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COVER NOTE

From:	General Secretariat of the Council
To:	Delegations
Subject:	Cooperation in the field of financial services and economic dynamics in Europe.

Delegations will find attached the Commission background paper on Cooperation in the field of financial services and economic dynamics in Europe for the EU and EFTA Ministers of Finance and Economy on 15 October 2013.

Encl.:

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS
International economic and financial relations, global governance
Globalisation - Trade – Development

DIRECTORATE GENERAL
INTERNAL MARKET
Financial services policy, relations with the Council

Cooperation in the field of financial services and economic dynamics in Europe

Background Paper

for the

EU EFTA ECOFIN Meeting

October 2013

Introduction

The pursuit of the four freedoms have benefitted citizens in the EU and EFTA and boosted integration of markets for goods and services, for capital and for labour. The recent dynamics of the European labour, capital and goods market show how adjustments take place within Europe – both within the EU and between the EU and EFTA. Among the markets, capital markets have received most attention recently. Capital markets will also receive most attention in this document. However, within Europe the labour market and the market for goods and services are playing their part in the necessary adjustment as well.

This background paper has two parts. In the first part, the focus is on the cooperation in the field of financial services with strong attention on regulation and supervision. The second part describes how adjustment has taken place so far through trade, capital flows, and migration. This second part is more grounded in recent economic developments. Although the two are highly linked, the specificity of the discussion on cooperation in the field of financial services warrants a separate treatment.

PART I Regulation and supervision

Cooperation in the field of financial services

The financial and economic crisis has illustrated that national supervision and crisis management requirements cannot keep pace with the integration of the financial system. The crisis has clearly shown that deficiencies in cross border supervision, a lack of focus on systemic risks and contagion channels, the domestic focus of national supervisors, and the feedback loop between banks and their sovereigns, particularly in challenging times, lead to undue fragmentation of the internal market with a negative impact on European economic growth.

The Commission engaged in an ambitious reform programme to address the weaknesses exhibited by the financial crisis and make the financial system more resilient. All the legislative initiatives included in the financial services reform programme implementing the G20 agenda have been put forward by the Commission. A number of them have now been adopted by the Council and Parliament.

The legislation finally adopted so far includes, inter alias, stronger capital rules for credit institutions and investment firms in the so-called CRDIV package, rules on bank remuneration and bonuses in the third Capital Requirements Directive, an EU-wide supervision regime for credit rating agencies, the creation of a genuine internal market for alternative investment fund managers, the European market infrastructure regulation on OTC derivatives, as well as a regulation on short-selling. The Regulations establishing the European Supervisory Authorities set up a European System of Financial Supervision to address the shortcomings in the area of cooperation, coordination, consistent application of the law and trust between national supervisors. The co-legislators are discussing currently the Commission's proposals for a review of the Markets in Financial Instruments Directive, a framework for the recovery and resolution of credit institutions and investment firms, Mortgage Credit Directive, Central Securities Depository Regulation, PRIPS, UCITS, etc.

All these pieces of legislation are internal market legislation under article 114 of the Treaty and destined for incorporation into the EEA Agreement. For as long as legislation is in force in the EU but not in the EFTA-EEA States, there is a danger for the level playing field and integrity of the EEA internal market.

The EU and EEA-EFTA states are discussing how to ensure that this significant volume of legislation is included in the EEA Agreement. There is agreement on the need to ensure the timely incorporation of the legislation, including the Regulations establishing the European Supervisory Authorities. The issue of how to reflect the direct powers of the European Supervisory Authorities vis-à-vis national authorities and financial operators in the EFTA-EEA states has been subject to discussion in a number of meetings at technical level. In June 2013, the EEA-EFTA states presented their suggestion as to how to incorporate the ESAs Regulations into the EEA Agreement. The proposal is based on the idea that the ESAs' decisions would be directly addressed to EEA-EFTA supervisory authorities with an option for the EEA-EFTA supervisory authorities to appeal these decisions before the EFTA Board of Appeal. The legal and technical feasibility of the proposal is being currently examined by the Commission services. This technical assessment would benefit, if it is complemented by testing how it would work in practice, for instance by looking at the transposability of the EU regulations on derivatives and credit rating agencies.

Beyond the financial reform, it is necessary to also mention the establishment of the Banking Union, in particular the Single Supervisory Mechanism conferring supervisory powers to the ECB, and the proposed Single Resolution Mechanism. Altogether, the Banking Union will improve the resilience of the Economic and Monetary Union and will, therefore, contribute to enhancing financial stability in the Euro area and beyond. At the same time, the creation of the Banking Union shall neither compromise the unity and integrity of the single market, nor its four freedoms, which remain one of the greatest achievements of European integration.

