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COMMISSION STAFF WORKING DOCUMENT

on the free movement of capital in the EU

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1. INTRODUCTION

Openness to capital movements is an important driver of economic growth in the EU. By moving freely across borders capital flows can allocate resources more efficiently. Free capital movements have enabled European citizens to diversify their portfolios and thereby optimise their saving and investment decisions. They can do so by carrying out transactions abroad, such as opening bank accounts, buying shares in non-domestic companies, investing where the best return is and purchasing real estate.

In particular, inward foreign direct investment (FDI) has positive effects on economic growth in the EU, due to the expansion of productive capacity, job creation, human capital enhancement, innovation and technology diffusion, and enterprise development. All of these contribute to the increase in income and wealth. Most evidence shows that the benefits of inward FDI on the growth of the receiving economy do not depend on the mode of entry and are of similar importance in the case of both greenfield investment[1] and mergers and acquisitions (M&As).[2] FDI can also contribute to the strengthening of the social economy in a competitive market, by spreading responsible business conduct rules among companies and by channelling resources towards 'impact investment' and social entrepreneurship.

Outward FDI can also be beneficial to the EU. EU firms invest abroad to improve access to foreign markets and to fully exploit the opportunities offered by those markets. Another motivation that prompts EU companies to invest abroad is to acquire resources that are not available in their domestic market or that are available at a lower cost elsewhere. They may also aim at acquiring specific types of assets, such as new technologies. Outward FDI can contribute to increasing EU exports and benefit intra-EU investment because of the positive impact on firm profitability. Outward investment can also generate positive spill-overs from technology sourcing investments.

The financial and economic crisis has had a significant negative impact on global flows of financial resources. The retrenchment in capital flows occurred mainly because of the increased risk aversion of investors, due to an abrupt drop in confidence. This was in marked contrast with pre-crisis years that had seen rising unfettered financial globalisation, driven in part by the removal of restrictions on international capital mobility.

Over the years, the EU has benefited greatly from capital movements, having been traditionally among the main recipients and senders of financial resources. However, the slump in capital flows caused by the crisis has hit the EU hard, as was the case for several other important economies including the United States. These recent developments call for an analysis of the Single Market's potential to continue attracting investment both from within the EU and from third countries.

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[1] Greenfield investment involves the establishment of new enterprises by direct investors.

[2] OECD (2008), 'Economic and Other Impacts of Foreign Corporate Takeovers in OECD Countries', in: *International Investment Perspectives 2007: Freedom of Investment in a Changing World* (pp. 65-91), Paris: OECD Publishing.

Capital flows can also pose risks. They can be volatile and may be large relative to the size of a country's financial markets or economy. Against this background, at the October 2011 Cannes Summit G20 Leaders agreed on a set of coherent conclusions to serve as a guide in the management of capital flows and called on the IMF to regularly monitor cross-border capital flows and their transmission channels as well as capital flow management measures applied by countries.[3] In December 2012, the IMF adopted an "institutional view" that acknowledges the need for a balanced approach for the management of capital flows, while reaffirming the primacy of sound macroeconomic policies, financial supervision and regulation, as well as strong institutions.[4] The IMF plans to develop operational guidance to integrate this view in its work.

The Treaty on the Functioning of the European Union (TFEU) explicitly recognises the importance of the free movement of capital and underlines the need to take stock of developments in this area regularly and to give an outlook for the future. This working document reflects the latest assessment made by the Economic and Financial Committee (EFC) of the Council of the EU on capital movements and freedom of payments, as required under Article 134 TFEU. It covers developments concerning the free movement of capital mainly in 2011, although where possible the period up to mid-2012 is also covered.

This working document is designed to give a transparent stock-taking on an annual basis. On substance, it draws largely from input provided by the Commission services. This includes empirical evidence on, and analyses of, capital flows within the EU and worldwide. It also provides information drawn from ongoing monitoring of developments in capital movements and investment in the Member States and from the handling of stakeholder complaints.[5]

This paper analyses recent developments in capital flows in the EU. It focuses on different categories of capital movements, in particular on foreign direct investment (including greenfield FDI and M&As) and portfolio investment. The performance of intra-EU flows, inflows into the EU and outflows from the EU is reviewed and compared with trends in global flows and with capital movements to and from a selection of individual countries. This document also examines the functioning of the Single Market for capital and its current legal framework and explains the action the Commission has taken to address the problems. While concentrating mainly on the Single Market, the document also appraises the external dimension of capital movements in the context of ongoing policy debates on systemic financial risks at the global level.

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[3] G20, *Cannes Summit Final Declaration. Building Our Common Future: Renewed Collective Action for the Benefit of All*, October 2011, paragraphs 10 and 18.

[4] International Monetary Fund (2012), *'The Liberalisation and Management of Capital Flows: An Institutional View', IMF Staff Paper*.

