Council of the
European Union

Brussels, 29 May 2018
(OR. en)

9411/18

ECOFIN 501
MDC 1

COVER NOTE

From:	Mr Hans VIJLBRIEF, President of EFC
date of receipt:	23 May 2018
To:	Mr Vladislav GORANOV, President of the ECOFIN Council
Subject:	Annual EFC Report for 2017 to the Commission and the Council on "The Movement of Capital and the Freedom of Payments"

Delegations will find attached the annual 2017 EFC Report to the Commission and the Council on "The Movement of Capital and the Freedom of Payments".

ANNEX

ECONOMIC AND FINANCIAL COMMITTEE

THE PRESIDENT

Brussels, 22 May 2018
ecfin.cef.cpe(2018)2392564

Mr Vladislav Goranov
Minister of Finance
Ministry of Finance
102 Ravovski Street
1040 Sofia

Concerns: Annual EFC Report for 2017 to the Commission and the Council on "The Movement of Capital and the Freedom of Payments"

Dear Mr President,

Under Article 134 (2) of the EC Treaty, the Economic and Financial Committee (EFC) is mandated, amongst other things, to: "*examine, at least once a year, the situation regarding the movement of capital and the freedom of payments, as they result from the application of this Treaty and of measures adopted by the Council;" and "report to the Commission and to the Council on the outcome of this examination*."

Accordingly, I hereby provide you with the annual EFC Report for 2017. Based on the Commission's examination, the Report highlights encouraging progress made in improving the access to capital markets and in lifting capital controls introduced as a result of the economic and financial crisis.

The free movement of capital is one of the four basic freedoms included in the TFEU and it is essential to ensure that it is not unduly hampered and can effectively underpin the objective of the Capital Markets Union (CMU) to build truly integrated, open, competitive and efficient European capital markets as a complement to bank financing.

In this regard, the EFC welcomes the continuing efforts to further the free movement of capital, notably by means of the follow-up to the **Joint Commission and Member States Roadmap of actions**[1] and encourages a continuation of the work on other identified barriers.

Under the umbrella of the **CMU initiative** a number of policy initiatives have been taken to support investment, growth and jobs by facilitating financing and capital movements. In particular, the Investment Plan for Europe has been reinforced with the recent adoption of an extended EFSI running until the end of 2020. Also, two thirds of the measures announced under the original CMU Action Plan have been delivered and the Commission has adopted a mid-term review that aims to address the remaining challenges by setting new priority measures to complement the original CMU Action Plan. The EFC welcomes the progress made so far and looks forward to further developing the CMU. Together with the Banking Union, CMU will figure prominently on our agenda.

However, despite encouraging developments, some issues remain that require further attention. So for instance, as reported in previous years, the issue of compatibility of intra-EU Bilateral Investment Treaties with EU law. Despite the recent CJEU preliminary ruling on the Achmea case C-284/16, views remain split. The EFC in this respect has called for a pragmatic and efficient solution that is compatible with EU law. The EFC has invited the Commission to take this forward in the appropriate fora and report back on the outcome. The EFC will flag the need, if any, for possible additional action to reinforce the single market as an investment destination in its next monitoring report.

Cross-border capital flows and financial stability may also be seriously affected by unintended consequences of national measures that aim at strengthening financial stability. This may be the case in respect of foreign-currency loans but also of the use of macro-prudential tools. The EFC will continue to carefully consider the measures taken by the Member States on macro-prudential risks to ensure that their application does not harm the free movement of capital flows.

[1] ECOFIN 431, of 19 May 2017. Most roadmap actions were implemented in various areas, such as a code of conduct publish in December 2017 to address burdensome withholding tax relief procedures; and the adoption of the Commission's legislative proposals on 12 March 2018 to tackle barriers to the cross-border distribution of investment funds, have already been implemented.

As in previous years, the EFC is grateful for the high quality assessments prepared by the Commission services, which greatly benefited our annual examination.

I have also written in similar terms to the President of the Commission.

Yours sincerely,

Hans Vijlbrief

EFC Chairman

Attachment:

Annual EFC Report to the Commission and the Council on the Movement of Capital and Freedom of Payments (16 April 2018, Ares(2018)1839263rev).