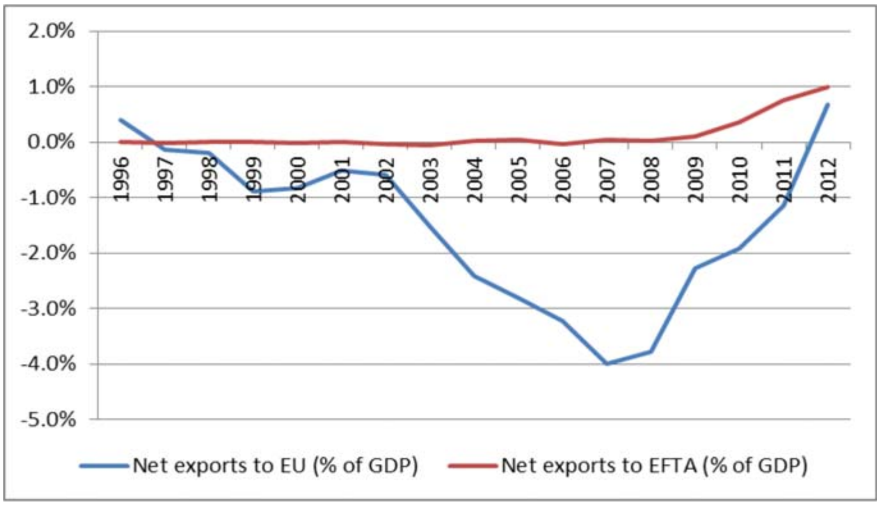
PART II Economic adjustments in Europe

The role of the internal market for goods and services in rebalancing

The high degree of integration in the market for goods and services in Europe is best exemplified by the fact that the EU absorbs roughly two thirds of EFTA's exports and EFTA partners absorb one ninth of the EU's exports. For the EU, EFTA is the second most important export destination after the USA. The resilience EFTA has shown since the start of the financial crisis in 2007 has benefited the euro area and has helped smoothing the impact of the crisis in the goods market on the group of countries that were hardest hit.

Graph 1 shows the developments in net trade of the five euro area member states with a relatively high yield (Ireland, Greece, Portugal, Spain, Italy). The division of trade within Europe is made between trade with EU and trade with EFTA.

Graph 1 Net trade of five euro area member states with relatively high yield (% of GDP)



Source: DataInsight

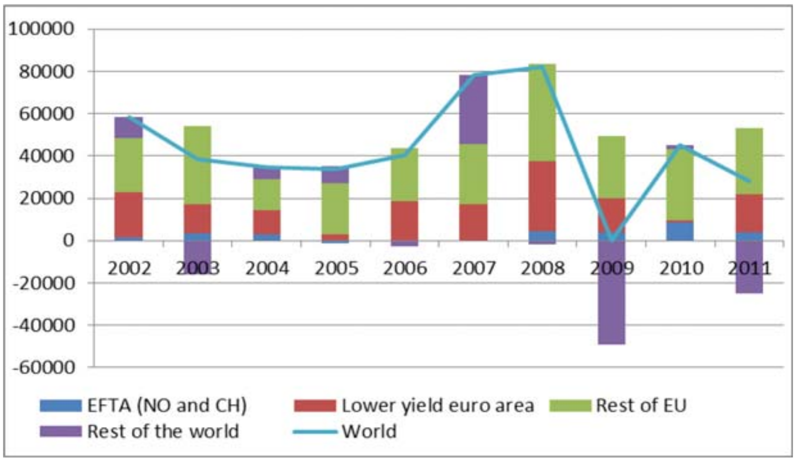
Trade with other EU MS, averaging 42% in the period 1995-2012, is much more important for these euro area member states than trade with EFTA, averaging 2%. Nonetheless, net trade with EFTA has been more anti-cyclical than trade with the EU. As graph 1 shows, net exports from high-yield euro area member states to EFTA got increasingly positive after 2008. This is mostly due to net exports from Italy to Switzerland. Net exports from the higher-yielding euro area member states to the rest of the EU reached their low at the start of the crisis. Thereafter, this trend was bent and net exports to the EU have started to contribute to economic growth in the group of five higher yield euro area member states last year.

For a structural improvement in the resilience of these five member states or any other member state confronted with adverse economic developments, it will be essential to maintain the internal market's high degree of integration. Deepening integration would seem to benefit resilience further as the five member states have increasingly been able to let net trade within wider Europe contribute to their economic growth and resilience.

Developments in capital markets: European foreign direct investment more stable than those from the rest-of-the-world

The capital market has been particular dynamic in the past five years. Bond and equity markets as well as bank flows have in particular been volatile. Foreign direct investment has again proven to be the most stable, due to its longer-term investment horizon. Graph 2 shows the foreign direct investments in higher yielding countries (IE, PT, EL, ES, IT) coming from lower yield euro area member states (AT, DE, FI, NL), from Switzerland and Norway[1], from the rest of the EU and from the rest of the world.

Graph 2 Foreign direct investment into five higher yielding euro area member states (EUR million)



[1] No or limited information was available for Iceland and Liechtenstein.