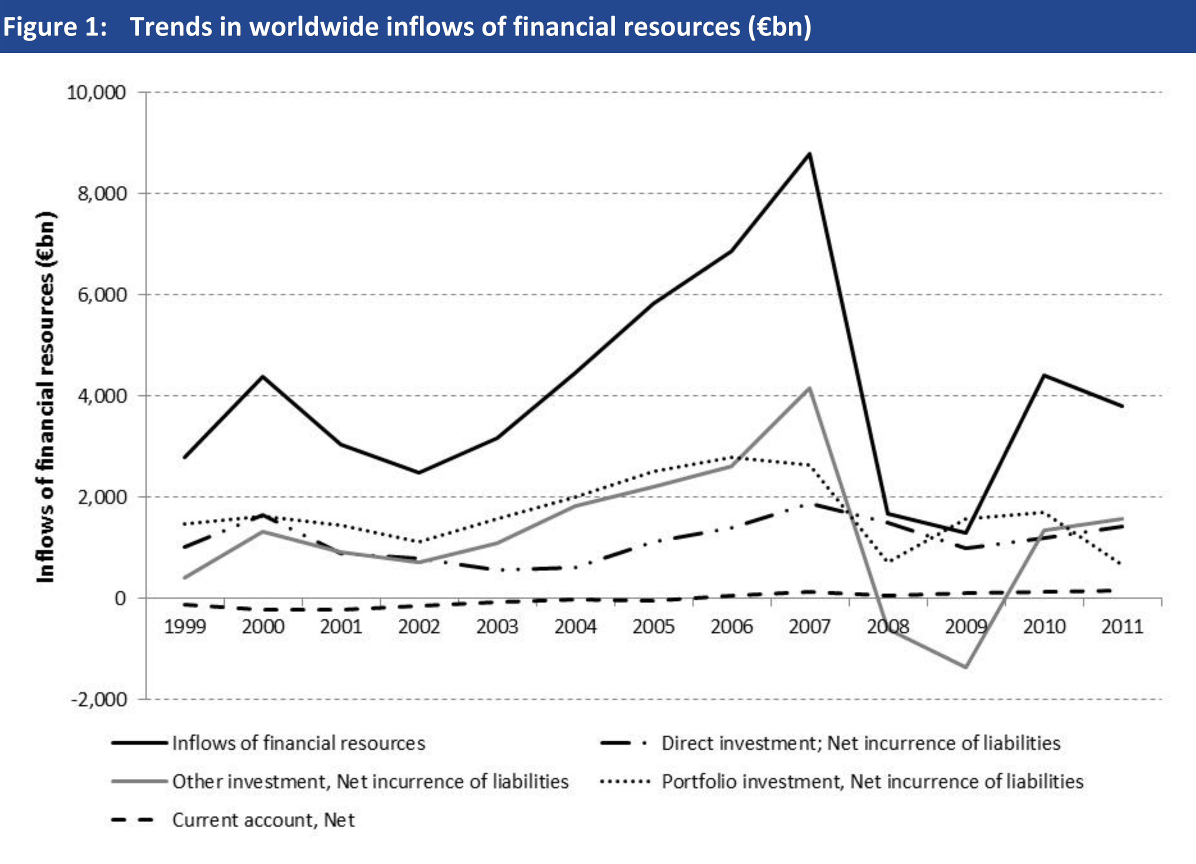
[5] Statistics on capital movements and the related analyses come mainly from a study carried out for the European Commission by London Economics: '*Analysis of developments in the field of direct investment and M&A'*. The study is available at: www.ec.europa.eu/internal_market/capital/reports

2. DEVELOPMENTS IN EU CAPITAL FLOWS

2.1. Recovery of capital flows, but some challenges lie ahead

The aggregate impact of the financial crisis may be gauged by the large drop in international inflows of capital between 2007 and 2008. The decrease in investment flows can be explained largely by the sudden liquidity drought in the financial system that marked the first months of the crisis. On a proportionate basis the EU27 and other high-income economies experienced declines of 89 % and 91 % respectively. However, starting in 2009 both the EU27 and other high-income economies showed signs of recovery, as inflows of financial resources increased more than threefold. Following a pick-up in 2010, total international capital flows (including FDI and portfolio flows) declined by 15 % in 2011, reaching just under €4 trillion (Figure 1). This decline was due in large part to the slowdown in private sector portfolio flows, whereas global FDI continued to recover and increased by 10.9 % to €1.1 trillion.[6]

Figure 1: Trends in worldwide inflows of financial resources (€bn)



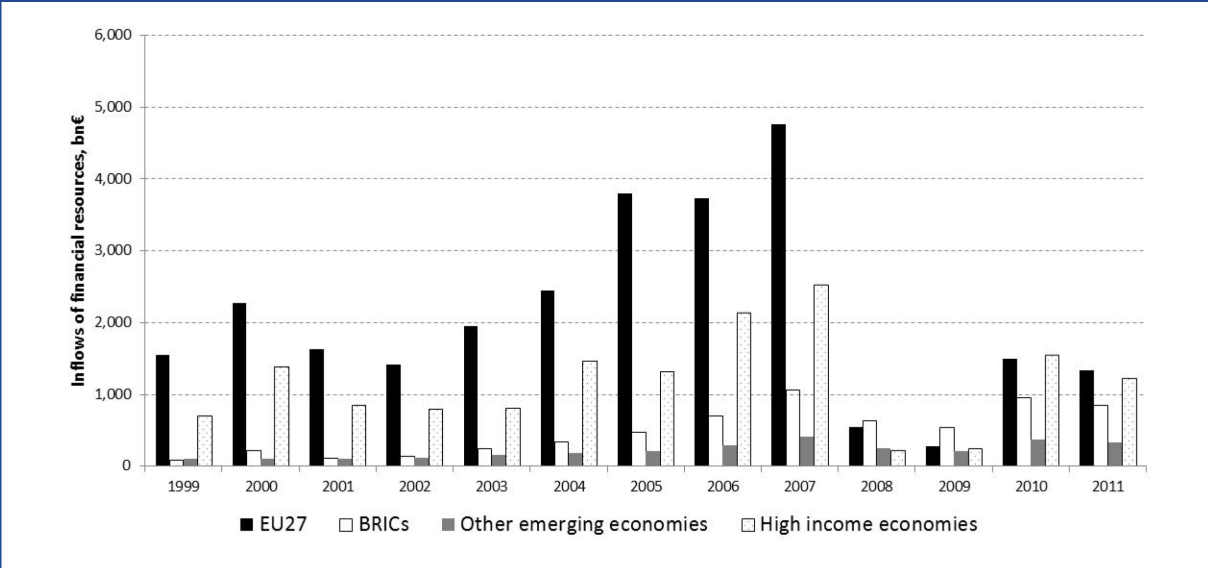
Note: 'Inflows of financial resources' = 'Current Account, Net' + 'Direct Investment, Net incurrence of liabilities' + 'Portfolio Investment (Excluding Financial Derivatives), Net incurrence of liabilities' + 'Other Investment, Net incurrence of liabilities'. Other investments include capital flows into bank accounts or as loans. Original data in US$ converted to € using annual €/US$ exchange rate available from Eurostat.