ECONOMIC AND FINANCIAL COMMITTEE

Brussels, 16 April 2018
ecfin.cef.cpe(2018)1839263rev

Annual EFC Report to the Commission and the Council on the Movement of Capital and the Freedom of Payments

INTRODUCTION

Under Article 134(2) of the Treaty on the Functioning of the European Union (TFEU), the Economic and Financial Committee (EFC) is called upon *"to examine, at least once a year, the situation regarding the movement of capital and the freedom of payments, as they result from the application of the Treaties and of measures adopted by the Council; the examination shall cover all measures relating to capital movements and payments; the Committee shall report to the Commission and to the Council on the outcome of this examination."*

Based on the Commission's examination, the EFC in its 21st Report assesses key developments in global and EU capital markets in 2016-2017, policy initiatives undertaken to enhance capital movements and international cooperation, and assesses remaining barriers and challenges to the movement of capital and the freedom of payments.

1. GENERAL CONTEXT AND DEVELOPMENTS

Against the background of improving economic conditions and accelerating growth, both global and EU capital flows have been stabilising in 2016-2017. Although it may not be reasonable to target pre-crisis levels as a benchmark, the current capital flows are still below those levels. As the recovery of investment levels remained incomplete, the EU maintained a savings surplus. The EU remained a net exporter of capital and this pattern can also be observed in the Euro area which became the largest capital exporter globally.

A remarkable transformation of global capital flows has taken place in the post-crisis period with excess external imbalances shifting from emerging to advanced economies. The US is experiencing a current account deficit, while the Euro area is experiencing sustained surpluses.

In addition, while the EU is committed to remaining one of the most open investment regimes in the world, the Commission proposed a new legal framework on screening FDI within the EU to accommodate increasing concerns about foreign investors seeking to acquire strategic assets that could allow them to influence European firms critical for EU's security and public order.

In order to continue efforts to tackle remaining barriers to cross-border investment, the May 2017 ECOFIN endorsed a Joint Commission and Member States' Roadmap of actions on national barriers to capital flows. On that occasion and in the context of the Capital Markets Union (CMU), the EFC report on the Movement of Capital and the Freedom of Payments was for the first time discussed at the Ecofin, which shows the strong political commitment on ensuring that the free movement of capital is not unduly hampered and can effectively underpin the building of truly integrated, open, competitive and efficient European capital markets as a complement to bank finance.

However, despite the initiatives taken to enhance the free movement of capital, a number of barriers remain to be addressed as well as a number of challenges, in particular against the backdrop of increased policy uncertainty at the global level, in particular: lower transparency in some off-shore financial centres; increased concentration of global imbalances pointing to weaker global adjustment mechanisms; and high equity market valuations which might trigger adjustments and capital flow restrictions

Against the background of the economic recovery, current geopolitical risks and uncertainties, the EFC reiterates that it is essential to continue to ensure that the free movement of capital is not unduly hampered, globally but also and particularly within the EU., This effectively underpins the objectives of the Banking Union and of the CMU initiative to build truly integrated, open, competitive and efficiently functioning and stable European financial markets. The EFC in this regard welcomes and will further discuss the Commission's Action Plans on sustainable finance and fintech and welcomes the strategic focus of the EFSI.

Especially for the Euro area, the establishment of a more integrated capital market complementing the Banking Union would allow for more private sector risk sharing across countries through cross-border capital flows adjustments. By offering more diversified sources of financing to investors, the Euro area could also be more resilient to economic shocks.

2. RECENT TRENDS IN EU CAPITAL FLOWS

Foreign Direct Investment (FDI)

Net cross-border investment in the EU remained negative in 2016 and the first three quarters of 2017 with outward FDI larger than inward investment. Whereas both intra- EU and extra-EU FDI inflows decreased in 2016, extra-EU inflows further dropped sharply in the third quarter of 2017.

The EU remained the most-targeted investment destination globally in 2017 through extra-EU mergers and acquisitions (M&A) of European companies, although it is expected to be overtaken by the US with regard to greenfield investments.

In contrast to the rest of the world, cross-border M&A continued to increase in the EU in 2017 due to intra-EU activity. For the first time since the crisis, intra-EU acquisitions were higher again than extra-EU acquisitions with the latter still remaining at a high level, but declining due to lower inflows from the US.

Global greenfield FDI showed a significant decline in 2017 due to a general decrease across the EU of investments from outside, whilst intra-EU investments remained.

Portfolio Investment

Since 2015 net portfolio investments into the EU has turned increasingly negative, irrespective of the big fluctuations on gross volumes between 2016 and 2017. This negative balance can be attributed to both the decline in net portfolio investment and developments in the Eurozone, where non-residents have continued to reduce their holdings of Eurozone long-term debt securities since 2014, a process which catalysed after the extended ECB bond buying programme.

Home bias in equity and bond markets

Equity and bond market home bias remain significant, indicating possible remaining barriers and disincentives to the free movement of capital. Euro area countries display a lower home bias compared to the EU-28, even though also their home bias remains steadily around 70%.