Source: OECD

Graph 2 shows that the largest contribution to volatility in higher-yielding euro area member states has come from outside Europe. Within Europe, foreign direct investment inflows from EFTA have been more stable than flows from lower-yielding euro area member states. Lower barriers to foreign direct investment in the European internal market seem, therefore, not to have led to heightened volatility. Rather, it appears that they contributed to continue providing finance at a time when investors from other non-European countries withdrew from the higher yielding European countries. As such FDI flows contributed to the resilience of these member states and to their chance to find new competitive advantages.

Structural adjustments in the internal market for labour: the role of migration

Recently, there has been quite some attention devoted to migration flows from the southern EU Member States to the northern Member States, in particular to Germany. Table 1 shows the size of total migration and the relative importance of migrants from the EU compared to all migrants. Of all migration flows in the EU, 42% was internal.

Table 1 Shares of extra-EU and intra-EU migrants in migration, 2011

	Total migration	All immigrants		Immigrants, 25 - 39yrs	
	(thousands)	Extra-EU	EU	Extra-EU	EU
To EU	1,716,200	58%	42%	60%	40%
Of which to:					
- Spain	457,649	66%	34%	70%	30%
- Italy	385,793	68%	32%	72%	28%
- Greece	110,823	62%	38%	58%	42%
- Germany	489,422	43%	57%	44%	56%
To Switzerland	148,799	30%	70%	28%	72%
To Norway	70,337	36%	64%	36%	64%

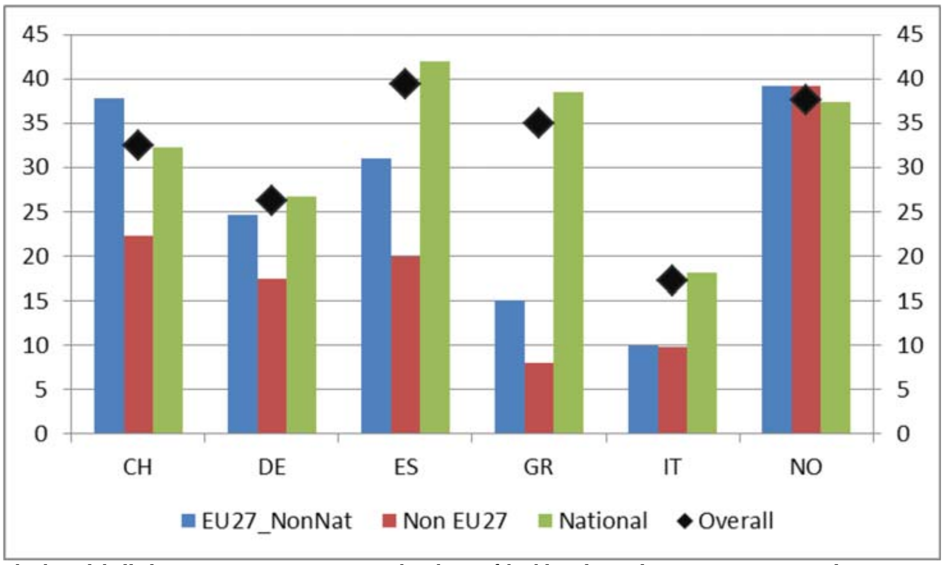
Note: EU total excludes BG, NL and RO for which no data were available
Source: Eurostat

Looking at the division between migrants coming from outside the EU and within the EU, it appears that migration from outside the EU is relatively important in Spain and Italy. Germany attracts relatively more migrants from within the EU. Due to the importance of extra-EU migration, Spain and Italy have a net immigration inflow from outside the EU and a net immigration outflow to the rest of the EU.

This division between, in particular, Germany on the one hand and Italy and Spain on the other hand gets more pronounced when looking at the migrants in the age group between 25-39 years. This age group tends to be the most attractive for recruitment by companies. Switzerland and Norway have the strongest performance in attracting migrants in this younger age group that is most attractive to recruiting companies.

Competitiveness is generally thought to benefit most from attracting the young and highly educated to the domestic labour force. When comparing migration flows of the highly educated within Europe, a relatively large flow can be seen towards the EFTA economies Norway and Switzerland. Switzerland, for instance, has attracted 46.000 highly educated employees between 2008 and 2011. This is four thousand more than the German labour market which is ten times as large. Graph 1 (below) shows the share of highly educated in employment compared to all employees of the same origin in 2011. As a result of the strong presence of highly-educated among immigrants, has the total of EU immigration in Switzerland (+1.0ppt) and Norway (+0.1ppt) added to the share of highly-educated in the total workforce. In Germany, on the other hand, total EU migration actually lowered the average educational attainment by 0.1 ppt.

Graph 3 Share of highly educated in labour force by origin (2010)



The bars labelled "EU27_NonNat represent the share of highly educated EU migrants in employment among all migrants from the EU. The bars labelled "Non EU27" show the share of highly educated in the total of employed migrants from outside the EU. The squares show the overall share of the highly educated in the employees in the respective countries. Highly educated are those at ISCED 1997 levels 5 and 6 (tertiary education). Source: Eurostat Labour Force Survey

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