Source: IMF Balance of Payments Statistics and Eurostat

[6] FDI has different sources and drivers than portfolio investment, therefore it is to be expected that the two categories of investment behave differently.

The evidence points to a shift in capital flows to the BRICs[7] and to other emerging economies in the post-crisis period, mirroring a relative decline of flows into high-income economies, and in particular into the EU (Figure 2). This trend was driven mainly by current account surpluses (meaning that the BRICs as a whole are net creditors vis-à-vis the rest of the world) but also by direct investment flows, which in recent years were higher in the BRICs than in the EU.[8] Although inflows of financial resources into the BRICs and other emerging economies also plummeted during the crisis, these capital movements experienced a strong rebound in 2010-11, and climbed back to almost their pre-crisis level. This implies that the gap between flows of financial resources to the EU and other high-income economies on the one hand and to the BRICs and other emerging economies on the other hand was much narrower in 2011 than it had been before the crisis.

Figure 2: Analysis by group of countries of worldwide inflows of financial resources



Note: 'Inflows of financial resources' = 'Current Account, Net' + 'Direct Investment In Reporting Economy, Liabilities' + 'Portfolio Investment (Excluding Financial Derivatives), Liabilities' + 'Other Investment, Liabilities'. Country groups are based on World Bank country groups with the following amendments: BRIC countries include Hong Kong and Macau; High income economies exclude the EU27;

other emerging economies include lower-middle and upper-middle income economies, excluding BRIC and EU27. Original data in US$

converted to €using annual €/US$ exchange available from Eurostat.

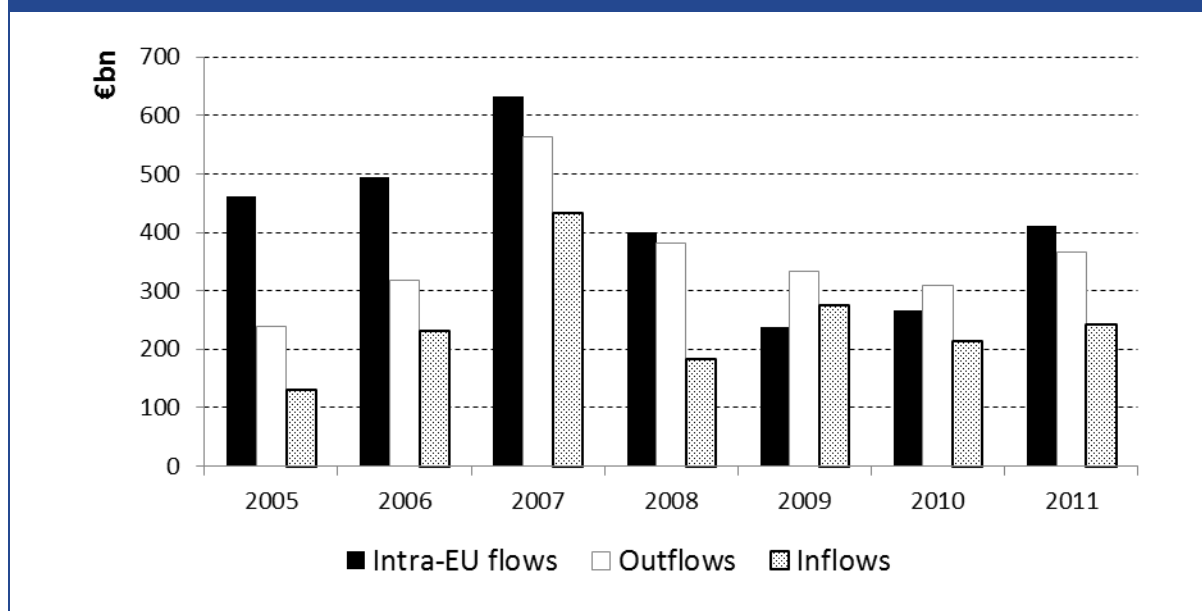
Source: IMF Balance of Payments and Eurostat

Within the broader category of international capital movements, FDI data show that EU flows made a marked recovery in 2011, in line with worldwide FDI developments (Figure 3). A more in-depth analysis of the destination of EU FDI flows reveals that extra-EU outflows reached their pre-crisis level faster than intra-EU flows, and that European companies preferred to invest in their domestic economies rather than in other EU countries.

[7] Brazil, Russia, India and China.

[8] However, there were significant differences between the BRICs. For example, while China and Russia had a current account surplus in 2010, the current accounts of Brazil and India were in deficit. These differences also existed among EU Member States.

Figure 3: EU27 inward and outward FDI flows, 2005-11, €bn



Note: 2010 flows, and to a lesser extent 2009 flows, have been updated at the end of 2012 mainly due to a benchmark revision of the Dutch population of Special Purpose Entities (SPEs) that revealed under-coverage in their regular survey and resulted in a substantial increase of the Dutch FDI flows for those years.

