chart 6, World FDI inflows,

Outturns for 2001-2014 and projections for 2015-2017, $ billion



Source: UNCTAD; *Note*: Excluding the Caribbean offshore centres.

Among the main reasons for the declining global FDI flows in 2014 were the mega-buyback divestment[19] of Vodafone-Verizon,[20] which lowered flows into the US, and

[17] This section uses UNCTAD FDI data based on the directional principle and Eurostat balance of payments data based on the assets/liabilities principle. Unless otherwise indicated, the data used in this section is from the UNCTAD World Investment Report 2015 released on 24 June 2015 with a cut-off date for data updates of May 2015. The UNCTAD FDI data is based on the directional principle, which is considered to better reflect the direction of ownership and control; this is important when analysing FDI flows in relation to policy design.

[18] UNCTAD, World Investment Reports for 2013 and 2014.

[19] In this context, the term ‘divestment’ refers to the sale of a multinational enterprise (MNE) either to another MNE or to a domestic investor. It does not include liquidation and capital impairment. However, in the case of sales to domestic investors, divestment may be a sign of de-globalisation and may result in permanently lower FDI stocks and flows.

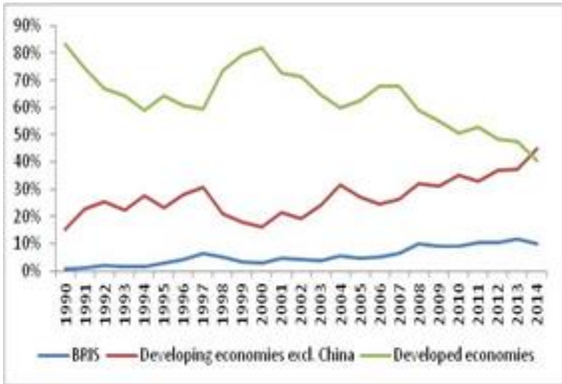
[20] In 2014 Vodafone Group Plc completed a disposal of its 45 % stake in Verizon Wireless, the biggest US mobile phone company. The USD 130 billion deal is considered the biggest sale of the decade so far and gave Verizon Communications sole ownership and full control of Verizon Wireless. The mega-buyback of shares by Verizon (US) from Vodafone (UK) is an international divestment and it significantly reduced the equity component of FDI inflows to the US. Verizon agreed to pay Vodafone USD 58.9 billion in cash, USD 60.2 billion in common stock and USD 5 billion in notes. Vodafone shareholders received 0.0263001 shares in Verizon for each Vodafone share held. Additionally, the group consolidated its share capital by issuing six new shares for every 11 old ones held.

geopolitical tensions, for instance between Russia and Ukraine. Multinational corporations continued to accumulate cash reserves and boosted buybacks of shares to record levels. In some cases, like the divestment of Vodafone-Verizon, the buyback of shares had a cross-border effect and resulted in redomestication of international activity.

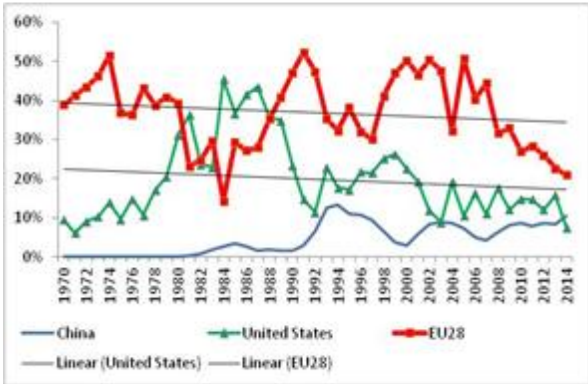
World FDI patterns have been changing in recent decades and the process accelerated after the economic crisis in 2007 (Chart 7). Since the mid-1980s, developing countries' share of world FDI flows has been gradually rising, in both inflows and outflows, while the relative positions of the EU-28 and the US as host regions have been declining. However, in 2014, for the first time, developing countries' share (excluding China) surpassed that of developed economies, mostly as a result of faster decline in Europe's share of global FDI inflows, the sovereign debt crisis and the fall in flows into the US in 2014 after the Vodafone-Verizon deal (Chart 7, Panel A).

Chart 7, Shares in world FDI inflows, 1970-2014, percentages

<u>Panel A</u>, Developed economies, developing economies and BRIS



<u>Panel B</u>, EU-28, advanced economies and China



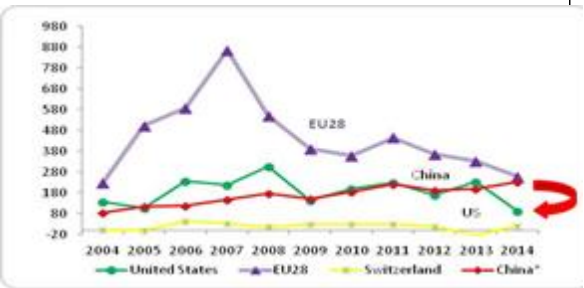
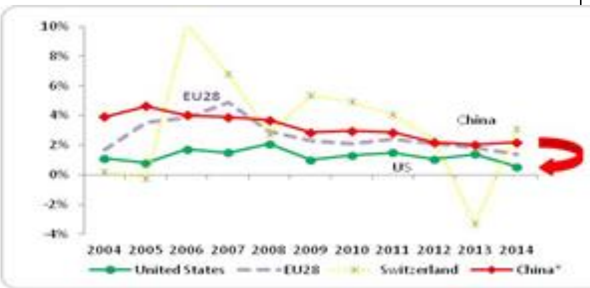
Source: UNCTAD; *Note*: Panel A: BRIS is BRICS excluding China (Brazil, Russia, India and South Africa); Panel B: China does not include Hong Kong, China.

The EU-28's share of global inflows declined further in 2014 from 23 % in 2013 to 21 % as flows into the EU fell, while they remained steady or rose in most other parts of the world (Chart 7, Panel A and Panel B). For instance the share of developing economies and China continued to rise in 2013-2014. The BRIS share (BRICS excluding China) declined by 2 percentage points (from 12 % to 10 %) as inflows were lower mostly due to the collapse of FDI inflows into Russia (down 70 %) and to a lesser extent into South Africa (down 31 %).

Despite its declining share of global inward FDI, the EU-28 remained, as a group, the biggest recipient of FDI in the world. Its share of global inward FDI, at 21 %, is still almost twice as large as that of the US (8 %) or China (10 %).[21]

[21] Expressed as a percentage of GDP (Chart 7, Panel B), FDI inflows into the EU, however, are lower than FDI flows into China, mostly because the decline in European FDI inflows in 2014 happened against the backdrop of increasing GDP (i.e. the denominator in the ratio of FDI inflows to GDP increased).

Chart 8, FDI flows into the EU-28 and some major advanced economies, 2004-2014

<u>Panel A</u>, In $ billions	**<u>Panel B</u>, In % of GDP**
	

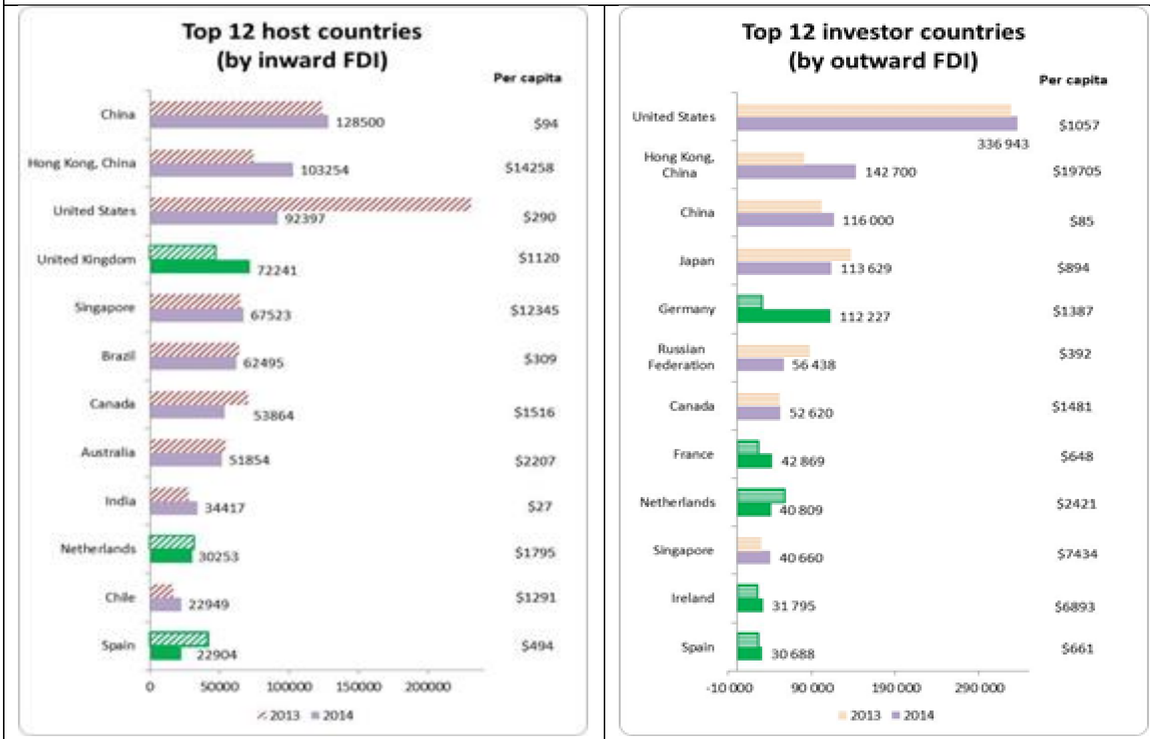
Source: FDI inflows — UNCTAD; GDP at current USD — WB WDI database. *Note*: *China includes China, Hong Kong SAR.

Chart 9 presents the global rankings of the top 12 best performing investor and recipient countries in 2014. Figures for 2013 are also presented, both for comparison and to assess whether top global performance was sustained over time or was due to exceptional factors at play in 2014.

Three EU countries figured among the top 12 host countries. The best performing EU Member State, the UK, was ranked fourth in the list of the global top FDI recipient countries. The top places were occupied by China and Hong Kong, which overtook the US as a result of lower inflows in the US due to the Vodafone-Verizon divestment. The Netherlands ranked tenth and its performance was almost equally strong in 2013 and 2014. Spain was twelfth, despite the decline of its FDI inflows in 2014 following an extraordinary strong performance in 2013.

Five EU countries were among the top 12 global investor countries. Germany became the fifth most important investor country in the world, with its outward FDI almost tripling in 2014. France was eighth after its outward FDI increased significantly in 2014. It was followed by the Netherlands, Ireland and Spain. The US remained the top investor country at USD 336 bn (EUR 305 bn) as its outflows were unaffected by the Vodafone-Verizon deal. It was followed by Hong Kong and China, both of which increased their outward FDI in 2014 and reduced the gap with the US, although still remaining far behind. Japan maintained its fourth place as a traditionally important FDI investor country, although its outward FDI declined in 2014 and was only USD 1 bn (EUR 907 million) higher than that of Germany.

Chart 9, Global FDI rankings for 2013-2014, $ millions



Source: UNCTAD WIR 2015, USD millions, directional principle, excluding FDI through resident SPEs.

2.3.3.2. European FDI developments

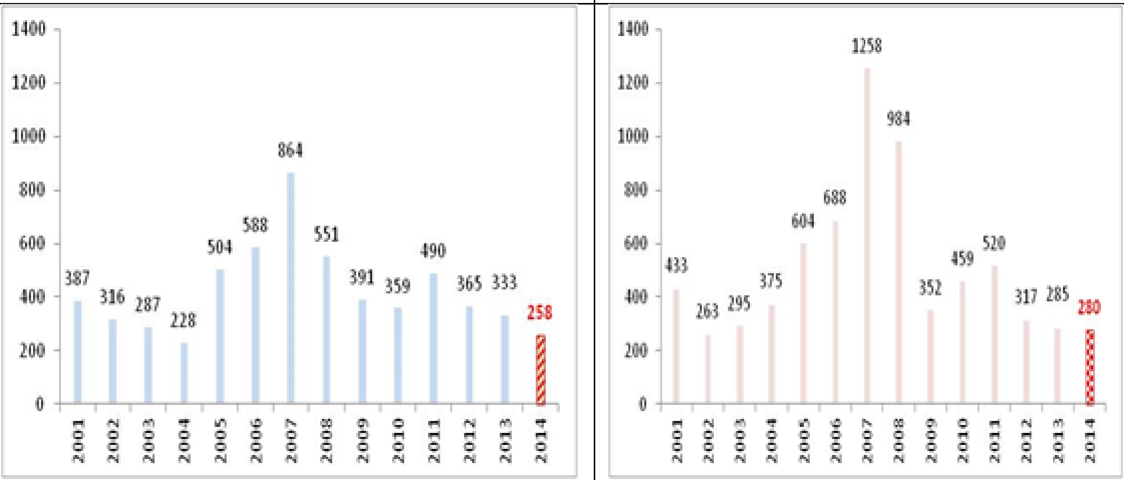
The European FDI recession continued in 2014 and FDI inflows into the EU have been declining now for the third consecutive year. Compared to 2013, they were down by USD 75 bn (EUR 68 bn) or 23 %, to USD 258 bn (EUR 234 bn) (Chart 10, Panel A). This level was lower than in 2009-2010 and close to the 2004 level.

The decline seems to be mostly due to a subdued economic recovery and slow economic growth that weighs on international investment. It might also reflect a certain lack of responsiveness in FDI to some of the traditional macroeconomic determinants of cross-border investment such as export performance or stock market valuations, that started to recover from the economic crisis albeit not all at the same pace.

FDI outflows also declined slightly in 2014, from USD 285 bn (EUR 258 bn) to USD 280 bn (EUR 254 bn), as shown in Chart 10, Panel B.

Chart 10, EU28 inward and outward FDI*, 2001-2014, $ billion

Panel A, EU-28 Inward FDI	Panel B, EU-28 Outward FDI



Source: UNCTAD WIR 2015, *Note*: *Including bilateral cross-border FDI flows.

The decline in EU FDI inflows (23 %) was more persistent and bigger than the fall in global FDI flows (16 %). While both world and EU FDI flows fell in 2014 (Charts 6 and 10), EU cross-border investment fell by more and recorded positive growth in only one year (2011) in the entire post-financial crisis period. As a result, by 2014 world FDI inflows were down 39 % compared with 2007, while FDI flows into the EU were still 70 % below their 2007 level and almost the entire pre-crisis boom in European FDI had been erased by 2014.

Chart 11 shows the detailed FDI performance of EU Member States based on Eurostat FDI statistics[22]. As the data include FDI through resident special purpose entities (SPEs), it permits to highlight the importance of the recent sharp decline in this type of FDI for EU Member States.

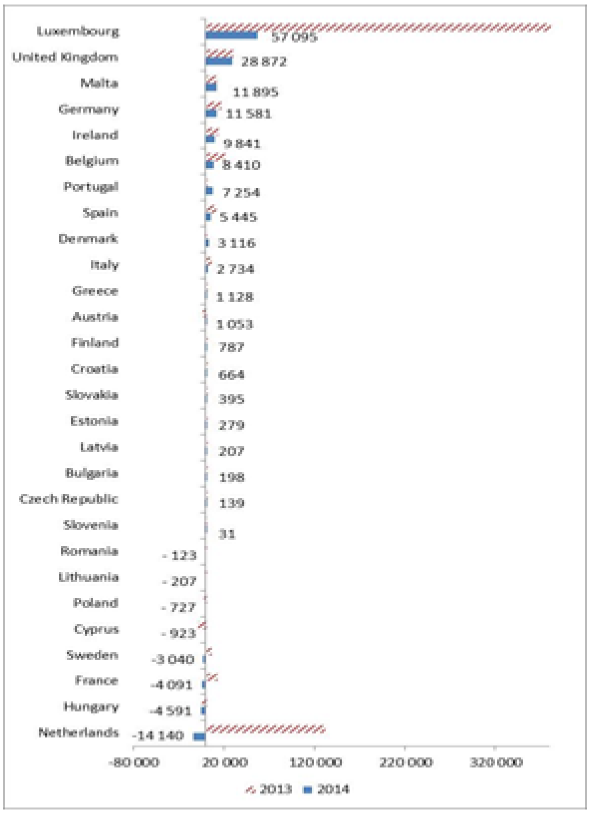
When FDI through resident SPEs is taken into account, Luxembourg still leads the EU ranking for both inward and outward FDI, despite the sharp decline in this type of FDI in 2014, after the record high levels reached in 2013.