The EFC acknowledges the efforts made so far to remove barriers and disincentives to cross border activities and notes the need to continue these efforts to further reduce the home bias.

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

In recent years, a number of policy initiatives have been taken to support investment, growth and jobs, by facilitating financing and capital movements.

The Investment Plan for Europe

The Investment Plan for Europe has been reinforced with the recent adoption of an extended EFSI running until the end of 2020 and with an elevated investment target of half a trillion Euro, which will further help to mobilise finance in strategic sectors of the EU's economy. As of March 2018, 87% of the original €315 billion target had already been met.

As regards the CMU, two thirds of the measures announced under the original Action Plan have been delivered and the Commission adopted in June 2017 a mid-term review aimed at addressing the remaining challenges by setting new priority measures to complement the original CMU Action Plan. Among the upcoming CMU initiatives, there is a proposal on an EU framework for covered bonds, published on 12th March 2018.

Synergies between the EFSI and CMU have been fostered in the past year, e.g. with regards to SME finance by reforming the regulatory framework to raise capital and supporting venture capital investments

Further progress towards establishing the CMU is being made, with the adoption by the Commission of a comprehensive CMU package on 8 March 2018 presenting a FinTech Action Plan, putting forward new rules that will help crowdfunding service providers to grow across the EU's single market, and adopting a comprehensive strategy for a financial system that supports the EU's climate and sustainable development agenda.

The EFC welcomes the progress made as well as the focus on issues such as Fintech and sustainable finance and looks forward to further developing the CMU project to help channel investments and support growth.

EU contribution to global developments on capital movements and payments

The objectives of smart, sustainable and inclusive growth, set out in the Europe 2020 Strategy aims to provide EU investors and investments with market access, legal certainty and a properly regulated business environment. This is sought after by increasing market access, through Free Trade Agreements (FTAs) with third countries, as well as stand-alone investment agreements.

The FTA between the EU and Canada (CETA), which entered into provisional application in September 2017 and will be fully implemented as soon as it has been ratified by all Member States, includes investment protection rules along the lines of the renewed approach. In addition, the EU continued negotiating stand-alone agreements with China and Myanmar.

The EFC will continue to monitor developments in this area.

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

The free movement of capital is fundamental to the single market. Therefore, the TFEU allows for restrictions on capital movements only under specific conditions, namely: national measures to prevent infringements of national laws, regulations on taxation and prudential supervision of financial institutions, and measures justified on grounds of public policy or public security (Article 65 1(b)). Measures may also be justified by other overriding reasons in the general interest, as recognised by the Court of Justice. All measures must be suitable and proportionate.

Capital controls

While capital controls are one of the most serious exceptions to the free-movement-of-capital principle, they are sometimes needed to prevent disorderly outflows from causing a financial and economic meltdown. This has been the case in Greece since 28 June 2015 and Iceland since 2008.

The restrictions that have been in force in *Greece* since 28 June 2015 are temporary in nature, which the Commission judged justified by the need to ensure the stability of the financial and banking system in Greece. In addition to the relaxation measures already implemented, the Greek authorities adopted and published *a roadmap in May 2017 on the gradual relaxation of capital controls with a view to abolishing them*, while at the same time safeguarding financial and macroeconomic stability.

Following the capital and foreign exchange controls introduced in *Iceland* in the aftermath of the severe banking crisis of 2008, pursuant to Article 43 of the EEA Agreement (permitting an EEA member to take 'protective measures' in case of capital markets disturbance or difficulties regarding balance of payments), only minor controls remain in place, in particular to prevent carry trade.

The EFC welcomes the alleviation of capital control as appropriate and invites the Commission to continue to monitor developments related to capital controls in Greece and Iceland.

Other measures

In the absence of secondary EU legislation harmonising the general rules on free movement of capital, the principles are mainly enforced by the Commission by monitoring their application in Member States. Whilst most unjustified barriers are solved through dialogue, in some cases formal infringement proceedings are launched to safeguard the integrity of the single market. In the reporting period, the Commission:

- Launched two infringement proceedings related to direct taxation under Article 63 of the TFEU and Article 40 of the European Economic Area (EEA) Agreement against Germany and Portugal.

- Closed 13 proceedings on tax restrictions to the free movement of capital. By 1 October 2017, there were 31 open infringement proceedings for violations in the field of direct taxation related to the free movement of capital.
- Brought a case against France to the CJEU for maintaining the provisions that allow a parent company to set off the tax credit originated from the distribution of dividends paid by a subsidiary established in France, against the advance payment for which the parent company is liable when it redistributes such dividends to its shareholders, but not offering that option for dividends paid by subsidiaries established in another Member State.
- Brought an action in the CJEU against Belgium for retaining provisions under which the rental income of Belgian taxpayers from the property on the national territory is estimated on the basis of outdated cadastral values, but the rental income from the property abroad is calculated on its actual rentable value, or on the actual net rent received.