Source: Eurostat —– EU Direct Investments (bop_fdi_main)

Outward FDI flows originating in the EU surpassed intra-EU flows to become the largest direct investment category in 2009. The shift of European companies from investing predominantly within the EU to investing in the rest of the world may have reflected better relative growth prospects for the rest of the world, particularly for emerging economies, compared with the EU in that year. Having said this, larger outward FDI compared with intra-EU flows suggests that European investors maintained a solid appetite for the growth prospects offered by non-EU countries, notwithstanding the 2009 recession in the EU27.

Although the pre-crisis level of extra-EU outflows reached their pre-crisis levels faster than intra-EU flows, in 2011 direct investment between EU Member States again surpassed outflows. This could point to a certain degree of resilience on the part of the Single Market for capital. Having said this, in 2011 EU direct investment remained below the 2007 level. For example intra-EU flows and FDI inflows into the EU were, respectively, 35% and 44% lower in 2011 than they had been in 2007, in spite of the strong rebound between 2010 and 2011. This could be due to the twin sovereign debt and banking sector crises in the euro area.

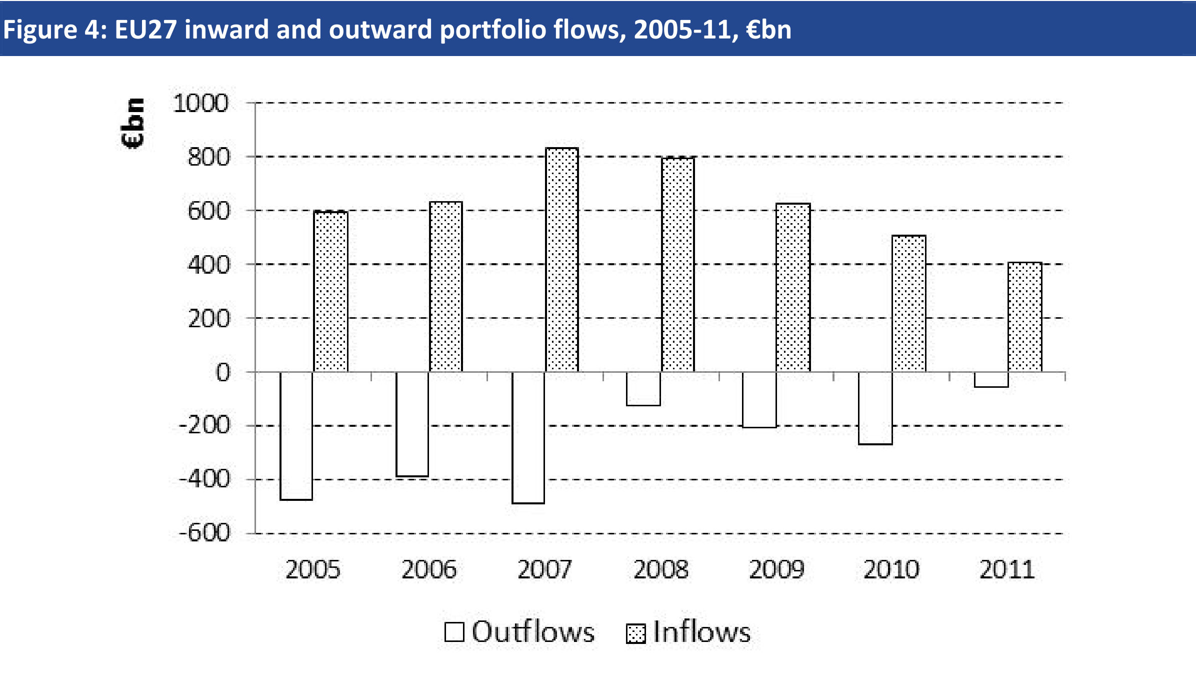
Furthermore, in 2011 and on average across EU Member States, companies showed a more marked home bias (*i.e.* a reduction of the share of foreign assets in their portfolios) in their investment decisions relative to previous years. European companies seemed to have a preference for investing in their domestic markets over investing in other EU countries. On average across the EU, the fall in gross fixed capital formation (i.e. investment in the domestic economy) was significantly less than that of direct investment to the rest of the EU. This evidence points to a growing risk of fragmentation in the Single Market for capital.

A certain degree of home bias is also evident by looking at trends in M&As undertaken by European companies in recent years. In the period 2009-11, intra-EU cross-border M&As decreased in comparison with purely domestic M&As. This is an indication that during the

economic downturn companies became more hesitant to undertake cross-border M&As because the uncertain economic outlook made such foreign acquisitions seem more risky than domestic acquisitions.

As regards portfolio investment, in the period 2005-11 the EU as a whole consistently experienced net inflows of financial resources (Figure 4). However, by 2011 portfolio investment inflows into the EU had fallen 49 % from their peak in 2007. In addition, before the crisis the EU had recorded large outflows of portfolio investments because EU-based investors were acquiring a significant amount of foreign assets. As a consequence of the outburst of the financial crisis, portfolio outflows dropped abruptly between 2007 and 2008, and then started to recover gradually. They plummeted again between 2010 and 2011, reaching their lowest level since 2005. These developments reflect the impact of the financial and economic crisis on this investment category, which is relatively more prone to retrenchment than FDI in the event of a shock.

Figure 4: EU27 inward and outward portfolio flows, 2005-11, €bn



Source: Eurostat — European Union balance of payments (bop_q_eu).