The UK took second place among the largest EU FDI host countries (Chart 11, Panel A). Although its 2014 high ranking was largely due to a single mega-deal, the Vodafone-Verizon buyback, its FDI performance as a host country was also strong in 2013 and therefore sustained in recent years. It was followed in the FDI host countries ranking by Malta, Germany and Ireland. From the Member States which joined the EU in 2004 or 2007, Croatia, Slovakia and Estonia were the highest ranking recipients of FDI in 2014. In contrast to previous years, the Netherlands registered negative inward FDI mostly due to declining FDI through resident SPEs.

[22] The data includes FDI through resident SPEs.

Chart 11, Ranking of EU Member States as hosts and recipients of FDI, 2013-2014, EUR millions

Panel A, Inward FDI



Panel B, Outward FDI

Source: EUROSTAT, FDI statistics, *Notes*: *Directional principle, including FDI through resident SPEs; **Inward FDI data for Latvia (2013), Portugal (2013 and 2014) and Slovakia (2013 and 2014) and Outward FDI data for Latvia(2013), Slovakia (2013 and 2014) and UK(2014) were not available from EUROSTAT and were replaced by UNCTAD data. Therefore, for those countries and years the data is excluding FDI through SPEs.

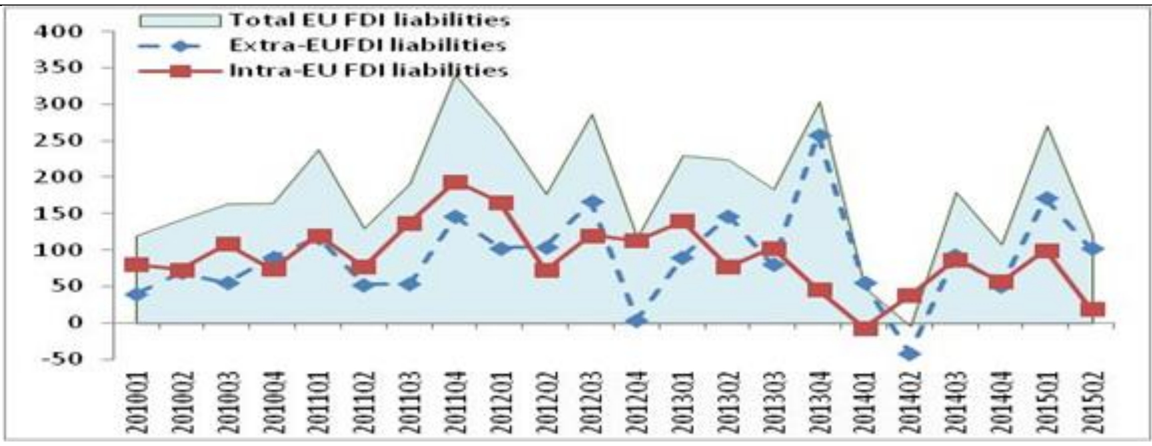
Germany overtook other source countries in 2014 and became the second largest EU investor Member State (Chart 11, Panel B). Its outward FDI almost tripled and stood at USD 112 bn. It was followed by the Netherlands, Ireland and France. Spain and Italy were significant investors as well. The UK recorded significant negative outward FDI as a result of the Vodafone-Verizon divestment. Other countries with negative outflows were Slovakia, Estonia and Romania. From the group of the Member States which joined the EU in 2004 and 2007, Bulgaria and the Czech Republic were having the highest FDI abroad in 2014.

2.3.3.3. Intra-EU versus extra-EU FDI

The current downturn in EU FDI has been characterised by declining intra-EU FDI flows and extra-EU FDI inflows exceeding intra-EU FDI inflows in some quarters (Chart 12).[23] In the pre-crisis period, intra-EU FDI inflows consistently exceeded extra-EU FDI inflows. This can perhaps be explained by the especially strong pre-crisis growth of bilateral investment flows within the EU in parallel with the introduction of the euro and the development of the single market.

However, the ongoing post-crisis unwinding of intra-EU FDI and macroeconomic adjustment seem to be happening mostly through a curtailment of intra-EU cross-border investment. In 2010-2011, the importance of extra-EU FDI inflows increased but they remained below intra-EU flows.

Chart 12, Intra- and extra-EU FDI inflows, Q1-2010 – Q2-2015, EUR billion



Source: Eurostat Balance of Payments Statistics BPM6 series; *Notes*: Based on the asset/liabilities principle; including FDI through resident special purpose entities (SPEs).

Extra and intra-EU FDI inflows are likely to stabilise at roughly the same level, around 50 % of total FDI inflows. For the moment there seem to be no signs that intra-EU FDI might start increasing again and overtaking extra-EU FDI inflows, as in the pre-crisis period.

2.3.3.4. FDI in resident special purpose entities (SPEs)

FDI assets and liabilities in resident special purpose entities (SPEs)[24] declined abruptly in 2014 and the beginning of 2015**.** For instance FDI inflows in SPEs in four EU countries with traditionally significant shares of FDI flows through SPEs, namely, Austria, Hungary, Luxembourg and the Netherlands, declined by more than 79 % (Chart 13). The

[23] The switch to new statistical reporting methodology and principles in 2014 based on the revised IMF Balance of Payments Manual (BPM6) and the fourth edition of the OECD Benchmark Definition of Foreign Direct Investment prevents comparison over a number of years.

[24] SPEs are businesses that have little physical presence in the host economies but which may provide important services for multinational companies in the form of financing or holding assets.

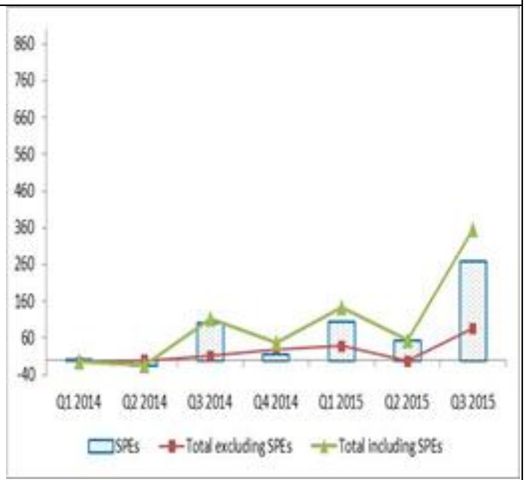
third quarter of 2015 showed some improvement but FDI inflows in resident SPEs were still far from the levels reached in 2011-2013.

Several changes occurred in the reporting and policy environment for the activities of SPEs from early 2014 (see for instance Section 4.6 for a description of recent policy initiatives taken to ensure that profit is taxed where economic activities take place and value is created). It is difficult, therefore, to identify the drivers of the collapse of FDI through resident SPEs in the EU in 2014-15. Following several years of discussion, new reporting requirements now apply under the fourth OECD Benchmark Definition of FDI. They require separate reporting of FDI inflows and positions of resident SPEs with the aim of publishing FDI figures that better reflect the impact of FDI on the host economies.[25]

Chart 13, FDI through resident SPEs in Austria, Luxembourg, Hungary and the Netherlands, 2006 — Q3-2015, EUR billion

A. Net FDI liabilities - annual data

B. Most recent quarters



Source: National Central Banks.

2.4. Mergers and acquisitions and greenfield FDI

This section takes a closer look at the composition of FDI flows by modes of entry. Companies can enter foreign markets either by acquiring existing companies through mergers and acquisitions (M&As) or by investing in new assets (greenfield investment).

The two modes differ in their impact on investment flows and the stock of production capacity in the host economies.[26] Mergers and acquisitions entail just a change in the ownership of existing companies without necessarily increasing domestic productive capacity. Furthermore, they are often conducted through exchanges of shares in companies, which may not involve cash payments. In such cases, there may be no

[25] Despite their limited physical presence, SPEs can have a significant impact on employment and economic activity in Member States that host non-trivial amounts of such FDI flows and multinational companies.

[26] World Investment Report 2006, UNCTAD.

additional external inflow of resources. In contrast, greenfield investment entails the creation of new productive facilities and inflows of new external financial resources available for investment in the host economy.

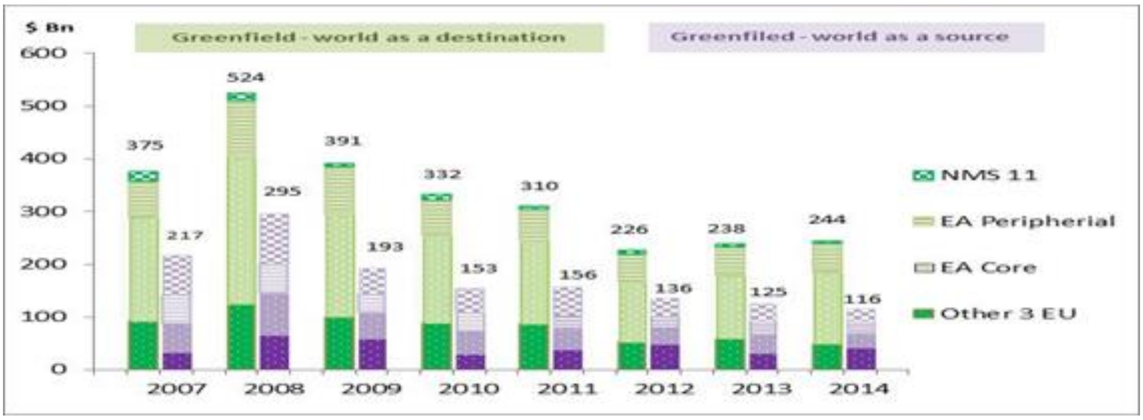
Greenfield investment, therefore, potentially has a higher short-term impact on economic growth in host economies. Of course, international production increases if a foreign company acquires domestic assets, and M&As can have positive indirect effects on the host economy through increases in productivity and technology spillovers due to transfers of technology and know-how or simply corporate restructuring.

2.4.1. *Greenfield investment*

Chart 14 presents cross-border outward (with the world as destination) and inward (with the world as source) greenfield investment.

In 2014 European companies increased their outward greenfield investment, with the core euro area recording the greatest rise, while the UK, Denmark and Sweden decreased their outward participation in new investment projects. Inward greenfield investment increased in UK, Denmark and Sweden and the core euro area[27]. It remained unchanged in the peripheral euro area[28] and the new Member States. Outward greenfield FDI was consistently higher than inward greenfield FDI in each year from 2007 to 2014.[29]

Chart 14, Cross-border EU greenfield FDI, 2007-14



Source: UNCTAD WIR 2015. *Note*: The country groupings for inward EU FDI investment (world as a source) are the same as those for outward greenfield investment (world as a destination).

[27] Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands.

[28] Cyprus, Malta, Greece, Spain, Portugal, Italy, Ireland.

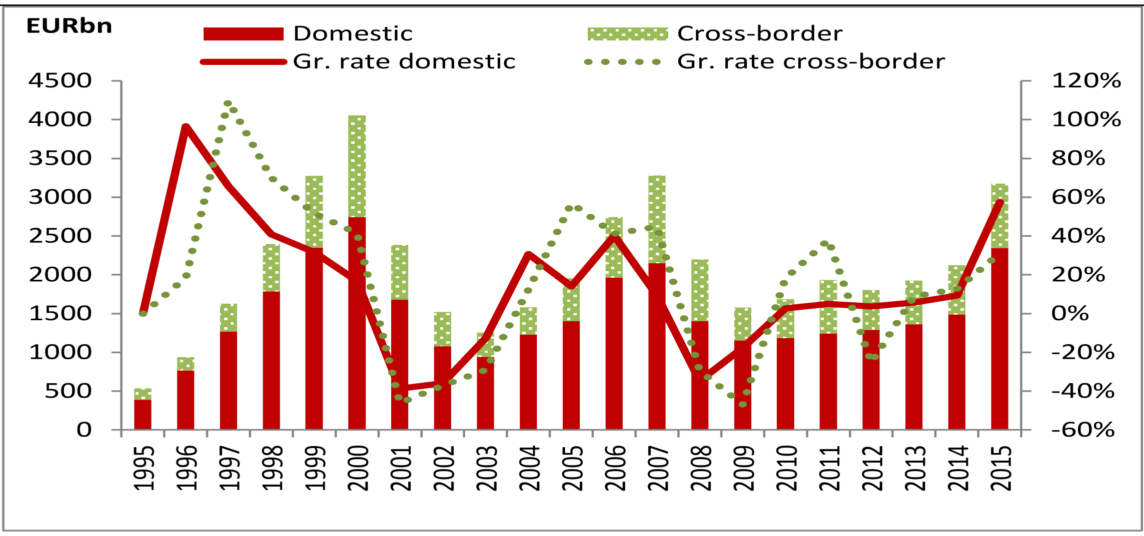
[29] As the data includes intra-EU investment, part of the outward greenfield FDI has been invested in other EU Member States.

2.4.2. *Mergers and acquisitions*

2.4.2.1. Global volumes

Chart 15 compares the volumes of global cross-border and domestic M&A deals. Global M&A deals increased by 10 % in 2014 and by further 50 % in 2015 (year-on-year) surpassing for the first time the 2007 peak of EUR 3.3 trillion. After declining by 25% in 2012, the volume of cross-border deals increased in both 2014 and 2015 and its growth rates were higher than that of domestic deals in 2014 but not in 2015 (at 13 % versus 9 %, respectively in 2014 and at 31 % versus 58 %, respectively in 2015). The share of cross-border deals stood at 30 % of the total volume of deals in 2014 but it declined to 26% of the total volume in 2015, which is lower than the pre-crisis peak of 35 % in 2007.

Chart 15, Global volumes of M&A deals, 1995-2015



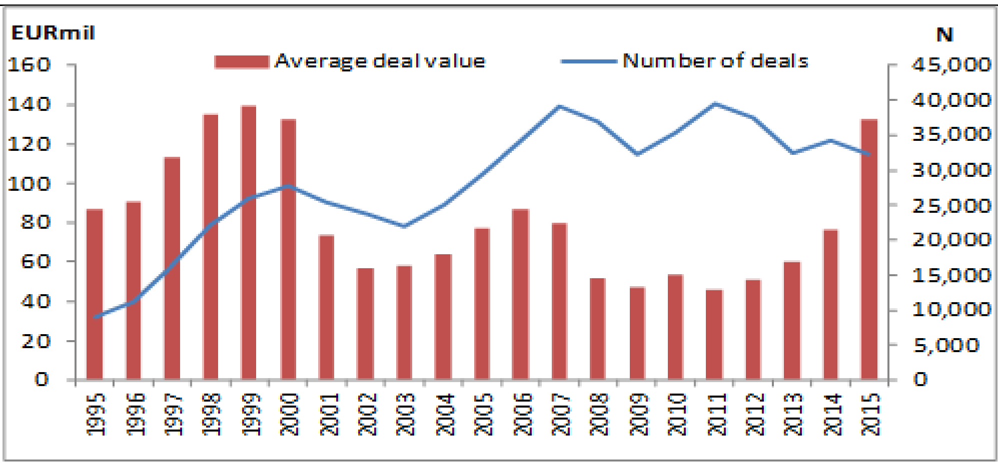
Source: Dealogic M&As Analytics, *Note*:* Final stakes acquired or sold higher than 10 %, rank eligible deals only, by date of completion of the deals.

The US (first) and China (second) led the 2015 as well as the 2014 global M&A rankings for both the most targeted nations and the most acquiring nations. The UK and France were the highest-ranking EU Member States among the most targeted nations (in third and fourth place, respectively). France moved up from sixth to fourth place in 2015 as a result of a significant increase in the volume of cross-border deals. The UK ranked fifth among the most acquiring nations, with Germany in seventh place and France in eighth place.

The most targeted sectors in 2015 by volume of deals were *healthcare*, followed by *real estate and property* and *computers and electronics*, while in 2014 the volume of deals was highest in *real estate and property* followed by *oil and gas* and *healthcare*.

The average deal value increased sharply in 2015 to well above the 2007 peak of EUR 87 million, as the number of deals was declining or not increasing as fast as the value of deals (Chart 16). This could be an indication of a slow-down in M&A activity and corporate restructuring (a lower number of deals and higher valuations).