The EFC underscores the importance of measures affecting cross-border investment to fully comply with the rules on the free movement of capital.

5. BARRIERS TO CROSS-BORDER CAPITAL FLOWS

Lacklustre investment growth and financial fragmentation in the EU to a certain extent reflect the presence of a number of remaining barriers to cross-border flows that come in different forms. Eliminating unjustified barriers to the free movement of capital within the EU is essential to build a genuine CMU and increase cross-border investment in Europe.

Barriers to cross-border investments

Capital markets in many European countries are still relatively underdeveloped and fragmented when compared to the US.

Following up to an EFC request, confirmed by the June 2015 Ecofin, the Commission established an Expert Group of Member States to address national barriers resulting in a Roadmap of actions which was endorsed by the ECOFIN in May 2017. By March 2018, the state of play on the implementation of the roadmap actions was the following:

- On the burdensome withholding tax relief procedures: a code of conduct was published on 11 December 2017.
- On barriers to the cross-border distribution of investment funds: the Commission has adopted legislative proposals on this issue on 12 March 2018.
- The issue of removing residence requirements for the managers of financial institutions when unjustified or disproportionate has been broadly discussed and one of the Member States has reported plans to change its legislation.
- On working to identify drivers for cross-border investment by pension funds and promote opportunities under the Investment Plan, the Commission is expected to release the result of a study on this issue by the end of 2018.
- A report summarising the work of the subgroup on financial literacy of consumers and SMEs is expected to be published in the following months.

The EFC welcomes the progress made with the implementation of the Roadmap and individual national actions of Member States; notes that the removal of the barriers mentioned in the roadmap were only a first step and encourages further work on other barriers identified to be pursued at a technical level; and will continue to closely monitor progress

Bilateral Investment Treaties (BITs) between EU Member States

As reported in previous EFC reports, views on the compatibility of intra-EU BITs with EU laws have been split. The Commission and some Member States consider intra-EU BITs to infringe EU law by violating the EU rules on free movement of capital, thus keeping the legal framework for treatment of investment in the single market fragmented. The Commission is taking legal action against Member States that maintain intra-EU BITs. However, a number of other Member States considers intra-EU BITs compatible with EU law and, in certain circumstances, indispensable to secure legal certainty for intra-EU investors until an alternative mechanism has been found.

In case C-284/16 Achmea[2], the CJEU ruled that Articles 267 and 344 TFEU must be interpreted as precluding a provision in an international agreement concluded between Member States, such as Article 8 of the Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Czech and Slovak Federative Republic, under which an investor from one of those Member States may, in the event of a dispute concerning investments in the other Member State, bring proceedings against the latter Member State before an arbitral tribunal whose jurisdiction that Member State has undertaken to accept.

The Commission will study in detail the consequences that follow from the ruling and will assist Member States in finding an efficient solution.

EFC reports have repeatedly called for a pragmatic and efficient solution to the issue of intra-EU BITs in a way that is compatible with EU law. The EFC will continue to monitor developments in this area and flag the need for additional action, if needed, to reinforce the single market as an investment destination within the CMU context.

Tax barriers

All initiatives announced in the 2015 Action Plan for a Fair and Efficient Corporate Tax System in the EU have now been launched to ensure that companies pay taxes where they make their profits. Member States adopted the Dispute Resolution Mechanisms Directive in July 2017 to provide an effective framework to resolve inter-state disputes regarding double taxation.

The EU has also concluded Protocols with five non-EU neighbour 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. The first and latter entered into force from 1 January 2016, first automatic exchanges took place in 2017. The three other agreements apply from 1 January 2017 for first exchanges to take place by end-September 2018.

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

In June 2017, the Council held an orientation debate on the common consolidated corporate tax base proposal (CCCTB) that had been relaunched by the Commission in October 2016, with the aim of establishing the right balance between the need to harmonise the tax rules across the EU and the need to maintain the right level of flexibility in their application. The objective of the CCCTB is that companies operating across borders in the EU would no longer have to deal with 28 different sets of national rules when calculating their taxable profits.

In the context of the CMU, the Commission published a Code of Conduct on withholding tax in December 2017 to encourage members to smoothen withholding tax reform procedures. Burdensome procedures for recovering withheld tax on portfolio investments have long been identified by Member States as a barrier to a true EU capital market.

The EFC recalls the importance of measures in flanking areas to encourage cross-border capital flows and the need to intensify work on tax transparency, while being conscious of the attractiveness of the EU as a destination for inward investments.