Finally, a country's net international investment position[9] can be a good indication of existing macroeconomic imbalances. Indeed, a Member State's net international investment position as a percentage of GDP is one of the key indicators taken into account in the initial phase of the of the Macroeconomic Imbalance Procedure (MIP).[10] An alert threshold of -35 % has been

[9] Net international investment position statistics record the net financial position (liabilities minus assets) of a country vis-à-vis the rest of the world, with data covering stocks of direct and portfolio investments, financial derivatives and other investment and reserve assets.

[10] Surveillance to prevent and correct macroeconomic imbalances under the MIP (based on Article 121 TFEU) was adopted by the EU as part of the so-called 'six-pack' governance package which provides for a significant reinforcement of surveillance of fiscal and macroeconomic policies.

set for this indicator: values below this threshold suggest that the Member State(s) concerned may be experiencing macroeconomic imbalances.[11]

The latest available indicators (from 2011) show that a majority of Member States had net international investment positions below the indicative threshold, ranging from moderate (-41.2 % for Slovenia) to substantial deviations (-105.0 % for Portugal and -105.9 % for Hungary). Other Member States posted high positive values for this indicator, including Belgium (65.7 %) and Luxembourg (107.8 %).

2.2. Concentration of capital flows in the EU and in few key sectors

An analysis of the geographical and sectoral distribution of FDI inflows and outflows, as well as inward and outward stocks,[12] shows that EU direct investment is largely concentrated within the Single Market and in a few industries. Nevertheless, emerging economies are playing an increasingly important role both as a source of and as a destination for EU FDI.

Geographical distribution

In 2010, inward direct investment from Member States represented 60 % of total EU inward FDI stock. Geographical proximity seems to play an important role as a determinant of intra-EU direct investment flows, as nearly half of that stock originated in neighbouring Member States. In addition to geography, the size of the sending economy in terms of direct investment is also significant, as large EU neighbouring and non-neighbouring Member States[13] and large non-EU countries[14] represented the main sources of direct investment inflows to the EU. The Single Market is also a very important destination for investment originating in the EU, as it held over half of the EU27 total outward direct investment stock in 2010.

FDI to the EU from the rest of the world come from a small number of sources: in 2011, the United States represented 35 % of total EU27 inward FDI stock originating outside the EU, followed by Switzerland with 12 %. In contrast, the BRIC economies accounted for 3 % of total EU inward FDI stock. The BRICS play a more important role as a destination for direct investment originating in the EU, as they held 11 % of total EU27 outward FDI stock in 2011.

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[11] It should be emphasised that the scoreboard indicators are not interpreted mechanically. Countries are assessed by looking at the evolution of indicators over time as well as taking into account the most recent developments and outlook. In addition, the assessment takes into account a combination of additional relevant information, such as the composition of external positions in terms of debt and equity.

[12] Inward stocks refer to all direct investment held by non-residents in the reporting economy; outward stocks are the investments of the reporting economy held abroad. Corresponding flows relate to investment during a period of time. Source: OECD (2012), *OECD Factbook 2011-2012: Economic, Environmental and Social Statistics*, OECD Publishing.

[13] Large EU economies in terms of direct investment include Belgium, Germany, France, Luxembourg, the Netherlands, and the United Kingdom. This categorisation should of course be interpreted with caution: for example, Luxembourg's large share of FDI results largely from the importance of special purpose entities in that country (representing some 85 % of Luxembourg's total direct investment, according to June 2012 Eurostat data). .

[14] Large non-EU economies in terms of direct investment include Brazil, China, India, Japan, Russia, Switzerland and the United States.

Therefore, the primary recipients and sources of EU inward and outward direct investment are developed economies. Nevertheless, emerging economies' share of the EU's stock of both inward and outward FDI has been rising in recent years. This shows how important it is for the Single Market to maintain an open framework for inward and outward capital flows vis-à-vis these countries. More can be done to benefit from capital flows originating in large emerging economies. While the BRICs account for about 15 % of global FDI outflows, the EU is not among the favoured destinations for that investment: only between 5 % and 10 % of FDI received in the EU originated in the BRIC economies in 2010.

FDI outflows from the EU to the BRICs were less affected by the overall contraction in EU investment in 2009-11. In fact, they rose steadily over that period. This may be an indication that the investment climate in the BRICs was more resilient to the effects of the global financial crisis than in the EU. Some commentators predict that, as investors seek to increase the geographical diversity of their portfolios, demand for emerging market assets will increase. They argue that this is because these countries seem to have been more resilient to the financial crisis and because they have strong growth prospects and macroeconomic fundamentals.[15]

The stock of EU investment in the BRICs grew from just under 2 % of EU GDP in 2004 to almost 4.5 % in 2011. In addition, an analysis of M&A data reveals that companies in the BRICs represent important targets for EU acquirers, accounting, on average, for more than one sixth of EU cross-border M&A activity between 2001 and 2011.

In relative terms, the largest EU FDI outflows to the BRICs originated in Germany (as a large and diversified source of FDI) and Spain (due in part to its close historical links with Latin America). In recent years, the United Kingdom's share of FDI outflows to the BRICs has also been increasing.

Distribution by sector

While almost two thirds of EU inward investment went to services in 2010, the manufacturing sector still accounts for a significant portion of FDI inflows, with 20 % of the total. Professional, scientific and technical activities attracted 11 % of total inward FDI. Head office activities were responsible for 9 % of inflows, which demonstrates the increasing importance of multinational companies.

The financial services sector was the main target for FDI inflows into the EU, with a 44% share in 2010. Financial services also feature among the main target sectors of the ten largest intra- and extra-EU M&A deals in 2011.