Chart 16, Average value of M&A deals, 1995-2015

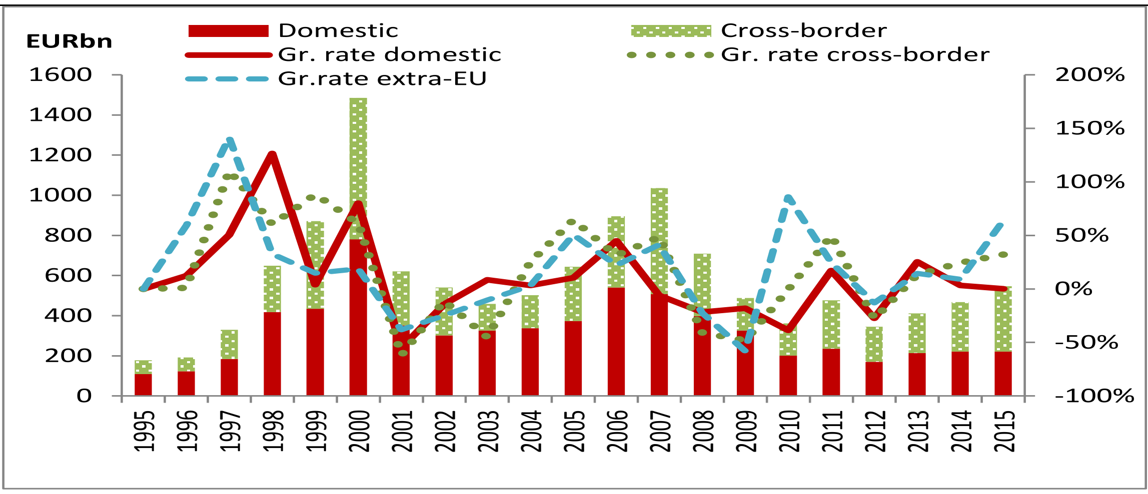


Source: Dealogic M&As Analytics, *Note*:* Final stakes acquired or sold higher than 10 %, rank eligible deals only, by date of completion of the deals. **'Average deal' values are equal to the total value of the deals divided by the total number of the deals.

In contrast to global developments depicted in Chart 15, the growth rate of cross-border deals targeting the EU surpassed that of domestic deals in both 2014 and 2015 (Chart 17). In fact the volume of EU inbound domestic deals (with an acquirer having the same nationality as the seller) remained almost unchanged in 2014-2015 and stood at EUR 221 billion or almost 60% lower than the pre-crisis peak of EUR 540 billion. The share of cross-border deals in the EU was significantly higher than that at the global level and stood at 48% of the total volume in 2014 and at 53% of the total volume in 2015. It surpassed in 2015 the pre-crisis peak of 51% of the total volume reached in 2007 again in contrast to global trends. A significant proportion of the cross-border deals in the EU were having acquirers from third countries (41% and 27% of all cross-border deals in 2014 and 2015, respectively, were with extra-EU acquirers).

Annex IV presents in more details the latest developments in international M&A and divestment by groups of EU Member States and for selected global partners.

Chart 17, EU inbound volumes of M&A deals, 1995-2015

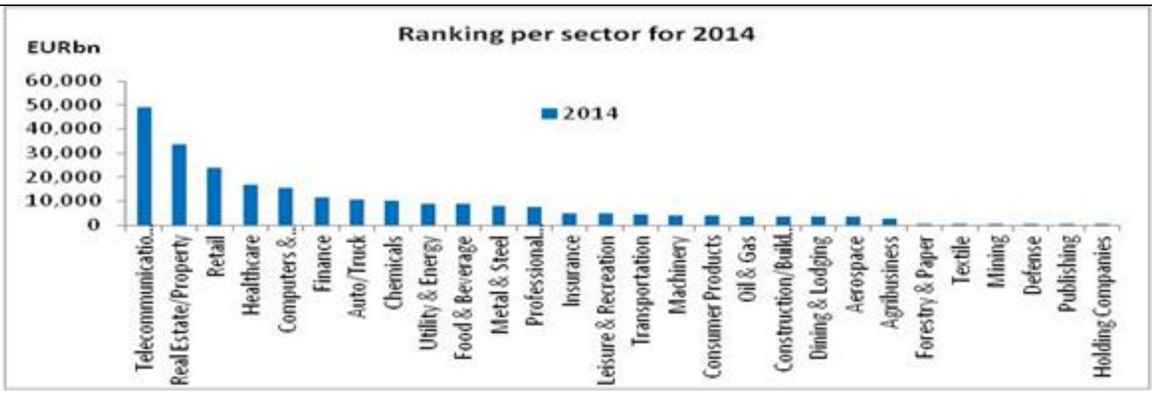


Source: Dealogic M&As Analytics, *Note*: *Final stakes acquired or sold higher than 10 %, rank eligible deals only, by date of completion of the deals.

2.4.2.2. Sectoral developments in EU-targeted mergers and acquisitions

In 2014 cross-border M&As in the EU were mostly in non-tradable sectors. The most targeted sectors were *telecommunications*, *real estate and property*, and *retail*, as shown in Chart 18. As in the global rankings, *healthcare* and *computers and electronics* were also high up (in fourth and fifth place, respectively). The volume of M&As in *finance* was more subdued in 2014 (than in previous years).

Chart 18, EU-targeted cross-border deals per sector, 2014

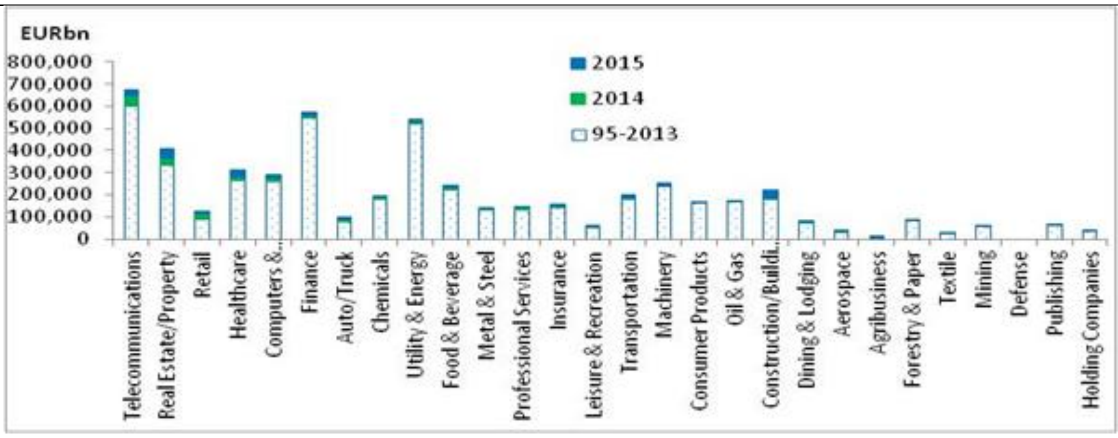


Source: Dealogic, *Note*: *Final stakes higher than 10 %, rank eligible deals, **Cross-border deals include both intra-EU and extra-EU deals.

Looking, however, at the cumulative value of EU-targeted cross-border deals for 1995 to 2015 (Chart 19), the sectors that saw the strongest demand and international restructuring are different, although again mostly non-tradable. The value of EU-targeted cross-border deals for 1995 to 2015 was highest in *telecommunications*, *finance* and *utility and energy*. The cumulative value of cross-border deals was relatively lower (than in 2014) in *real estate and property* and *retail* and very low in *agribusiness, textile, forestry and paper* and *mining*.

The cumulative number of EU cross-border deals in the *defence* sector[30] from 1995 to 2015 was very low (26). This reflects its strategic character for most Member States, which entails less, or restricted, openness to foreign investors. Not only was the number of cross-border deals very low, but so was their value (EUR 800 million as of November 2015) which indicates that the deals probably did not involve essential parts of or companies in the sector.

Chart 19, EU-targeted cross-border deals per sector, cumulative, 1995-2015



Source: Dealogic, *Note*: *Data for 2015 — as of November 2015, **Final stakes higher than 10 %, ***The sectors are in order of the 2014 ranking, as in the previous chart, in order to illustrate the difference between the most recent 2014-2015 developments and the ranking for the entire period 1995-2015.

3. LEGAL FRAMEWORK FOR THE FREE MOVEMENT OF CAPITAL AND PAYMENTS

3.1. Legal framework at EU level

The principle of free movement of capital is at the heart of the single market and is one of its four fundamental freedoms. The scope of application of the rules on free movement of capital is broad. Although the Treaty on the Functioning of the European Union (TFEU) does not contain an explicit definition of capital movements, the case-law of the Court of Justice of the European Union has consistently supported a broad definition,[31] covering: FDI, real estate investments or purchases, securities investments (for instance shares, bonds, bills and unit trusts), granting of loans and credits, and other operations with financial institutions, including personal capital operations such as dowries, legacies and endowments. This list is open and non-exhaustive. Therefore, the rules on free movement of capital, together with other EU laws, apply to all cross-border flows of financial resources including FDI, portfolio investment, and other investments such as cross-border bank loans.

[30] The sector of defence deserves special attention as it is a sector considered as strategic in all Member States and, therefore, is subject to specific rules for cross-border investment.

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

The objective of free movement of capital is to ensure openness vis-à-vis other Member States and non-EU countries. To this end, the EU Treaty prohibits all restrictions on capital movements and payments (Article 63 TFEU). However, this openness is not unconditional: the Treaty allows capital movements to be restricted under specific conditions.

The restrictions cover national measures to prevent infringements of national laws and regulations on taxation and prudential supervision of financial institutions, and measures justified on grounds of public policy or public security[32] (Article 65 1(b)). Measures may also be justified by other overriding reasons in the general interest,[33] as recognised by the Court of Justice. The exceptions provided for in the Treaty must not be used as a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments. All measures must be suitable and proportionate.

There is no secondary EU legislation harmonising the general rules on free movement of capital.[34] The policy is therefore mainly enforced by monitoring developments in Member States and their application of the principles across the economy. This requires continuous efforts to stay abreast of political and economic developments in the EU and globally.

3.2. Framework for investment in the Member States

A growing number of Member States — 12 so far, according to information available to the Commission services[35] — have set up mechanisms to review investment in order to safeguard public security or public policy interests, and/or exercise special powers over companies operating in strategic sectors.[36] 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 intra-EU/EEA investors to deal with cases of possible circumvention of the rules by extra-EU investors.

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[32] Public policy and public security may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society (judgments in *Rutili* v *Minister for the Interior*, C-36/75, EU:C:1975:137; and *Calfa*, C-348/96, EU:C:1999:6). Moreover, such exceptions must not be misapplied so as, in fact, to serve purely economic ends (*Rutili*).

[33] Examples of overriding reasons in the general interest include: the need to safeguard energy supply (Case C-174/04 Commission v Italy); the protection of consumers (*Caixa-Bank France* v *Ministère de l'Economie*, C-442/02, para. 21); the protection of the good reputation of the national financial system (*Alpine Investments*, C-384/93, para. 44); the need to guarantee the stability and security of the assets administered by a pension fund, in particular by the adoption of prudential rules (*Commission* v *Poland*, C-271/09).

[34] However, there is extensive EU legislation on the financial services sector, and legislation on specific aspects of capital movements and payments in financial markets.

[35] Austria, Denmark, Finland, France, Germany, Italy, Lithuania, Poland, Portugal, Slovenia, Spain and the UK.

[36] Three Member States (Denmark, Spain and Slovenia) limit their mechanisms to defence, where measures are as a rule permitted under Article 346(1)(b) TFEU.

In 2015, Poland adopted an 'Act on the control of certain investments' which sets out a mechanism to review certain investments in specific sectors (defence, energy-related sectors, telecommunication and chemicals). The law requires notification of all direct and indirect investments amounting to over 20 % of the capital of the companies concerned. On the basis of the information provided, the competent authority may oppose investment on specific public interest grounds if they are in line with Article 65 TFEU. So far, Poland's Council of Ministers, however, has not adopted a list of companies concerned.

Any measure affecting cross-border investment must fully comply with the rules on free movement of capital to avoid making the EU less attractive as an investment destination.

3.3. Infringement proceedings

Formal infringement proceedings are important to maintain the integrity of the single market for capital, but they are used as a last resort. Many barriers to capital movements are solved through dialogue with Member States, either through informal problem-solving procedures, or through bilateral or multilateral contacts.

During the reporting period, the Commission closed three infringement cases. Two were closed following satisfactory amendments to the contested national measures. One was closed because the subject matter did not fall within the scope of Article 63 TFEU. The Commission opened eleven new infringement cases, five on laws regulating the acquisition of agricultural land, and six on intra-EU bilateral investment treaties between Member States (see Section 4.3).[37] The Commission adopted a reasoned opinion in a case relating to usufruct rights for agricultural land in Hungary.

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. In this area, the Commission launched one infringement proceeding in 2015 under Article 63 TFEU and Article 40 of the EEA Agreement. Eleven proceedings were closed after Member States amended the relevant legislation; in seven of those cases the amendments were made following a judgment of the Court of Justice.

The Commission also brought a case to the Court of Justice against Greece because of a difference in the treatment of residents and non-residents regarding tax on the first immovable property acquired by inheritance.[38]

In the same year, the Court ruled in one tax case on a restriction on free movement of capital following infringement proceedings. French legislation exempts gifts and legacies to foreign public bodies or to charitable bodies from payment of duty, but only if such bodies are established in Member States that have concluded bilateral agreements with France. This condition was judged to be contrary to EU law.[39]

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[37] The report includes only those infringement cases where the Commission has taken a formal decision (starting from the adoption of a letter of formal notice, in accordance with the procedure laid down in Article 258 TFEU).

[38] *Commission* v *Hellenic Republic*, C-244/15.

[39] *Commission v France, C-485/14, EU:C:2015:506.*

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

4.1. Action plan on building a capital markets union

Despite the progress made over the past 50 years, capital markets in most European countries are still relatively underdeveloped and fragmented. While the European economy is as big as that of the US, Europe's equity markets are less than half the size, and its debt markets less than a third in terms of market capitalisation. The gap between Member States is even bigger than that between Europe and the US.

The action plan on building a capital markets union (CMU), published by the Commission on 30 September 2015, aims at better integrating capital markets in order to increase and diversify funding sources for growth in Europe. It is an opportunity to complement Europe's strong tradition of bank financing by: (i) unlocking more investment from the EU and the rest of the world, (ii) better connecting financing to investment projects across the EU, (iii) making the financial system more stable and (iv) deepening financial integration and increasing competition.

The CMU should, in particular, provide more funding choices for Europe's businesses and SMEs (which currently receive five times less funding from capital markets than US SMEs). For example, the modernisation of the Prospectus Directive proposed by the Commission on 30 November 2015 will make it less costly for businesses to raise funds publicly and a package of measures is planned to support venture capital and equity financing in the EU.

Another priority for the action plan is to ensure an appropriate regulatory environment for long-term and sustainable investment in Europe's infrastructure, where there are high investment needs — for example, it is estimated that the EU's transition to a low carbon economy will require EUR 200 billion of investment per year.[40] As part of the action plan, Solvency II calibrations will, for example, be revised to better reflect the true risk of infrastructure investment. This will be followed by a review of the treatment of bank exposure to infrastructure under the Capital Requirements Regulation. Furthermore, in December 2015 the Commission services launched a public consultation on incentives for and possible barriers to long-term and sustainable investment. Investors who integrate sustainability and governance issues into investment decisions could play an important role in and benefit from the investment opportunities arising from the transition to a low carbon economy.

The action plan also includes measures to increase investment and choices for retail and institutional investors. Following the Green Paper *Retail financial services* (see Section 4.4), the Commission services will also explore ways to increase choice in retirement saving and build an optional EU market for personal private pensions.

Finally, in the action plan, the Commission presented legislative proposals for simpler, transparent and standardised European securitisation in order to free up capacity on banks' balance sheets and provide opportunities for long-term investors.

[40] PRIMES, 2030 Impact Assessment.

Overall, building the CMU should move the EU closer to a situation where: SMEs can raise financing as easily as large companies; the cost of investing and of access to investment products converges across the EU; obtaining finance through capital markets is increasingly straightforward; and seeking funding in another Member State is not impeded by unnecessary legal or supervisory barriers.

4.2. Addressing unjustified barriers to the free movement of capital

In order to build a genuine CMU and increase cross-border investment in Europe, it is essential to eliminate barriers to free movement of capital between the 28 Member States that are not justified by the public interest, not proportionate or incompatible with other general principles of EU law in accordance with the Treaty and case-law.

A number of these barriers stem from national legislation or administrative practices. Some relate to national 'gold-plating'[41] of EU minimum rules, or may arise from differences in the application of EU rules. Others stem from national measures taken in areas where there is no EU legislation or where responsibility remains at national level.

Under the CMU action plan, following a call by the Economic and Financial Committee, the Commission has started working with Member States to map unjustified barriers to free movement of capital.

As stated in the conclusions of the Economic and Financial Affairs (ECOFIN) Council of 19 June 2015, which broadly supported the work under way, the intention is to develop, with Member States, a roadmap for tackling these barriers and removing the most damaging ones. A first meeting with Member States took place on 13 October 2015. It examined existing barriers to obtain an overview and identify those most economically harmful for the development of the single market for capital.

This first meeting also allowed Member States and the Commission to discuss the best methods for Member States of proactively tackling the different types of national barriers. These could include peer reviews, performance checks, exchanges of best practices, focused economic studies or discussions in smaller groups on issues that would concern only some Member States. The group also agreed to prioritise the most relevant barriers and to avoid duplicating work done in other specialised fora.