6. CHALLENGES TO CROSS-BORDER CAPITAL FLOWS

Cross-border capital flows and financial stability may also be seriously affected by unintended consequences of national measures that aim at strengthening financial stability.

Foreign currency loans

Lending in foreign currencies is considered as capital movements thus falling under the scope of the free movement of capital and the freedom of establishment. National measures interfering with outstanding foreign-currency loans may in principle be regarded as restrictions to the freedom of capital movements. When assessing whether a particular measure can be regarded as proportionate to its objective, it has to be analysed whether other, less restrictive measures could achieve the same results, taking into consideration aspects such as the extent of burden sharing among the parties involved, the potential impact on financial and macroeconomic stability as well as the impact on legal certainty, aiming at ensuring that measures taken respect EU law and avoid moral hazard.

The entry into force of the Mortgage Credit Directive 2014/17/EU (MCD) is expected to lead momentum to cross-border mortgage lending and help develop an integrated EU market, as it ensures that retail customers would have adequate information concerning credits denominated in a foreign currency. Unlike in 2016, no new special measures were taken by Member States in this field during 2017 though there are still ongoing discussions in some Member States.

The EFC will continue to closely monitor any potential measure regarding lending in foreign currencies that may affect the free movement of capital in the EU.

The macro-prudential framework

The European Commission and the European macro-prudential bodies (the ECB, the Financial Stability Committee, and the ESRB) continuously monitor the use of macro-prudential measures and their compatibility with the free movement of capital, especially in respect of restrictions in foreign currency lending but also on the possible cross border effects of the use of macro prudential capital buffers.

Since the establishment of the ESRB and the introduction of macro-prudential tools in the CRD IV/CRR, the framework for macro-prudential policy has become more complex, notably following the creation of the Banking Union. Overall, the use of macro-prudential measures by Member States has not given rise to major issues in relation to the free movement of capital during the reporting period.

Moreover, in the context of the low interest rate environment since the financial crisis, market based financial actors have stepped into the areas where banks would not make enough profit. The increasing role of these actors calls for a close monitoring in terms of movement of capital and to explore in which areas the macro-prudential framework should be extended beyond banking, as well as to setting up system-wide stress tests.

With input from the competent authorities, the EFC will continue to carefully consider the measures taken by Member States on macro-prudential risks and to ensure that their application is done in a way that does not unduly impact the free movement of capital flows

Investments in real estate and agricultural land

Following Article 63 TFEU, capital movements include cross-border transactions between residents and non-residents. In the context of real estate, these transactions include acquisitions, rights of usufruct, easements and building rights (Annex to Directive 88/361/EEC). The EU's free movement of capital rules allow Member States to temporarily apply restrictions to the Treaty freedom.

As regards the acquisition of agricultural land, Member States are allowed to maintain, during a transition period, derogations from the free movement of capital rules as foreseen in their Accession Treaties. Croatia is the only country for which this is still the case until 1 July 2020.

Following the expiry of the transitional derogations for other Member States, new national laws were adopted regulating the acquisitions of agricultural land, but infringement procedures were started in 2015 against five of those national laws (Bulgaria, Hungary, Lithuania, Slovakia and Latvia). In 2017, Latvia and Lithuania changed their national law to address the concerns raised; the Commission is currently assessing the new laws.

During the reporting period, the Commission adopted an Interpretative Communication on "Acquisition of farmland and European Union law" which recognises agricultural land as a special asset which deserves particular protection and providing guidance on how those objectives can be achieved in respect of EU law, in particular the free movement of capital principle.

7. CONCLUSION

The EU has one of the most open frameworks and remains committed to enhancing free movement of capital and freedom of payments. With this aim, a number of major policy initiatives have been developed in 2017. Flagship policies such as the CMU aim to unlock the substantial savings held in the EU and help channel these towards the most productive investments. The mid-term review of the CMU should ensure that it better connects savings to investment and strengthens the European financial system by improving private risk-sharing, providing alternative sources of financing and increasing options for retail and institutional investors

The Joint European Commission/Member States Roadmap of actions on national barriers is essential to further support Member States in building a single capital market.

A number of key initiatives have also been taken to support the free movement of capital in Europe, including in the field of taxation to contribute to more integrated capital markets and a level playing field, as well as appropriate surveillance of the financial sector.

The EFC supports further developing these policies, in line with relevant Council conclusions, notably on the CMU, the Investment Plan and the completion of the Banking Union. The implementation of such policies will contribute to enhance the free movement of capital and the freedom of payments, thus underpinning the EU single market as an attractive market for placing long term investments.