There are several reasons for the dominance of the financial services sector. First, investment in financial services can be very mobile in comparison to investment in other sectors, and there is therefore a relatively high level of cross-border activity. Second, the relative importance of financial services results partly from the use of special purpose entities (SPEs) for acquiring or creating foreign affiliates. If an EU manufacturing company acquires a company abroad through an SPE, the transaction will be attributed to the financial services sector and not the manufacturing sector. Third, the financial services sector's very frequent

[15] Gian-Maria Milesi-Ferretti and Cedric Tille (2011), 'The Great Retrenchment: International Capital Flows During the Global Financial Crisis,' *Working Papers 382011*, Hong Kong Institute for Monetary Research.

use of intra-company loans (which is one of the components of FDI) when compared with other sectors also plays a role.

While overall FDI inflows into the EU fell between 2008 and 2009, investment in financial intermediation recovered strongly in the same period, with an increase of 25.7 percentage points. The sector whose share had the next largest increase, at 7.3 percentage points, was the electricity, gas and water sector. However, the upturn in FDI in the EU financial services sector was short-lived, as investment in this industry fell again in 2010 (in line with overall FDI inflows), due to the persistence of challenging economic conditions.[16]

There are some differences between the Member States in the reasons behind the lack of a convincing recovery in FDI in the financial services sector. For example, much of the decline in flows to the United Kingdom in recent years occurred in the financial services sector. This was due to the wider recession rather than for sector-specific reasons. In France, foreign investors seem to have had concerns about the country's ability to reform the economy and handle a banking crisis.[17]

3. NEED TO BOOST THE SINGLE MARKET FOR CAPITAL

3.1. Openness of the Single Market to capital movements

The functioning of the Single Market for capital can be partially captured through an analysis of the convergence (or divergence) of direct investment between the Member States. In this context, the degree of convergence/divergence is measured as the spread of Member States' openness to FDI (measured by FDI inflows as a percentage of GDP) against the EU27 average. Convergence occurs when the spread narrows over time, indicating that Member States have a similar degree of openness to FDI. Divergence takes place when the spread widens, and there are significant differences in the size of FDI flows into individual Member States.

This analysis has limitations, as openness to direct investment is driven by several factors including the size and structure of the national economy, and not exclusively by restrictions on investment. For example, it is natural for small economies to be more open to FDI than larger economies, because the former are more dependent on foreign capital than the latter. Likewise, catching-up countries are likely to attract a high share of FDI relative to the size of their economies. However, measures restricting FDI inflows such as equity restrictions, screening and approval requirements and other operational restrictions can also affect the degree of openness of a Member State to capital movements. In addition, if restrictions on FDI differ significantly across the EU this may result in a high degree of divergence, as some Member States will be more attractive destinations for direct investment than others. Therefore, the analysis of convergence and divergence of openness to FDI can provide some indications of the level of integration of the Single Market for capital.

[16] As the breakdown of EU direct investment by economic activity is released later than aggregate FDI figures, data at the sectorial level is only available until 2010.

[17] Source: A.T. Kearney (2012), 'Cautious Investors Feed a Tentative Recovery', *The 2012 Foreign Direct Investment Confidence Index,* A.T. Kearney.

There is some evidence of convergence of direct investment inflows for the EU27 as a whole, both for extra- and intra-EU inflows. This would suggest that, on the whole, EU countries are becoming equally open to FDI. The degree of openness of inflows has fluctuated significantly over recent years, with the most recent trends showing broad convergence, pointing to improvements in the Single Market for capital.

3.2. Fragmentation of the Single Market for capital

The free movement of capital is one of the four fundamental Single Market freedoms. The basic principle enshrined in the EU Treaty, which is essential for the functioning of the Single Market, prohibits all restrictions on capital movements and payments between Member States as well as between Member States and third countries (Article 63 TFEU). The Treaty, therefore, sets out the objective of openness both towards other Member States and towards third countries. However, this freedom is not unconditional as the Treaty allows Member States to apply national rules to restrict capital movements under certain specific conditions (Article 65 TFEU). There are no harmonised general rules on the free movement of capital in the form of secondary EU legislation. However, at the EU level there is extensive sectorial legislation in financial services, as well as secondary legislation on specific aspects of capital movements and payments in financial markets.

Although the Treaty lacks an explicit definition of capital movements, the Court of Justice of the European Union (CJEU) has constantly confirmed its broad definition, covering: FDI, real estate investments or purchases, securities investments (for instance in 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, endowments, etc.[18]

In addition, the Treaty of Lisbon added a further element in relation to third country direct investment by introducing a new exclusive competence on FDI as part of the Common Commercial Policy (Article 207 TFEU).

The ongoing number of cases of potential restrictions (whether pursued through infringements or informal problem solving mechanisms) points out those areas where problems to the smooth functioning of the Single Market for free movement of capital still exist. The issues addressed in complaints or otherwise brought to the Commission's attention concern special rights of the State in privatised companies, bilateral investment treaties, foreign investment control, acquisition of agricultural real estate or other investment restrictions.

One element of the current legal framework that has an impact on investors is represented by national screening mechanisms for foreign investments or investments in strategic companies or sectors, which may further fragment the Single Market. Most Member States have some kind of mechanism in place for screening incoming investments, the objective of which is to vet investments on the basis of national security or public policy. The majority of these screening mechanisms cover both intra-EU and third country investments. Only few Member States have a screening mechanism limited to third countries and no Member State has a screening mechanism limited to intra-EU investments. Screening mechanisms are often adopted against a perceived risk of investment in strategic sectors. For example, three Member States adopted new screening mechanisms in 2012. To the extent that these

[18] In the absence of a definition in the Treaty of 'movement of capital' the CJEU has recognised the nomenclature annexed to Council Directive 88/361/EEC as having indicative value.

mechanisms are permitted under the Treaty principles, the diverse conditions under which Member States assess incoming investments may further fragment the Single Market and undermine efficient investment decisions from the perspective of the EU as a whole.