This work will continue in the course of 2016 and should serve as an essential contribution to a Commission report comprising a list of major barriers that can be eliminated proactively by Member States and a roadmap on how, when and by whom this could be done. This report is due in the fourth quarter of 2016 under the action plan. It will be followed by an implementation phase to 2019.

4.3. Ending intra-EU bilateral investment treaties

Bilateral investment treaties between Member States (intra-EU BITs) are infringing EU law inter alia by violating the EU rules on free movement of capital, in particular by keping the legal framework for treatment of investment in the single market fragmented. The Commission has consistently pointed out to all Member States that intra-EU BITs

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[41] 'Gold-plating' refers here to additional requirements imposed by Member States on top of the requirements set out in EU law.

are incompatible with EU law in several regards and should end as soon as possible. However, most Member States have taken no action to terminate them.[42]

The violation of EU law by Member States through intra-EU BITs has been aggravated by the fact that the number of international arbitration proceedings based on these treaties has been increasing in recent years.[43] In addition, there have been new concerns that certain interpretations by arbitral tribunals may conflict with EU law.[44] The procedures in place allow the Commission to intervene in such cases on matters of EU law, through submissions as *amicus curiae*, including in regard to the jurisdiction of the arbitral tribunals. In practice, however, the impact of such submissions has been limited. Besides the violation of EU law, this situation may create legal uncertainty and confusion for cross-border investors, at a time when the EU's top priority is to promote an environment that encourages investment.

For all these reasons, in June 2015 the Commission entered the first stage of infringement proceedings against five Member States[45] and launched an administrative dialogue with the remaining 21 Member States who still have intra-EU BITs in place.[46] The Commission subsequently met with all Member States on 1 October 2015 to help them with the technicalities of the termination of their intra-EU BITs and to discuss the current EU framework relevant for investment protection within the single market.

4.4. The Green Paper *Retail Financial Services*

Despite significant progress in recent years, the EU market for retail financial services and insurance is still fragmented, and a single market in this area does not truly exist at present. Consequently, consumers in the EU's domestic markets do not always receive the benefits of unfettered competition — including cheaper prices and greater choice — that are available in other sectors (e.g. air transport). To this end, the Commission issued a Green Paper on retail financial services on 10 December 2015.[47] It launched an open public consultation until 18 March 2016, seeking stakeholders' views on how to bring about better outcomes for consumers and firms in terms of better access, more

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42 Only two Member States — Ireland and Italy — have ended all their intra-EU BITs, in 2012 and 2013 respectively.

43 According to UNCTAD, in 2014 a quarter of all known new disputes (eleven) were intra-EU cases. Half of these were brought pursuant to the Energy Charter Treaty (ECT), and the rest on the basis of intra-EU BITs. The overall number of intra-EU investment arbitrations that year was 99, representing approximately 16 per cent of all cases globally.

44 For instance, one recent arbitration proceeding based on an intra-EU BIT has produced an outcome that the Commission considers incompatible with EU law, as the damages established by the arbitral award constitute illegal state aid (see ICSID Case No ARB/05/20 *Ioan Micula, Viorel Micula, S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L.* v *Romania*).

45 The Commission had already sought clarification from these five Member States through administrative dialogues (in the 'EU Pilot'), given that the bilateral agreements in question had been relied on in arbitration proceedings and had led to issues regarding compatibility with EU law.

46 See IP/15/5198.

47 Green Paper *Retail Financial Services: Better products, more choice, and greater opportunities for consumers and businesses*, COM(2015) 630 final.

transparent markets and increased competition, as well as greater consumer choice and improved consumer protection across the EU in an increasingly digital environment.

The Green Paper seeks to identify the specific barriers and the main challenges that consumers and firms face in making use of the single market, and ways in which those barriers and challenges could be overcome. It is not intended to review recently adopted legislation whose transposition and enforcement at national level are being closely monitored by the Commission. Rather, it complements the Commission's work on creating a capital markets union by encouraging further development of competitive and integrated markets for retail investment. It is also related to other parallel Commission priorities and work streams such as the digital single market, the single market strategy and the sectoral inquiry into e-commerce.

4.5. Adoption of a package of legislation on an EU-wide market for card and electronic payments

The revised Payments Services Directive (PSD2) was adopted in November 2015 and will be published in the Official Journal shortly. It is part of the so-called payments package together with the Interchange Fee Regulation. The package aims to better serve the needs of an effective European payments market, fully contributing to a payments environment which nurtures competition, innovation and security for the benefit of all stakeholders and consumers.

PSD2 provides a legal and supervisory framework for emerging actors in the payment market which until now were unregulated (so-called third-party payment service providers) and will contribute to a level playing field for payment service providers. It improves the security requirements for initiating and processing electronic payments and the protection of consumers' financial data. Furthermore, it widens the scope of the directive to include certain transactions with non-EU countries where only one of the payment service providers is located within the EU ('one-leg transactions'). This will improve transparency for outgoing money remittances, which could lead to reduced costs for users. The number of exclusions from the directive has been narrowed down, e.g. by allowing only exclusions for micro-payments conducted through telecom operators for digital content, tickets and charity purposes services (EUR 50 per transaction and EUR 300 maximum per billing month). The directive will increase consumer protection in a number of areas, partly by reducing liability for non-authorised payments. It also boosts cooperation and information exchange between authorities that authorise and supervise payment institutions.

The Interchange Fee Regulation was adopted by the Council on 20 April 2015 and published in the Official Journal on 19 May 2015.[48] The Regulation, combined with PSD2, introduces maximum levels for interchange fees for transactions based on consumer debit and credit cards, and bans surcharges on these types of cards. Capping interchange fees will reduce costs for retailers and consumers, and surcharging will no longer be permitted for those cards subject to capping. The caps are set at 0.2 % of the value of the transaction for debit cards and 0.3 % for credit cards. This provision applies from 9 December 2015. The Regulation includes other measures to foster competition on the cards market, such as a ban on requirements that retailers accept all cards of the same

[48] Regulation 751 of 2015.

brand (‘honour all cards’ rules) and a rule that payment licences should cover the whole EU territory.

4.6. Initiatives in the field of direct taxation

Recent policy initiatives in the field of taxation also contributed to more integrated capital markets in the EU by avoiding the resurgence of barriers that could result from the behaviour of certain companies that do not pay their fair share of tax.

In June 2015, the Commission adopted the communication *A Fair and Efficient Corporate Tax System in the European Union: 5 key areas for action*. The initiatives included in that action plan aim at tackling tax avoidance while securing sustainable revenues for Member States and strengthening the single market. While taking into account the need to increase the efficiency of the tax environment for businesses in the single market, the key objective is to ensure that companies are taxed where their profits are generated and cannot avoid paying their fair share of tax through aggressive tax planning[49]. Concrete measures have been taken in the *Anti-Tax Avoidance Package* of 28 January 2016.

On 9 December 2014, the Council adopted Directive 2014/107/EU amending the 2011 Directive on Administrative Cooperation in order to apply the OECD’s *Global Standard for Automatic Exchange of Financial Account Information* in the EU. Since then, work has continued at EU level to ensure timely and effective entry into application of the directive on January 2016 and a smooth transition to the new standard. Until now, cooperation has been based on the EU Savings Directive (EUSD).

A phased repeal of the EUSD was proposed by the Commission in March 2015 and, after adoption by the Council, took effect from 1 January 2016.

The Commission has, in the meantime, finalised technical negotiations with five non-EU European countries (Liechtenstein, Switzerland, Monaco, Andorra and San Marino) to align their existing agreements with the EU on the taxation of savings with the OECD Global Standard. Two of the revised agreements (with Switzerland and San Marino) had been signed by the end of 2015.

In connection with aggressive tax planning by multinationals, in 2014 the Commission opened four in-depth investigations to examine whether rulings issued by tax authorities, on the corporate income tax to be paid by Apple in Ireland, Starbucks in the Netherlands, Fiat Finance and Trade in Luxembourg, and Amazon in Luxembourg complied with EU rules on state aid. The cases concerning Starbucks and Fiat Finance and Trade were concluded on 21 October 2015 with decisions that they did not comply and that tax should be recovered.

In December 2014, the Commission announced that it would enlarge the enquiry into the practice of tax rulings under EU state aid rules to cover all Member States. On the basis of the information received, in June 2015, the Commission asked 15 Member States to

49 The economic environment has become more globalised, mobile and digital. Business models and corporate structures have become more complex, making it easier to shift profits. This has made it more difficult to determine which country is supposed to tax a multinational company's income. Certain companies are exploiting this situation to artificially shift profits to the lowest tax jurisdictions and minimise their overall tax contribution.

provide the texts of a substantial number of individual tax rulings. However, requesting these tax rulings does not prejudge whether this will lead to individual state aid investigations concerning the recipients of these tax rulings. On 7 February 2015 and 3 December 2015 respectively, the Commission opened further investigations regarding the Belgian scheme of 'excess profit' tax rulings and McDonald's in Luxembourg.

4.7. End of capital controls in Cyprus

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

In March 2013, to deal with the risk that mass capital flight would lead to a collapse of the Cypriot banking system, the Cypriot authorities had adopted capital controls which limited both the outflows of deposits from the country and the flow of capital between banks in Cyprus. The measures were intended, in particular, to prevent massive outflows of deposits of uninsured depositors in the two largest banks in Cyprus (Bank of Cyprus and Laiki Bank), which were subject to a bail-in. Massive outflows would have threatened the stability of the Cypriot financial system and caused further damage to the real economy. In these exceptional circumstances, the Commission considered the imposition of capital controls to be compatible with the free movement of capital.

While they can be justified in exceptional circumstances and under certain conditions, capital control measures can, however, only be temporary and may not last longer than necessary. They need to be gradually relaxed as the risks to financial stability diminish.

In line with this, and based on a roadmap adopted in August 2013, the Cypriot authorities gradually relaxed capital controls. After 35 general decrees and 26 decrees specific to foreign banks, capital controls were no longer renewed and thus finally expired at the end of March 2015.

Since then, deposits have remained stable and even increased slightly at aggregate level, despite short-lived instability related to the worsened situation in Greece in the summer. The deposit outflows in the second quarter of 2015, which originated mainly in Greek subsidiaries, were reversed in the third quarter and afterwards. Overall, deposits in both domestic and international banks have been increasing, signalling resident clients' recovering confidence in the system. At the same time, the liquidity buffers which had deteriorated in the majority of the banks in the first half of 2015 grew again in the third quarter of the year. The reliance on central bank funding was markedly reduced, thanks to both the overall stabilisation of the deposit base and the successful deleveraging of banks' assets.

5. OTHER MAJOR CHALLENGES REQUIRING REGULAR MONITORING

5.1. Capital controls in Iceland and in Greece

5.1.1. Capital controls in Iceland

Iceland is a member of the EEA and Article 40 of the EEA Agreement establishes the principle of the free movement of capital in the EEA. However, Article 43 of the EEA Agreement expressly permits a Contracting Party to take 'protective measures' if there is a disturbance in the functioning of its capital market, or if it is in difficulties as regards its balance of payments.

Capital and foreign exchange controls were introduced in Iceland in 2008 in response to a severe banking crisis and acute pressure on the country's balance of payments.

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

On 7 June 2015, the Icelandic Government presented a comprehensive strategy to gradually lift capital controls without jeopardising the country's economic and financial stability. In particular, the strategy aims at preventing three categories of assets from flowing into the foreign exchange market once capital controls are liberalised: (i) the krónur (ISK)-denominated assets of the failed banks' estates; (ii) the estates' foreign-denominated claims against Icelandic residents; and (iii) the offshore krónur held by non-residents.

In order to do so, the strategy, which was turned into law by the Icelandic Parliament, the *Alþingi*, focuses on two priorities:

- Creditors of failed banks' estates (ISK 900 billion, EUR 6.3 billion) willing to obtain the authorisation to transfer funds were encouraged to complete 'composition agreements' with the government by the end of 2015 in order to avoid paying a 'stability tax' of 39 % of the failed banks' total assets. The draft agreements proposed by the estates of Kaupþing, Landsbankinn and Glitnir were accepted by the Icelandic state on 28 October 2015. As part of the agreement, the estate of Glitnir will hand over Islandsbanki to the state.

- Regarding the issue of offshore ISK (ISK 300 billion — EUR 2.1 billion — of highly liquid foreign-owned ISK assets), foreign owners were given three options: currency auctions, long-term Treasury bonds or locked non-interest-bearing accounts.

Once these measures have been implemented, the ISK 1 200 billion overhang should no longer pose a threat to economic stability, allowing the controls to be relaxed further in 2016.

5.1.2. Capital controls in Greece

Capital controls were decided by the national authorities on 28 June 2015. These controls included a bank holiday, the temporary closure of the Athens Stock Exchange, a daily EUR 60 limit on cash withdrawals and the creation of a Bank Transactions Approval Committee (BTAC). The BTAC was tasked with approving a number of transactions, for example for medical expenses and the import of pharmaceutical products.

The European Commission made an immediate assessment of these measures and considered on 29 June 2015 that the stability of the financial and banking system in Greece constituted a matter of overriding public interest and public policy that justified the imposition of temporary restrictions on capital flows.

The Greek authorities abolished the bank holiday from 20 July 2015 and allowed the Athens stock exchange to reopen on 3 August 2015 with restrictions for funds deposited in accounts held with Greek credit institutions, which could not be used by investors to purchase financial instruments. The Greek authorities removed this restriction on 7 December 2015.

The Greek authorities also adopted a number of measures to adjust and alleviate existing capital controls. Most notably:

- While the daily EUR 60 limit on cash withdrawals is still in place, cash not withdrawn daily can now be withdrawn cumulatively up to the amount of EUR 420 per week.

- The BTAC decided to create special subcommittees operating in credit institutions. The role of these special subcommittees is to approve businesses' requests for transfers and payments abroad of up to EUR 150 000 per day per client in order to facilitate the import and export of goods and services.

- A series of adjustments were made on 11 August 2015 for natural persons, such as increasing the exemption for students living abroad to EUR 8 000 per quarter.

The European Commission will continue to monitor developments in the capital controls decided by the Greek authorities. It will assess the suitability and proportionality of these measures, taking into account the liquidity and solvency of the banks, so as to ensure Greece's macro-financial stability, in line with the Memorandum of Understanding signed between Greece and the European Commission (acting on behalf of the European Stability Mechanism) on 19 August 2015.

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

Considerable attention has been paid to lending in foreign currencies in recent years as such lending to unhedged borrowers proved to be very risky in the aftermath of the financial crisis. Currency fluctuations can hit borrowers hard and can cause significant systemic risks in countries with extensive foreign exchange lending.[50]

In several Member States, Swiss franc loans, and in particular Swiss franc mortgage loans, were very popular from early 2000 until the beginning of 2008 as they offered relatively low interest rates. However, the sharp Swiss franc appreciation in 2011, and especially in January 2015, made these loans significantly more expensive to repay. As a result, many Swiss franc borrowers started to face financial difficulties and public demonstrations took place.

[50] Risks related to foreign currency lending were addressed in the European Systemic Risk Board's Recommendation of 21 September 2011 on lending in foreign currencies (ESRB/2011/1).

Hungary issued a number of laws, central bank regulations and financial supervision recommendations and pursued a range of projects between 2009 and 2014 to help borrowers. In November 2014, Hungary adopted a law which converted foreign currency loans into forints at the market rate. The law was based on a negotiated agreement with the banking sector and was adopted in November 2014 just before the Swiss franc appreciation in January 2015. As a result, the negative impact of the Swiss franc appreciation in January 2015 was avoided.

Right after the January 2015 appreciation, Croatia reacted with a short-term measure in January 2015 freezing the exchange rate with the Swiss franc for one year at the rate applicable prior to the Swiss franc's appreciation. In September 2015, Croatia then introduced a permanent solution by adopting a law amending the Consumer Credit Act and Credit Institutions Act. This law grants all borrowers the possibility to convert Swiss franc loans into euro loans at historical exchange rates, thereby putting borrowers in the same position as they would have been had they taken out euro-denominated loans from the outset. The Croatian National Bank has estimated the cost of this law at HRK 8 billion (EUR 1.05 billion, 2.44 % of GDP) before tax. It is to be borne almost exclusively by the credit institutions. Given that most Croatian banks granted only a negligible sum in Swiss franc loans, the credit institutions affected are mainly foreign-owned.

National measures interfering with existing loans may constitute restrictions on the free movement of capital, which are in principle forbidden by the Treaty but can be justified if they prove to be necessary and proportionate to protect certain public interests. In particular, Member States may take measures to help borrowers in order to avoid over-indebtness, provided that the measures are suitable and proportionate to the achievement of this objective. The country-specific recommendation adopted by the Council in July 2015 called upon Croatia to adopt proportionate and equitable solutions in this matter. The Commission services are assessing the Croatian law on its compliance with the Treaty, in particular in light of proportionality.

Commission services are closely following discussions on possible measures in relation to foreign currency loans in other countries as well. In Poland, a law setting up a 'Mortgage assistance fund' was adopted in October 2015. This fund, financed by the banking sector, should serve indebted borrowers in financial difficulty. In January 2016, the President's Office presented a draft legislation proposal, that would allow borrowers to have their foreign exchange loans converted in zloty denominated loans under favourable terms or to pay off their debt by handing in mortgaged property to the bank. In Romania, discussions on measures regarding foreign currency loans are ongoing.

At EU level, a new directive on credit agreements for consumers relating to residential immovable property[51] was adopted in February 2014. This directive aims to foster responsible lending practices and better protect consumers throughout Europe and, in the long run, to establish a single European mortgage loan market. The directive also strives to increase the protection of consumers as far as foreign currency mortgage loans are concerned by providing for regular warnings to borrowers about fluctuations of the exchange rates and mechanisms to reduce the risks related to them. In addition, it obliges Member States either to grant consumers a right to convert their foreign currency loan to

[51] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 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.

an alternative currency under specified conditions or to put in place other arrangements to reduce the foreign currency risk.

The directive has to be implemented by the Member States by 21 March 2016 and is only applicable to loan agreements concluded after that date. It will therefore be applicable to new agreements, but not existing loans. The Commission will monitor the correct implementation of the Directive in all Member States.

5.3. Investments in real estate and agricultural land

The free movement of capital encompasses the right to acquire, use or dispose of real estate (including secondary residences, agricultural land and forestry) on the territory of another Member State.[52] National measures regarding investments in real estate are therefore subject to monitoring by the Commission.

At the time of accession to the European Union and in order to avoid sudden disturbances in land markets, specific derogations from the rules on free movement of capital were granted to some Member States allowing them to maintain existing restrictions on the acquisition of real estate. The accession treaties of Denmark, Finland (Protocol No 2 on the Åland Islands) and Malta provide for permanent derogations on the acquisition of secondary residences. For Poland[53] and Croatia, derogations on the acquisition of agricultural land will be in force until 30 April 2016 and 30 June 2020 respectively. Croatia is also allowed to request a three-year extension. All other temporary derogations granted on the acquisition of secondary residences[54] and agricultural real estate[55] have expired.

Among those countries which were granted a transition period, six Member States adopted new legislation regulating the acquisition of agricultural and forestry land before or, in some cases, after the temporary derogations expired. The new land laws generally pursue policy objectives (for example preserving farming on agricultural land, supporting agricultural communities and preventing land speculation) which may justify restrictions under the internal market rules. Nevertheless, concerns arose regarding the compatibility of certain provisions of five new land laws with EU law, in particular in relation to the principle of proportionality.

For these reasons, on 26 March 2015 and 29 April 2015, the Commission sent letters of formal notice to Bulgaria, Hungary, Lithuania, Slovakia and Latvia asking them to submit their observations on their laws regulating the acquisition of agricultural land. The Commission is currently assessing whether their national legislation restricts the rights of cross-border investors in a way that breaches EU law on the free movement of capital and freedom of establishment.

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[52] See, for example, the judgment of 1 October 2009 in *Woningstichting Sint Servatius*, C-567/07, paragraph 20 and the case law cited there.

[53] Poland has a 12-year transition period.

[54] The transition period expired on 1 May 2009 for Cyprus, the Czech Republic, Hungary and Poland and on 1 January 2012 for Bulgaria and Romania.

[55] The transition period expired on 1 May 2011 for the Czech Republic and Estonia because they did not request an extension, on 31 December 2013 for Bulgaria and Romania, and on 30 April 2014 for Hungary, Latvia, Lithuania and Slovakia.

On 18 June 2015, the Commission also requested Hungary to take the necessary measures to comply with EU rules on the rights of cross-border investors to use agricultural land. The contested Hungarian law had the effect of terminating, as from 1 May 2014, certain usufruct rights. As a result, investors, including foreign ones, lost the value of their investments without compensation.

5.4. Cross-border banking services

EU banking legislation allows bank supervisors to impose constraints or requirements on bank activities, in particular to address financial stability concerns. Nevertheless, the prudential measures taken for this purpose have to comply with the Treaty's rules on the free movement of capital and freedom of establishment.

This implies that supervisors cannot restrict the cross-border transfer of bank capital unless this is justified on grounds of overriding public interest. Moreover, the measures taken must not be discriminatory and must be proportionate to the objectives pursued. Prudential and financial stability considerations may qualify as matters of overriding public interest.

In 2013, a survey of supervisory practices restricting cross-border transfers of capital by banks conducted by the Commission services revealed that a number of national measures having the effect of ring-fencing bank assets had been taken between 2008 and 2013, mostly in response to the economic and financial crisis. These included measures limiting intragroup exposure, prohibiting intragroup flows of liquidity or capital or prohibiting the distribution of profits to the parent company.

The Commission called on national supervisors to take appropriate action in order to avoid unduly restrictive supervisory measures, and in particular to cooperate closely with fellow supervisors and with the European Banking Authority.

Since the survey, EU banking legislation has undergone a substantial overhaul with the adoption of the Capital Requirements Directive (CRD IV[56]) and the Capital Requirements Regulation (CRR[57]); these have been in force since 1 January 2014. The new rules laid down in CRD IV and the CRR establish a stronger and more uniform prudential framework, which is largely directly applicable. This will help achieve a sounder and safer common banking market, which should reduce the incentives for ring-fencing measures.

Furthermore, in October 2014 the Commission adopted a delegated act (DA) to introduce detailed and harmonised liquidity coverage requirements (LCR) in the EU.[58] The LCR DA defines the liquid assets, cash outflows and cash inflows needed to calculate the liquidity coverage ratio. These detailed binding rules on liquidity have applied since 1 October 2015 and aim to promote mutual supervisory confidence between competent authorities. They should also help limit any undesirable practices that may trap liquidity within national borders.

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56 Directive 2013/36/EU.

57 Regulation (EU) No 575/2013.

58 Commission Delegated Regulation (EU) 2015/61 of 10 October 2014.

From the date of application of the LCR DA, the supervision of liquidity risk in EU bank branches is the responsibility of the home supervisor and no longer of the host supervisor. This change in liquidity supervision should also help reduce the level of trapped liquidity in a jurisdiction, because in principle branches in a host country no longer have to comply with the host country's liquidity rules. In addition, the liquidity situation of subsidiaries in a host country will also improve. The CRR allows liquidity requirements to be waived for institutions on a case-by-case basis, provided the requirements are applied at the level of a single liquidity sub-group. Waivers can also be granted at cross-border level provided the various competent authorities involved give their consent. Cross-border single liquidity sub-groups will have to comply with the LCR on a cross-border basis, thus helping to limit trapped liquidity at national level.

In June 2014, the Commission reviewed the legal obstacles to the free movement of funds between institutions within a single liquidity sub-group and published a report.[59] The report concluded that there were no relevant legal obstacles preventing institutions from entering into contracts that provide for the free movement of funds between them within a single liquidity sub-group. It also concluded that the LCR DA allows preferential treatment for certain outflows and inflows in a group context, which should also facilitate more efficient liquidity management in a group.

In 2015, further progress was made towards creating a banking union and developing a single rulebook for banks. These measures are expected to significantly reduce the risk of ring-fencing.

Since November 2014, the single supervisory mechanism (SSM) has been fully operational, with the ECB taking on the supervision of the 123 largest banks and banking groups and overseeing the supervision of all other banks in the euro area. By supervising banking at EU level it is possible to compare banks' situations across countries and different business models and evaluate how banks are linked to the rest of the financial system. The supervisory assessment of banks ('supervisory review and evaluation process' — SREP) carried out in 2015 under the SSM framework was based on a standard methodology developed by the ECB in close cooperation with the 19 national supervisors on the basis of the SREP Guidelines developed by the European Banking Authority. This is aimed at improving consistency with respect to the level of capital requirements that are determined as a result of such assessment, while keeping in mind that proportionality of the supervisory review has to be ensured at the same time. The Commission is currently conducting a review to assess the effectiveness of the SSM. It plans to send a report on the results of the review to the European Parliament and Council in the course of 2016.

The single rulebook for all EU banks has been developed further with the transposition of CRD IV, the Bank Recovery and Resolution Directive[60] and Deposit Guarantee Schemes Directive[61]. The Commission has been monitoring the transposition of these directives in national law, and has launched infringement proceedings against those that failed to

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[59] COM(2014)327/F1, Report from the Commission to the European Parliament and the Council, *Legal obstacles to the free movement of funds between institutions within a single liquidity sub-group*. http://ec.europa.eu/transparency/regdoc/rep/1/2014/EN/1-2014-327-EN-F1-1.Pdf

[60] Directive 2014/59/EU

[61] Directive 2014/49/EU

adopt all the required national measures within the deadline. The Commission has also adopted a number of delegated and implementing acts, as well as binding technical standards to give full effect to the single banking rulebook.[62]

The single rulebook will be complemented by the European Deposit Insurance Scheme and further risk reduction measures[63]. Commission services will continue to monitor the level of integration of the European banking market, including compliance with the principle of the free movement of capital.

5.5. Macro-prudential measures

Macro-prudential policy and the flexibility to act at Member State level are essential to safeguard financial stability, especially in the euro area.

The EU macro-prudential framework aims to accommodate the need for Member States to have flexibility for financial stability purposes while providing appropriate safeguards to prevent undermining the single market. These safeguards apply in particular to the free movement of capital when measures lock-in capital or liquidity in certain jurisdictions. In practical terms, this means that measures have to be proportionate, justified by the level of systemic risk and that there must be a degree of EU control and coordination in order to avoid negative cross-border effects.

Macro-prudential measures such as reductions in loan-to-value ratios can limit the risk of an unsustainable housing boom, given very low borrowing costs. This can also work in reverse, where macro-prudential policy can ease any undesired sectoral effects of monetary tightening. Therefore, to counter procyclical effects, macro-prudential measures have recently started to be used more proactively, especially because common monetary policy cannot be adjusted to reflect country-specific circumstances.

Macro-prudential authorities rely on a series of measures that can be divided into two main categories: those that seek to influence lenders' behaviour and those that focus on borrowers' behaviour.

Banks are already subject to capital-based measures at European level stemming from capital requirements legislation (the CRR/CRD IV), including the countercyclical capital buffer (CCB), the 'systemic risk buffer' and the capital surcharge on systemically important institutions. In 2014 and 2015, one third of EU countries introduced systemic risk buffers or similar measures.[64] However, except for the CCB, capital-based measures seem to have had a more indirect, limited effect on cyclical adjustments and the costs of loans. This may make them less effective in restraining excessive credit demand if house prices appreciate.

[62] See the full list at http://ec.europa.eu/finance/bank/regcapital/acts/index_en.htm.

[63] Regulation proposal COM/2015/0586 final; Communication COM/2015/0587 final

[64] These countries are Austria, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, the Netherlands, Slovakia and Sweden.

An increasing number of European countries are also introducing borrower-based measures to address the impact of low interest rates on their housing market.[65] Borrower-based measures appear to be especially important in effective macro-prudential policy due to the strong link between the housing market and credit growth, which makes the housing market a source of potential systemic risk. These measures have the advantage of targeting particular sectors affected by financial imbalances and that they can be adjusted to country-specific circumstances. However, the use of borrower-based measures is subject to national legislation.

The use of macro-prudential measures by the Member States has not given rise to major issues in relation to the free movement of capital, despite them being relatively actively implemented since the entry into force of the CRR/CRD IV. However, the European Commission continuously monitors the use of macro-prudential measures and their compatibility with the free movement of capital.

Since the ESRB and the macro-prudential toolset of the CRD IV/CRR pre-date the banking union, the framework for macro-prudential surveillance became more complex. In light of recent developments and concerns expressed by stakeholders, Commission services have started a comprehensive revision of the EU macro-prudential framework for the coming years. The objective is to combine an effective governance structure with streamlined policy measures that achieve an appropriate balance between national flexibility to address country-specific risks and the smooth functioning of the single market.

5.6. Progress in the Single Euro Payments Area (SEPA)

Migration to SEPA was completed in August 2014. The latest figures of migration at that time indicated that almost 100 % of both SEPA Credit Transfers (SCT) and SEPA Direct Debits (SDD) had migrated. Some euro area Member States opted to make use of the scope for exceptions under the SEPA Regulation[66] until February 2016. Non-euro Member States have to migrate to SCT and SDD for euro payments by the end of October 2016.

The next steps in the short term include phasing out these options. In particular, the euro area Member States are working hard to phase out the option of leaving certain country-specific niche products out of the SEPA scheme.

Although the euro area Member States have almost fully migrated to SCT and SDD, post-migration issues do arise. In particular, citizens sometimes find that foreign companies/service providers do not recognise their bank account. The Commission has initiated discussions with Member States where the authority designated to solve these types of issues has not intervened appropriately.

However, SEPA does not end with the harmonisation of credit transfers and direct debits. The focus is progressively shifting to payment cards, mobile and electronic payments, and instant payments.

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[65] Recently Czech Republic, Denmark, Estonia, Ireland, Latvia, Lithuania, Hungary, Malta, the Netherlands, Slovakia, Sweden, the United Kingdom and Norway.

[66] Regulation (EU) No 260/2012

5.7. Transposition of the Payment Accounts Directive

The Payment Accounts Directive[67] tackles three areas: the transparency and comparability of payment account fees, switching between payment accounts and access to a basic payment account.

As regards the transparency and comparability of payment account fees, the directive will make it easier for consumers to compare the fees charged for payment accounts by payment service providers in the EU through standardised terminology and information documents. Member States will also ensure that at least one comparison website is available at national level.

Furthermore, the directive will establish a simple and quick procedure for consumers who wish to switch their payment account from one to another payment service provider within the same Member State. It will also provide some assistance to consumers who open an account cross-border.

Lastly, the directive will give all EU consumers the right to access to basic banking services, provided that they comply with anti-money laundering requirements. These basic banking services must be provided free of charge or at a reasonable cost, and must enable people to perform everyday transactions such as withdrawing cash, receiving a salary and making payments (including online) using a payment card. All Member States must ensure that all, or a sufficient number of, credit institutions provide these basic bank services within the country.

The three areas are closely inter-related. The measures on the comparability of account fees allow consumers to have a complete overview of the offers on the market, and the measures on switching make it easy for them to change their account if a better offer is available. All these elements aim to boost competition in the financial services market to the benefit of consumers. However, to guarantee that as many consumers as possible can really benefit from these improvements, it is essential to ensure that every EU citizen has the right to basic payment account services.

Member States must enact the Payment Accounts Directive in their national law by 18 September 2016. Member States started the transposition process and have been supported by the Commission, mainly through transposition workshops held in October 2014, June 2015 and January 2016.

6. EU CONTRIBUTION TO GLOBAL DEVELOPMENTS ON CAPITAL MOVEMENTS AND PAYMENTS

6.1. Investment protection agreements with non-EU countries

6.1.1. Free trade agreements and stand-alone investment agreements

The EU started to devise a common international investment policy following the entry into force of the Treaty of Lisbon. Article 207 TFEU gives the EU exclusive competence for foreign direct investment under the common commercial policy.

[67] Directive 2014/92/EU.

In this context, the Commission started negotiations on investment with a number of non-EU countries, either as part of free trade agreements or in stand-alone investment agreements.

Negotiations on free trade agreements with investment protection rules were concluded with Canada in September 2014, with Singapore in October 2014 and with Vietnam in December 2015.

Negotiations are ongoing with:

- Japan (14th round in December 2015);
- the US (transatlantic trade and investment partnership — 11th round in October 2015, but without substantial discussions on investment protection);
- China (stand-alone investment agreement — 8th round in December 2015);
- Morocco (4th round in April 2014);
- Myanmar (3rd round in September 2015);
- Tunisia (1st round in October 2015).

The Commission has received authorisations from the Council to start a similar process with Egypt and Jordan, but these negotiations have not yet started.

In international practice, investment protection provisions typically cover a number of standards on issues such as:

- non-discrimination;
- free transfer;
- fair and equitable treatment and expropriation;
- the possibility of dispute resolution between investors and states.

Some of these provisions have raised concerns in the past, in particular over states' right to regulate. The Commission has taken steps to address these concerns.

The Commission has carried out a public consultation over the approach to investment taken in the transatlantic trade and investment partnership. Based on the results of the consultation, the Commission has started work on a possible reform in four areas:

- right to regulate;
- establishment and functioning of arbitral tribunals;
- the relationship between domestic judicial systems and investor-state dispute settlement (ISDS);
- review of ISDS decisions.

In order to address the concerns raised, the Commission presented a concept paper in May 2015, followed by a proposal for a new negotiation text in September 2015. The aim is to safeguard the EU’s and Member States’ right to regulate and to set up a new investment court system composed of qualified judges and including an appeal tribunal.