In addition, the financial crisis has had an impact on the free movement of capital and in particular on the cross-border provision of banking services. Consequently it seems that, in a number of instances, national supervisors have taken unilateral prudential measures in order to respond to potential stability concerns triggered by the sovereign crisis. These measures have a so called 'ring-fencing' effect on bank's assets. In many cases, the introduction of such measures may be justified on grounds of overriding public interest to maintain the stability of national financial markets. However, any disproportionate ring-fencing measures, may have a negative impact on other Member States and may further contribute to the fragmentation of the Single Market for banking. In order to identify the best way to limit the potential adverse impact of ring-fencing measures on the Single Market, the Commission services have requested information about current supervisory practices (see below).

The crisis has also had an impact on the provision of cross-border credit to certain EU Member States. The credit flows into these countries had grown rapidly prior to the crisis. However, the crisis triggered a sharp reduction or reversal of some of these credit flows, as banks from other EU Member States reduced their foreign exposures. In 2011, as funding problems of these latter banks worsened and recapitalisation targets were introduced, concerns mounted about the impact of deleveraging on the Member States at the receiving end of the credit flows.

Finally, the Single Market for capital continues to be fragmented by existing Bilateral Investment Treaties (BITs) between certain Member States. Where both parties are EU Member States, there is in principle no need for these agreements since both national law and EU law provide for appropriate investment protection standards and remedies. However, in 2011, there were 176 Intra-EU BITs in force. All of them had been concluded at a time when at least one of the two parties was not yet a member of the EU.[19] Of these, 130 are between an EU15 and an EU12 Member State, 44 are between two EU12 Member States and 2 are between two EU15 Member States. Such agreements clearly lead to discrimination between EU investors and are incompatible with EU law.[20] In particular, most Intra-EU BITs provide for the possibility of investor-to-State arbitration procedures of a binding character, which is not subject to review by the CJEU on issues of interpretation of EU law. This form of international arbitration is incompatible with the exclusive competence of EU courts to rule on the rights and obligations of Member States under EU law. In contrast to national courts, arbitral tribunals are not bound to respect the primacy of EU law and, in case of doubt, are neither required nor in a position to refer questions to the CJEU for a preliminary ruling. In any case, such investor-to-State arbitration is very costly and thus not easily accessible to SMEs.

[19] The Commission services sent a formal information request to Member States asking for, among other elements, the texts of all Intra-EU BITs which are still in force, or which are still applicable to existing investments.

[20] In the cases, C-205/06, C-249/06 and C 118/07 concerning third country BITs, the CJEU has ruled that certain elements of such bilateral agreements are incompatible with the Treaty.

3.3. Bottlenecks in the Single Market for capital

The Treaty principles on the free movement of capital provide the fundamental foundation for the development of the Single Market for capital and make the EU an attractive destination for investment. Over the years, the Single Market for the free movement of capital has been advanced through a series of judgments by the CJEU in order to enforce the aforementioned Treaty principles. One of the most recent examples of the CJEU judgments re-confirms the extensive scope of these principles. In the case C-271/09[21], the Court confirmed that investments by open pension funds are subject to the free movement of capital principle by rejecting the arguments of the Polish authorities that such funds are exempted from this freedom under the exclusive competence to define the national social security system (Article 153(4) TFEU) and ownership regime (Article 345 TFEU).

Currently, the Commission services are working on different strands in order to ensure the enforcement of this policy.

Monitoring of national policies

The Commission services are closely monitoring issues related to the free movement of capital, with the aim of following developments in EU capital markets and assisting Member States in solving the highest possible number of cases without launching infringement procedures.

A recent example of these monitoring activities is in the area of banking services, where the Commission services are closely examining the 'ring-fencing' measures taken by several Member States. The Commission services recently indicated to all national banking supervisors that Single Market rules apply to supervisory activities in the banking sector and requested information about their most recent practices in this area. Close cooperation between all competent authorities and institutions is crucial to mitigate any risk of disintegration of the Single Market.

Close attention is also given to the extensive privatisation programmes currently being undertaken in the Member States which receive EU/IMF financial assistance. In addition, the Commission services are examining the energy sector in a number of Member States, as it seems that special rights are introduced in certain electricity and gas companies. Although Member States have broad discretion in regulating sectors with a fundamental interest for society, such as water utility services, these sectors remain subject to the EU fundamental rules and should comply with the principle of the free movement of capital.

Within the Single Market, acquisition caps or special rights for retaining State control over privatised companies, in particular in strategic sectors such as energy and telecommunications, may have a dissuasive effect on investment. They may hinder privatised companies from achieving the full benefits of privatisation, they may distort market-driven cross-border activity (both direct and portfolio investment) and they may often create obstacles to achieving a level playing field for corporate control. However, Member States may have a legitimate interest in protecting their public policy or public security. Therefore, the challenge is to find a right balance between the aim of attracting investment in the Single

[21] Case C-271/09 of 21 December 2011, Commission v Poland.

Market and the Member States' need to protect their legitimate public policy or public security objectives.

In the framework of monitoring, the Commission services have pursued a number of cases of restrictions on the free movement of capital, either through informal problem solving mechanisms or through infringement procedures. During the reporting period, there were 18 formal infringement cases open against 14 Member States.[22] Recently opened cases concern issues such as mortgages imposed after privatisation or cash controls at borders.