The new negotiation text will become part of the EU’s proposal to the US. The Commission will also seek to include similar provisions in current and future negotiations. In February 2016 an agreement was reached with Canada to include the new approach on investment protection and investment dispute settlement in the EU-Canada Comprehensive Economic and Trade Agreement ('CETA').

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

The EU's comprehensive investment policy will be introduced progressively through investment protection negotiations which will gradually replace the Member States’ relevant bilateral investment agreements with the non-EU countries in question. For non-EU countries for which no immediate EU-wide investment negotiations are scheduled, the Regulation[68] on transitional arrangements establishes a mechanism for empowering Member States — under certain conditions — to negotiate BITs.

Under the Regulation, Member States must ask for an authorisation to negotiate, sign or maintain post-Lisbon BITs. New notifications of the opening of negotiations with non-EU countries are submitted on a continuous basis and are assessed by the Commission to determine whether they are compatible with EU law and consistent with EU investment policy. Authorisations are granted in consultation with Member States through a committee procedure.

6.2. International organisations and fora

6.2.1. Free movement of capital in the OECD

The OECD has continued to coordinate policies helping governments to keep markets open while they develop effective policies to respond to genuine concerns raised by international capital flows and investment. The Commission has actively contributed to this work and in particular has supported the enforcement of the OECD codes of liberalisation of capital movements and current invisible operations, which is done through a dedicated advisory task force.

The codes were agreed in the early 1960s, but they are a living and open instrument. With this in mind, in 2015 the OECD investment committee tasked the OECD advisory task force with launching a review of the codes. The review is intended to assess whether the codes have served their purpose and to take into account the changes in the financial system and new associated risks since the last review in the 1990s. The members of the task force, which include governmental experts from OECD members and the Commission,[69] agree that a review will not necessarily lead to a revision of the codes and should not weaken the degree of liberalisation they offer.

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[68] Regulation (EU) No1219/2012

[69] In addition to government experts from OECD members, the task force is open to government experts from non-OECD G20 and Financial Stability Board members and other interested non-members, as well as experts from the IMF and other relevant international organisations such as the ECB.

In July 2015, the OECD also adopted new recommendations on principles of corporate governance and on guidelines on corporate governance of state-owned enterprises (SOEs).

The 2015 guidelines complement and modernise the principles set out in the 2005 guidelines. They offer an international standard to help governments professionalise their state ownership practices, strengthen accountability for SOE performance and maintain a level playing field when state-owned and private companies compete in the commercial marketplace. The guidelines also help to maximise SOE contributions to economic growth and development.

The principles of corporate governance are intended to help policymakers evaluate and improve the legal, regulatory and institutional framework for corporate governance, which in turn will support economic efficiency, sustainable growth and financial stability. The principles were endorsed by the G20 at the 15-16 November 2015 summit as a tool to help ensure a strong corporate governance framework that will support private investment.

6.2.2. The financial action task force

The Commission actively participates in the work of the financial action task force (FATF) on anti-money laundering and preventing terrorist financing. The FATF’s fourth round of peer reviews, which is proceeding at a fast pace, discussed the first few reports, including the reports on Norway, Spain, Belgium and Italy. The FATF regularly issues an updated public statement listing the jurisdictions with high money laundering/ terrorist financing risks. The most recent update was in October 2015. It expressed in particular concern over the financing generated by and provided to the terrorist group the Islamic State of Iraq and the Levant (ISIL).

Answering the calls of the JHA Council and of the ECOFIN Council, on 2 February 2016, the Commission adopted an Action Plan to strengthen the fight against the financing of terrorism. The Action plan focuses on tracing terrorists' financial movements, preventing them from moving funds or other assets, and on disrupting the sources of revenue used by terrorist organisations. According to the Action plan, the Commission services will prepare amendments to the Fourth Anti-Money Laundering Directive by the end of the second quarter of 2016, targeting virtual currencies and anonymous prepaid cards, enhancing the powers of EU Financial Intelligence Units and ensuring they have faster access to information on the holders of bank and payment accounts. The Commission services will also aim at further coordinating the enhanced measures to be applied in case of transactions involving high risk third countries. The plan also includes measures to improve the efficiency of the EU's transposition of UN asset freezing measures, to limit risks linked to cash payments and to assess the need for additional measures to track terrorism financing.

Furthermore, on 2 December 2015, the Commission adopted two important measures: a proposal for a Directive on terrorism, which will strengthen the EU's arsenal in preventing terrorist attacks by criminalizing preparatory acts such as training and travel abroad for terrorist purposes as well as aiding or abetting, inciting and attempting terrorist acts, and the financing of the various terrorist offences; an Action Plan to step up the fight against criminals and terrorists from accessing firearms and explosives through a reinforced control of illicit detention and import to the EU.

6.2.3. International forum of sovereign wealth funds

According to UNCTAD, between 15 and 25 % of listed companies in the EU have sovereign wealth fund (SWF) shareholders. With respect to FDI, at the end of 2013, about 43 % of the cumulative SWF investment was in the EU. However, FDI by SWFs (USD 40 billion, — worldwide total for 2013) remains a very small fraction of their portfolios.

The Commission participated as an observer in the seventh annual meeting of the International Forum of Sovereign Wealth Funds (IFSWF) held between 29 September – — and 1 October 2015. The event, which was hosted by the Italian *Fondo Strategico Italiano* in Milan, and began by a focus on:

- the Investment Plan for Europe (presented by the Commission and the European Investment Bank);
- the relationship between Sovereign Wealth Funds and external asset managers and;
- the importance of SWFs as countercyclical and responsible institutional investors.

IFSWF members welcomed the Investment Plan for Europe and recognised it as a step forward in addressing the investment gap in the EU.

6.3. Economic and financial sanctions

The possibility of applying economic and financial restrictive measures in relation to non-EU countries is one of the general exceptions to the free movement of capital and payments. In particular, Article 75 TFEU provides for the possibility of economic and financial administrative measures against individuals, groups or non-state entities to prevent and combat terrorism. Under Article 215 TFEU, economic and financial restrictive measures may be taken against non-EU countries, or individuals, groups or non-state entities, based on decisions adopted under the common foreign and security policy. Restrictive measures are in force across the EU with respect to terrorist organisations such as Al Qaida. Measures include the freezing of assets and embargoes on providing arms, related material and certain services. Restrictive measures such as these are essential to the EU’s common foreign and security policy.

The most prominent of the EU's existing sanctions regimes during the reporting period were those relating to Iran and Russia. An international settlement decided in Vienna on 14 July 2015 — the Joint Comprehensive Plan of Action (JCPOA)[70] — has resulted in an agreement with Iran to suspend a number of EU sanctions as part of a long-term process towards removing UN and Western sanctions in exchange for Iranian cooperation and cessation of its nuclear-related activities.

The EU’s restrictive measures in relation to Russia, first introduced on 31 July 2014 in response to the illegal annexation of Crimea and ongoing destabilisation of Ukraine, include bans targeting Russian interests in the financial, oil and defence sectors. The

[70] This was negotiated with Iran by the ‘E3/EU+3’ (China, France, Germany, the Russian Federation, the United Kingdom and the United States, with the High Representative of the European Union for Foreign Affairs and Security Policy).

EU's restrictive financial measures[71] aim to cut off strategic state-owned Russian companies from EU and international financing sources, thus imposing an indirect financial cost on the Russian state. In addition, the Regulation[72] imposing sanctions on Russia prohibits exports from the EU of sensitive technologies or providing related services to Russian entities for the development of oil projects in the Arctic, prohibits exports of dual-use goods to military end-users and imposes an arms embargo.

In March 2015, the European Council linked the lifting of EU sanctions to the implementation of the Minsk peace agreements. On 21 December 2015, the Council prolonged EU economic sanctions against Russia until 31 July 2016, before which time the Council will review the situation in Ukraine.

7. CONCLUSION

This Commission staff working document shows that the recovery of capital flows in the EU is still weaker than in other world regions. The EU, however, became a net importer of capital in the most recent period. There is still less financial integration between EU countries than there was before the crisis.

This economic context strengthens the need for prompt implementation of the Investment Plan for Europe, which should be based on effective free movement of capital and freedom of payments, underpinning a well-functioning single market for capital.

This is also the aim of the action plan for a capital markets union which was presented by the Commission on 30 September 2015 as part of the Investment Plan for Europe. Overall, the 33 actions in the plan should boost cross-border capital flows by providing a greater choice of funding for Europe’s businesses and SMEs, an appropriate regulatory environment for investment in Europe’s infrastructure, increased investment and choice for retail and institutional investors and enhanced bank lending, for instance through the proposals for legislation on simpler, transparent and standardised European securitisation.

2015 also saw a number of important policy initiatives supporting the free movement of capital and freedom of payments. Infringement proceedings were launched to terminate Member States’ intra-EU BITs with a view to making sure that cross-border EU investors are subject to the same rules in the single market and enjoy similar protection under EU rules. The Green Paper on retail financial services launched a consultation process that should lead to a stronger single market for consumers and for payments, as should the adoption of the legislative package for an EU-wide market for electronic payments. A number of initiatives were taken in the field of taxation, contributing to more integrated capital markets. Finally, Cyprus took the decision to remove existing capital controls with no side-effects on financial stability.

[71] The financial services measures in relation to Russia list five banks, three oil companies and three defence companies, their non-EU subsidiaries and entities acting on their behalf or at their direction. The measures prohibit people in the EU from dealing in any way with transferable securities or money market instruments issued by the targeted entities with a maturity exceeding 30 days and from providing new loans or credit to them with a maturity exceeding 30 days, except where these are to finance non-prohibited EU trade.

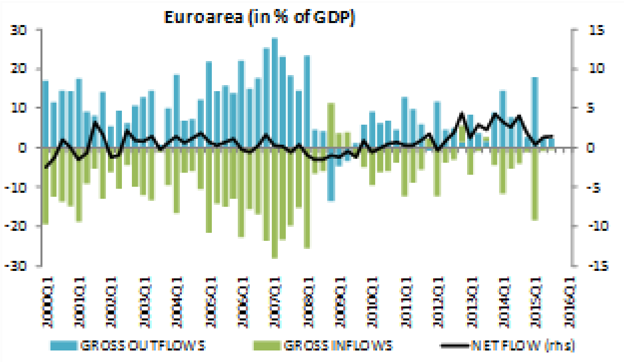
[72] Council Regulation (EU) No 833/2014 amended by Council Regulation (EU) No 960/2014, Council Regulation (EU) No 1290/2014 and Council Regulation (EU) 2015/1797

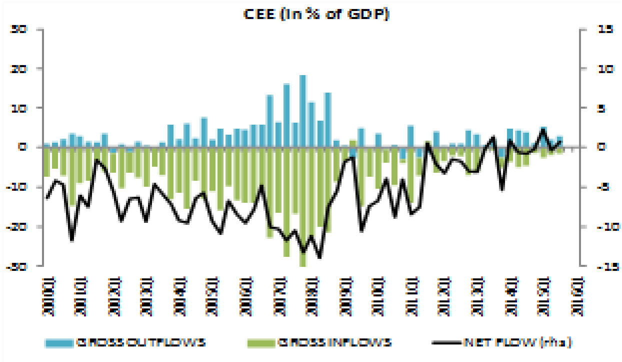
Alongside these key initiatives, the free movement of capital in the EU was ensured through appropriate micro- and macro-surveillance of the financial sector, monitoring of national laws in particular in specific sectors (such as the acquisition of agricultural land, where the rights of cross-border investors should not be unduly restricted), the related launch of infringement proceedings where necessary, and work with Member States to ensure EU rules are transposed effectively (e.g. for the Payment Accounts Directive).

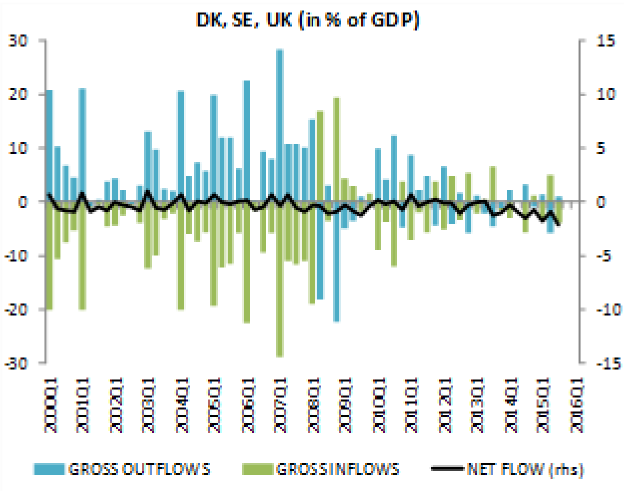
Since the free movement of capital is the only single market freedom that also applies to non-EU countries, it is essential that initiatives taken to promote cross-border capital flows within the EU go together with initiatives aimed at attracting capital from outside the EU. In 2015, as part of the transatlantic trade and investment partnership (TTIP) negotiations, the Commission proposed a new investment court system that would replace the existing ISDS in all ongoing and future EU investment negotiations. This would further improve investment agreements with non-EU countries, which, together with work in international organisations (such as the OECD) and fora (such as the International Forum of Sovereign Wealth Funds), have an important contribution to make to attracting foreign investment to Europe.

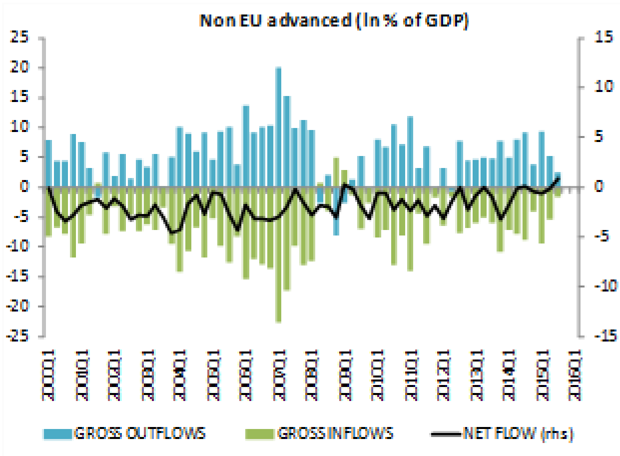
ANNEX I

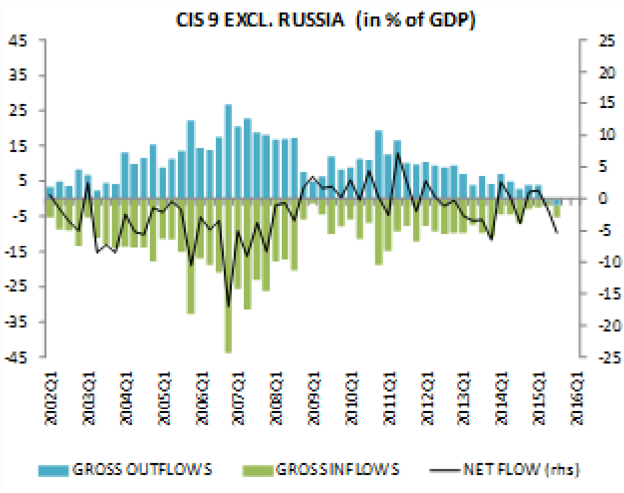
Gross and net capital flows in the world (per cent of GDP)

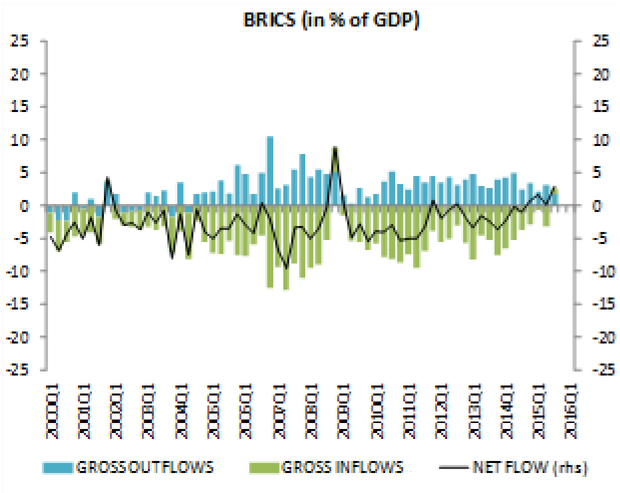


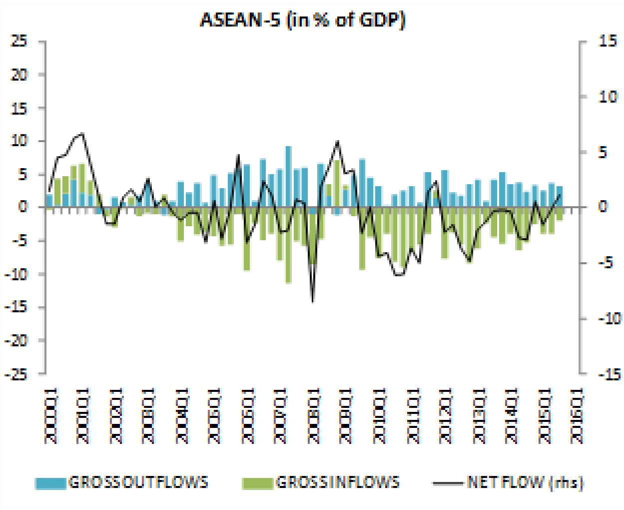


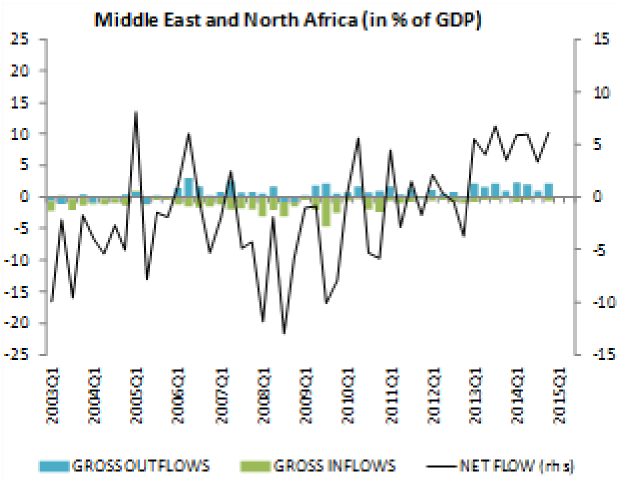


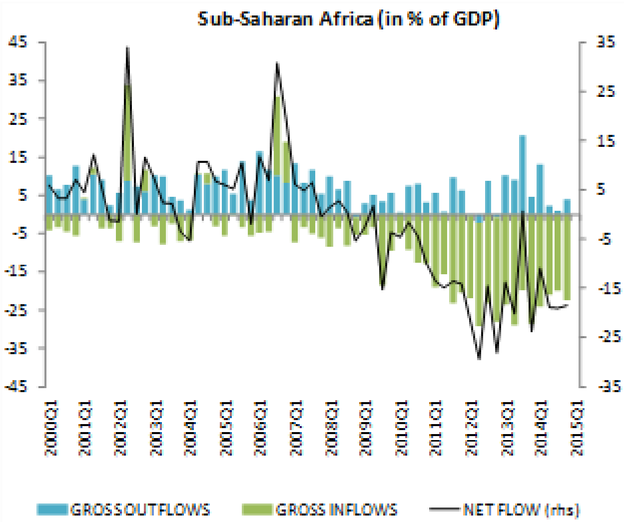


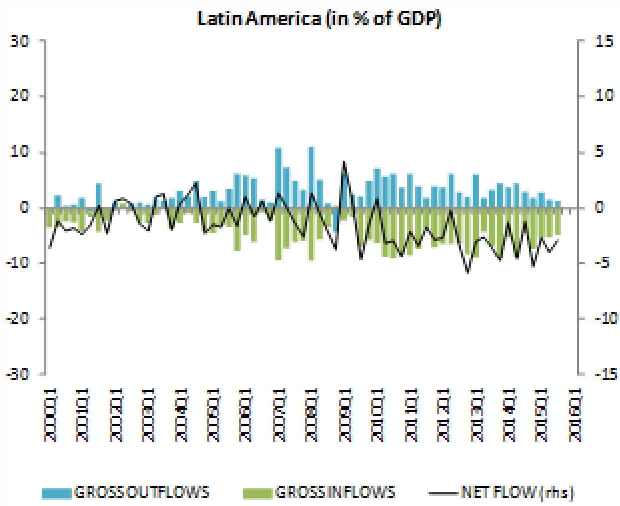


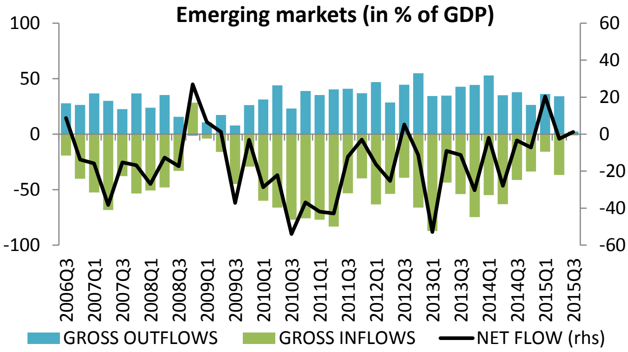








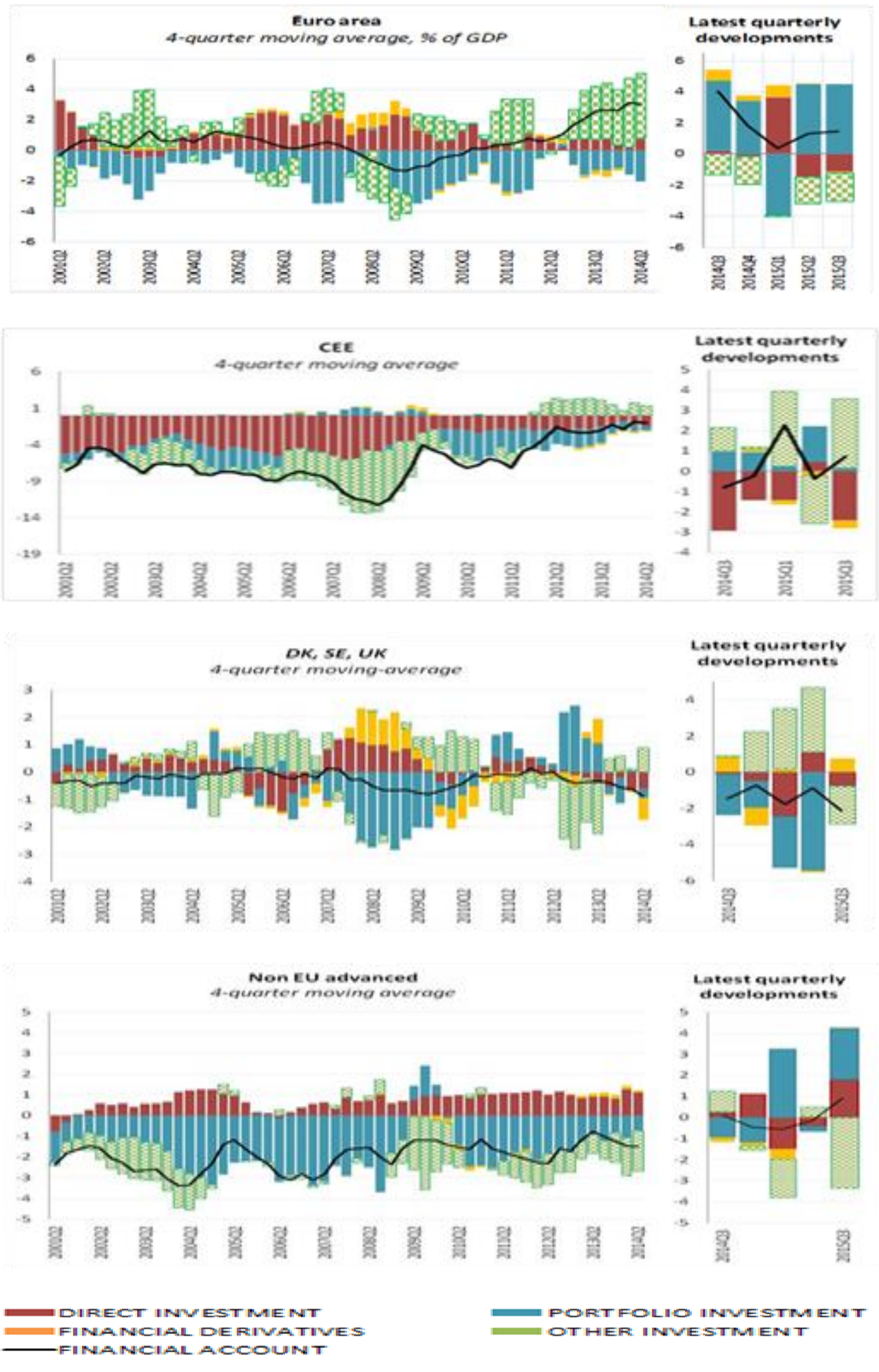




Source: IMF IFS (quarterly capital flows); WEO (annual GDP). *Note*: The country groups are as follows: EU countries – including bilateral **euro area** = EA 19; other EU-3 = United Kingdom, Sweden, Denmark; **CEE 6** = Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania, data for Bulgaria – as of Q2 2015; **non-EU advanced** = Canada, Japan, United States, Australia, Hong Kong, Iceland, Israel, Korea, New Zealand, Norway, Switzerland, data for Canada, Norway and Switzerland – as of Q2 2015; **BRICS** = Brazil, Russia, India, China, South Africa, data for India as of Q2 2015; **CIS 9** (excl. Russia) = Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Ukraine; **Latin America** = Argentina, Bolivia, Chile, Costa Rica, Colombia, El Salvador, Guatemala, Panama, Venezuela, Mexico, Uruguay; **Middle East and North Africa** = Jordan, Lebanon, Morocco, Saudi Arabia, Yemen; **Sub-Saharan Africa** = Cabo Verde, Lesotho, Mozambique, Namibia; **ASEAN-5** = Indonesia, Philippines, Thailand, Vietnam, Malaysia (until 2010). **Emeging markets** = 22 of the 23 countries included in the MSCI emerging market index, excluding the United Arab Emirates, data for Malaysia and India – as of Q2 2015, data for Peru – as of Q1 2015, data for Egypt – as of Q4 2014.
Gross inflows/outflows are calculated as the sum of the liabilities/assets of the following instruments: direct investment, portfolio investment and other investment, where gross inflows are reported with a negative sign. Net flow is the net financial account excluding reserves and financial derivatives.

ANNEX II

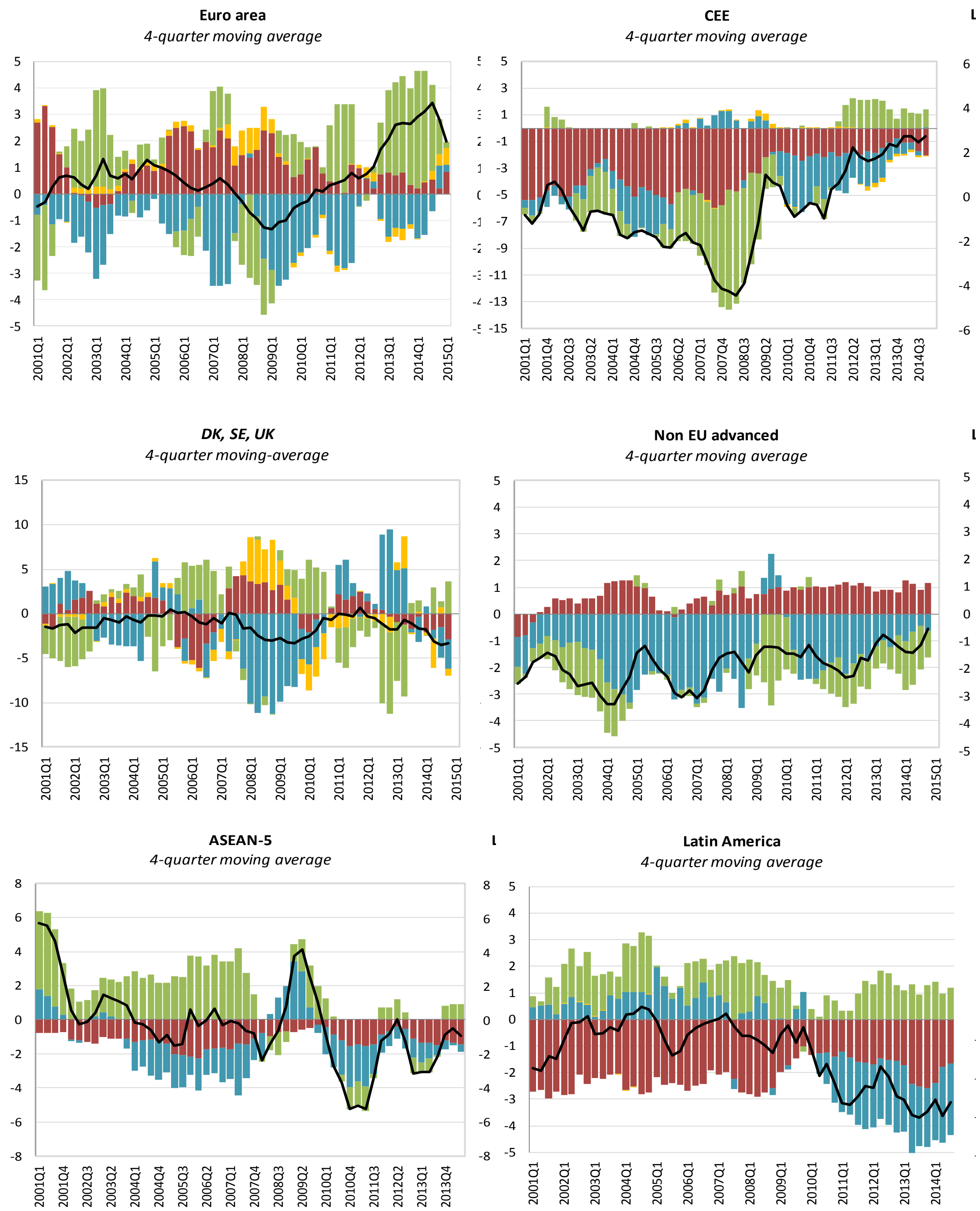
Composition of net capital flows in the world (in per cent of GDP)

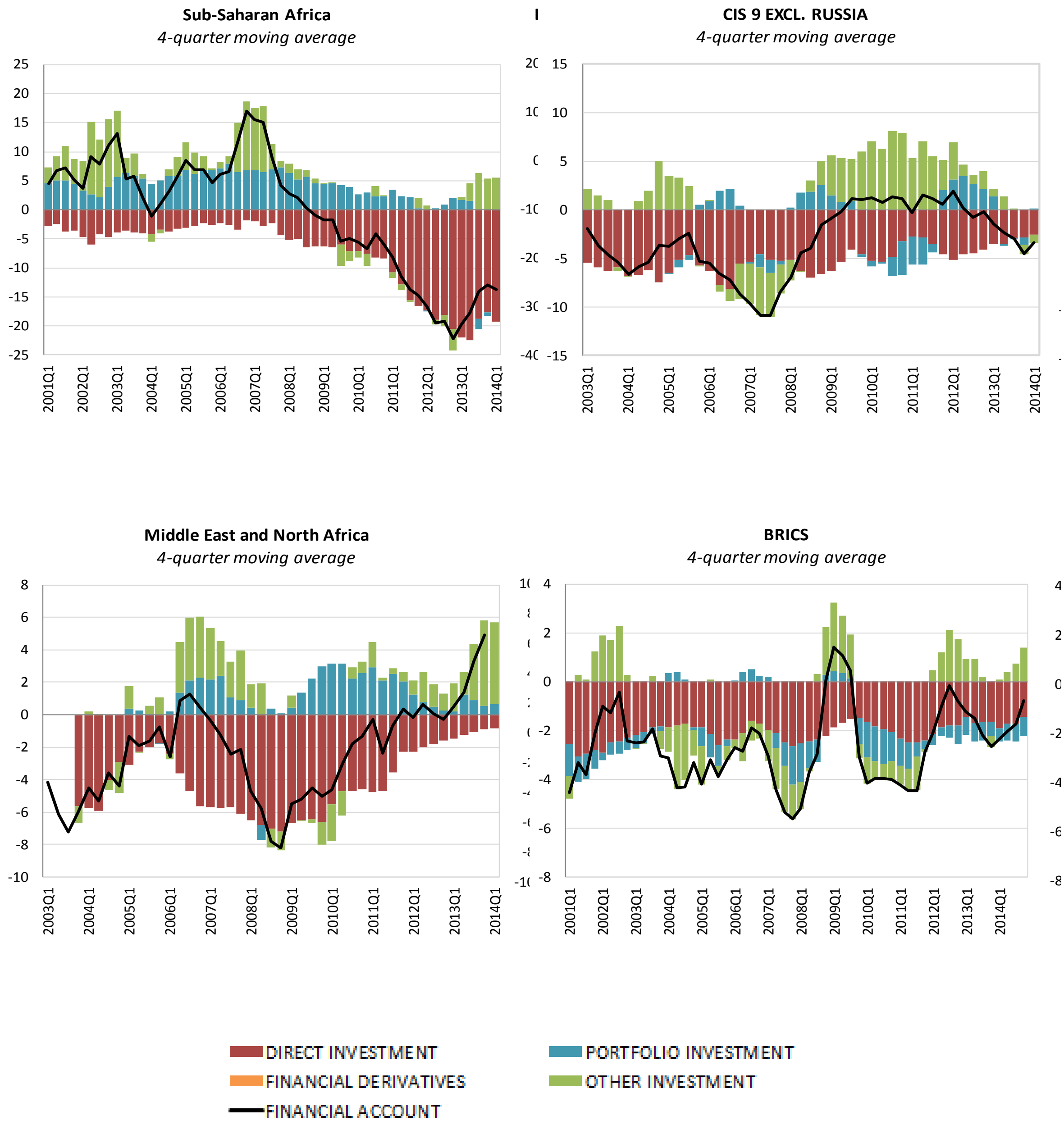


Source: IMF IFS (quarterly capital flows) and WEO (annual GDP); *Note*: see the definition of the country groups in the note to Chart 2.