The Commission services have continued to assist Member States in finding satisfactory solutions, either before reaching the stage of referral to the CJEU or even before opening infringement procedures. Therefore, several cases were closed at an early stage of the procedure.

An example of such a case in which a solution was found at an early stage concerned the provision of cross-border credit to certain Member States (as mentioned above). In the autumn of 2011, a Member State had passed a law to allow the early and full repayment of foreign currency denominated mortgages loans at a fixed statutory exchange rate different from market rates, and thus potentially infringing the free movement of capital rules. With the Commission services' assistance, a solution was found that was less harmful to the banking sector and provided for partial compensation to banks for their losses resulting from this measure.

Screening mechanisms

Contrary to the situation at the OECD, there is currently no EU-wide mechanism through which Member States should systematically inform the Commission about new rules concerning free movement of capital. However, the Commission services are regularly assessing national rules and assisting Member States to formulate provisions that are in conformity with the Treaty principles. The fact that most Member States' screening mechanisms cover both third country and intra-EU investments reflects the reality of today's globalised world, where it may be difficult to distinguish between intra-EU and third country investments.

The Greek system represents an example of a national screening mechanism which the CJEU found to be incompatible with EU law. In the recent case C-244/11[23], the CJEU outlawed both control mechanisms stipulated in the Greek law with regard to investment in strategic companies, *i.e.* the ex-ante authorisation of investment exceeding a 20% threshold based on only indicatively listed and inappropriate criteria, and the ex-post approval of important company decisions introduced without any clear criteria as to the circumstances foreseen for the State intervention. The Greek law applied to all investments, *i.e.* to both intra-EU and third country investments.

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[22] Three cases have been closed since June 2012, bringing the number of open cases to 15.

[23] Case C-244/11 of 8 November 2012, Commission v Greece.

Investment protection

The Commission services are discussing with the Member States the need to phase out Intra-EU BITs and to find a solution acceptable to all. In this context, all Member States recognise the importance of solid investment protection within the EU. Therefore, the Commission services are exploring with Member States the possibility to create an additional mechanism for investment protection. The main features of this model would be the direct involvement of industry and the Commission, its low costs, and its accessibility, in particular for SMEs. This new mechanism could consist in the establishment of contact points for investment protection in each Member State, complemented by a mediation mechanism for the settlement of investor-to-State disputes. Such a mechanism would require a commitment by all Member States to reinforce their efforts to assist investors in realising their Single Market rights and protecting their legitimate interests.

The external dimension of the Single Market for capital movements

Genuine openness and an open framework for both inward and outward capital flows vis-à-vis third countries are assets for the functioning of the Single Market: regardless of its origin or destination investment has a positive effect on the economy of the receiving (or sending) Member State and of the EU as a whole. The Treaty explicitly recognises this and in principle treats third country investments and capital flows on an equal footing with those within the EU.

The general principle of openness to foreign investments is also reflected in international agreements, such as the OECD. Consequently, along the same lines and in the mutual interest, the Commission continues to promote openness to foreign investments in international fora and bilaterally with its trading partners.

4. CONCLUSION

The free movement of capital policy is at the heart of the Single Market. Its aim is to promote growth by fostering intra-EU investment and enhancing the EU's attractiveness to foreign investment. It has brought tangible benefits over the years and has safeguarded the openness of EU markets for investments.

Following a modest pick-up in 2010, the financial and economic crisis has still had a significant negative impact on global flows of financial resources, including for the EU in the reporting period covered by this working document (2011 to mid- 2012).

Although FDI data show that EU flows made a marked recovery in 2011, there are still some challenges ahead. On the one hand, FDI is increasingly directed towards countries outside the EU. In the reporting period, high-income economies (mainly the United States and Switzerland) maintained their lead among the senders and recipients of extra-EU direct investment. At the same time, the emerging economies, in particular the BRICs, increased their shares of both inward and outward FDI with the EU. This underlines the importance of maintaining the Single Market open vis-à-vis investment with these countries. On the other hand, European companies are showing an increasing preference for investing in their domestic economies. Both these trends are occurring at the expense of intra-EU direct investment.

Impediments to investment possibilities into the EU still remain, both from an intra-EU perspective and with regard to third countries. Such obstacles undermine the policy's objectives and can have an adverse impact on the economy. The Commission services have continued to monitor the markets in order to detect malfunctions in the EU capital markets as early as possible and thus prevent fragmentation of the Single Market for capital. These activities include the handling of cases of potential restrictions to the free movement of capital principles with the aim of finding a solution at an earliest possible stage without launching infringement procedures, actions taken in relation to possible ring-fencing measures by national supervisors and the monitoring of privatisation programmes in specific Member States. Furthermore, the Commission services have assessed recently introduced national screening mechanisms. Finally, it has engaged in discussions with the Member States on possible solutions to terminate the intra-EU BIT, and on reinforcing investment protection in the EU through an additional investment protection mechanism.

However, the Single Market for capital is facing a number of new challenges, such as new waves of privatisations triggered by the sovereign debt crises and the urgent need for the EU to attract investments while ensuring that Member States are able to protect their legitimate public policy or public security objectives. The application of non-transparent measures may have a dissuasive effect on investors from other Member States and reduce the EU’s ability to attract foreign investment.

In a globalised and fast-changing world, it may not be sufficient to pursue the free movement of capital policy primarily through infringement proceedings. This policy has to be actively pursued and promoted in order to reinforce its potential to respond to the changing economic and political realities in Member States and the EU as a whole.