Composition of net capital flows in the world (in per cent of GDP)

– 4-period moving averages





Source: IMF IFS (quarterly capital flows) and WEO (annual GDP); *Note*: see the definition of the country groups in the note to Chart 2.

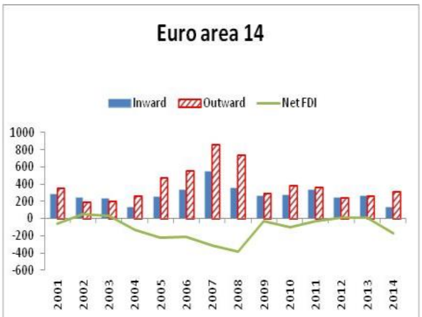
ANNEX III

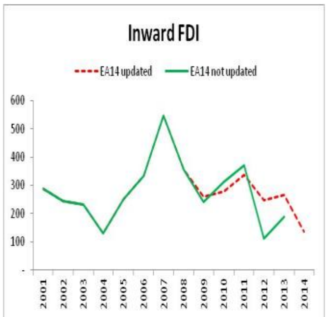
FDI flows by group of EU Member States, 2001-2014, $ billions

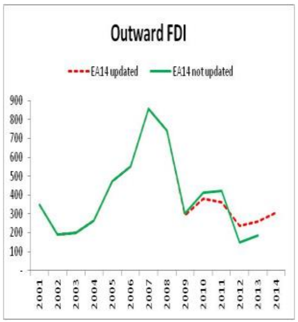
Panel A, FDI flows

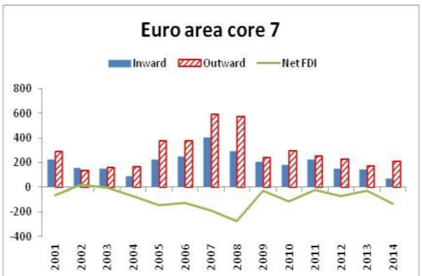
Panel B, 2015 update of inward FDI

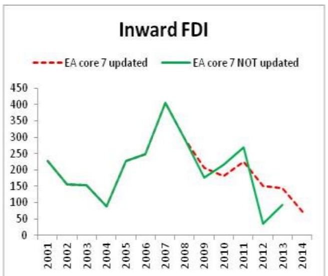
Panel C, 2015 update of outward FDI

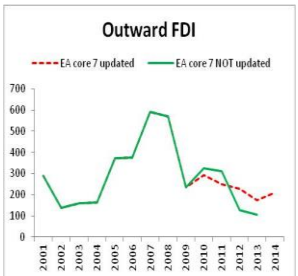


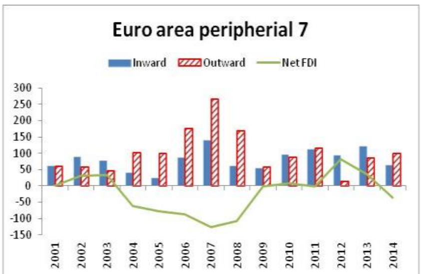


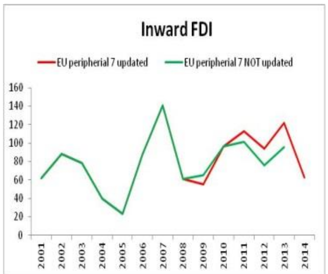


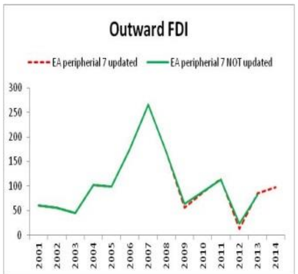


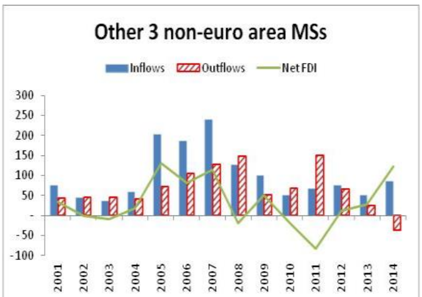


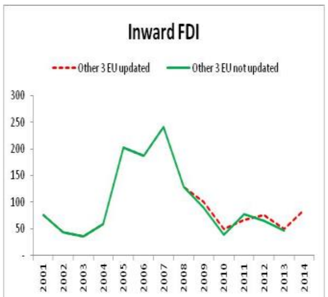


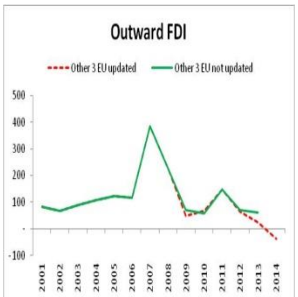


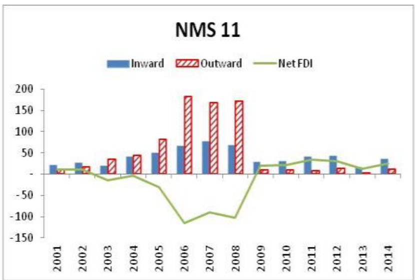


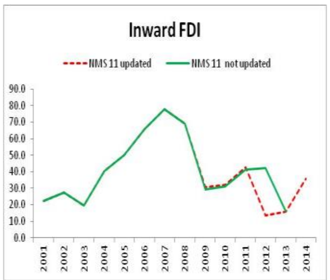


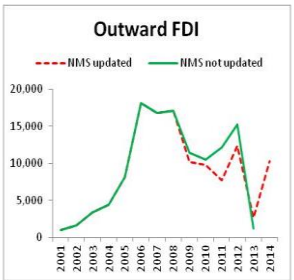












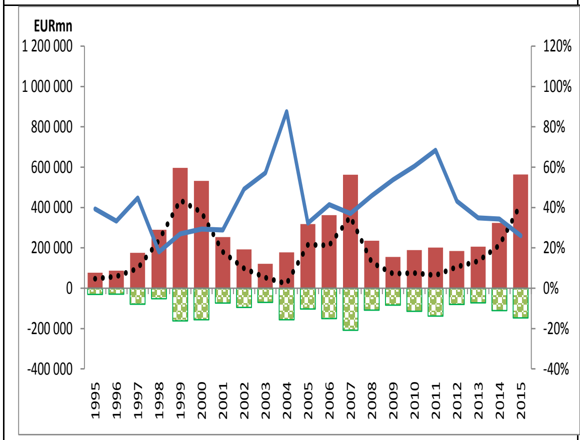
Source: Authors calculations based on UNCTAD, WIR 2015 (for the *updated* series) and WIR 2014 (for the *not updates* series from the previous 2014 vintage of data).

ANNEX IV

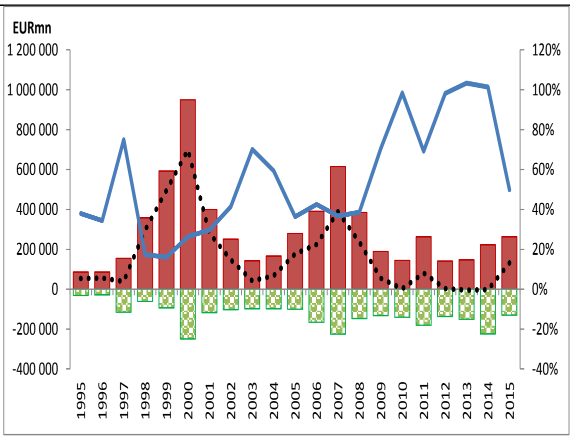
Trends in cross-border mergers and acquisitions and international divestment

International Divestment
International M&As
Net cross-border deals
Share of Int. Div. in Int. M&As (right axis)

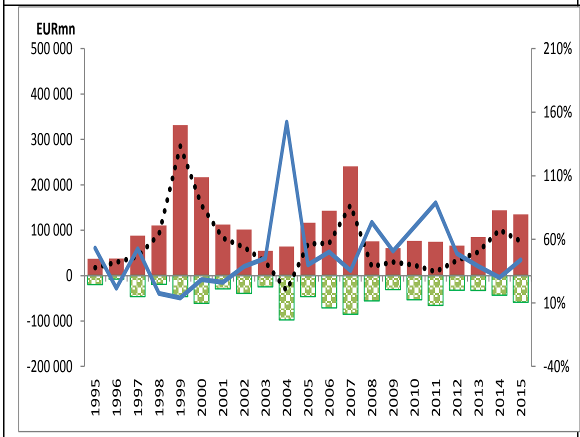
European Union – Inward*



European Union – Outward*



Euro Area Core 7 – Inbound*



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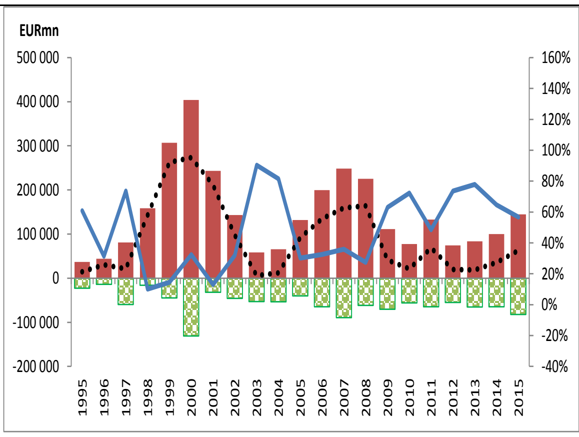
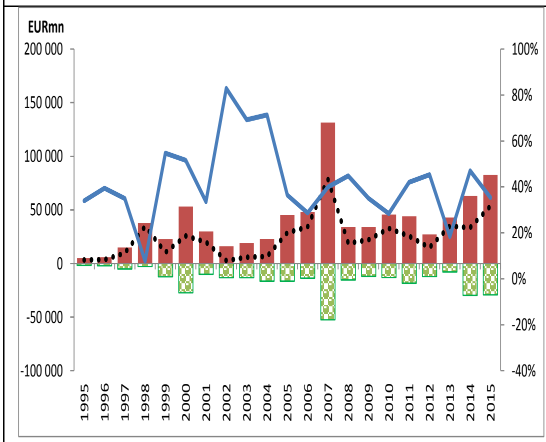
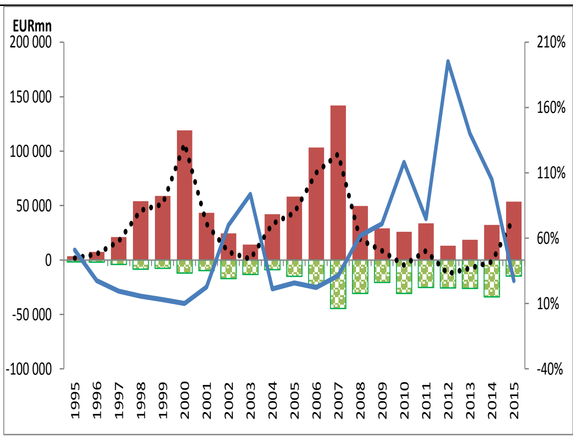
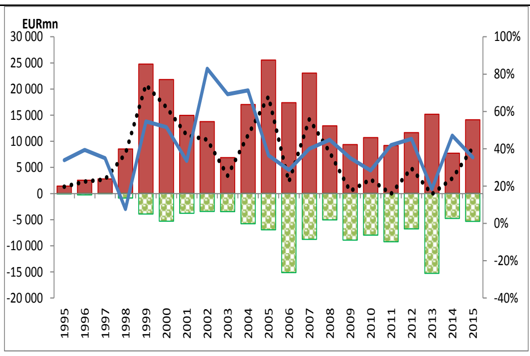
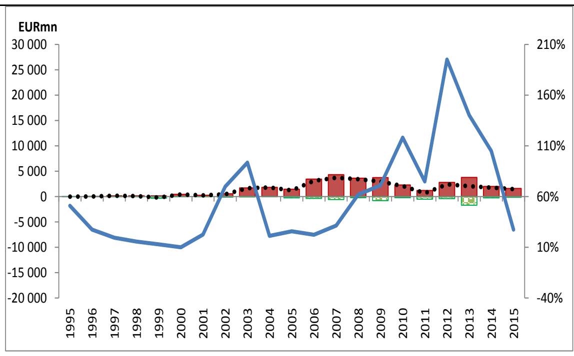


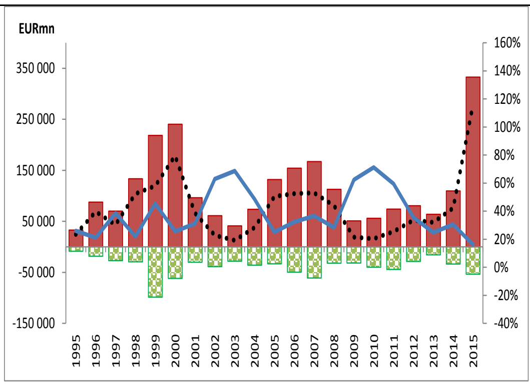
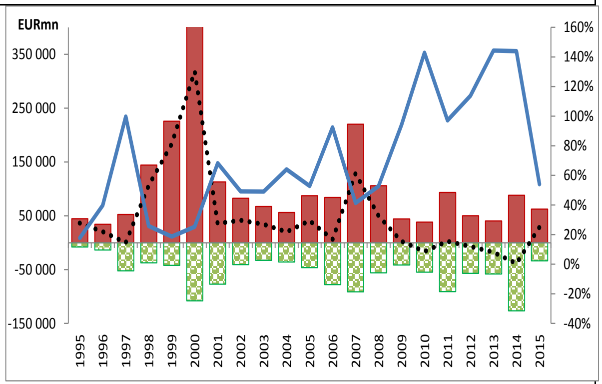
Euro Area Peripheral 7 – Inbound*

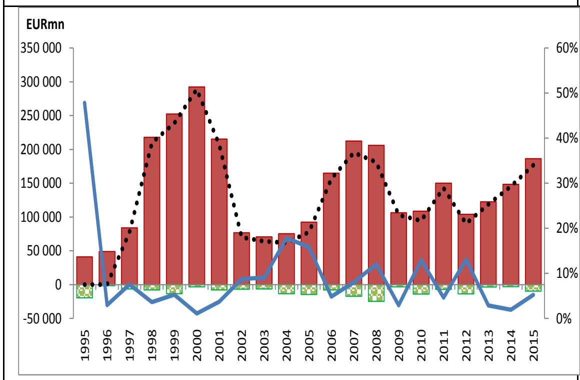
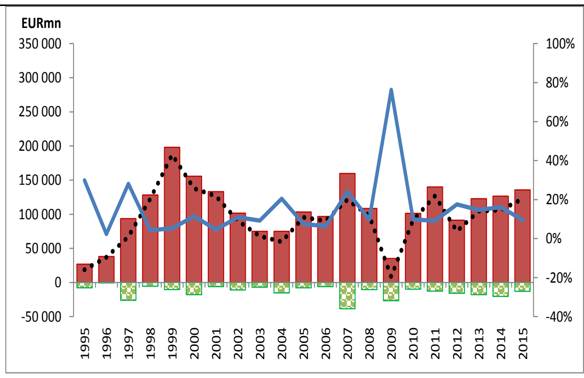


Euro Area Peripheral 7 – Outbound*



New Member States 11 – Inbound*	New Member States 11 – Outbound*
	

Denmark, Sweden and UK – Inbound*	Denmark, Sweden and UK – Outbound*
	

US- Inbound	US - Outbound
	

Source: Dealogic M&A Analytics database, Commission services calculations. *Notes*: *Figures for EU Member States include bilateral flows within the EU, **Deals with final acquired or sold stakes higher than 10%, rank eligible deals only.

”***Inward international M&A***” – all transactions in which the target compagny is located in the region in question, while the acquirer is located outside of this region.

“***Inward international divestment***” – all transactions in which the target compagny is located in the region in question, while the divestor is located outside of this region.

“***Outward international M&A***” – all transactions in which the target compagny is located outside of the region in question, while the acquirer is located inside this region.

“***Outward international divestment***” – all transactions in which the target compagny is located outside of the region in question, while the divestor is located inside this region.