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PART 1/3

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

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

1. INTRODUCTION

This report is part of an 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 report begins by reviewing the recent developments in EU and global capital flows in 2015 and in the first half of 2016 (depending on data availability). It then provides an overview of the applicable legal framework and describes the main initiatives taken in 2016 to support the free movement of capital and the freedom of payments. Finally, the report highlights other important challenges that required regular monitoring, and it reviews the main developments in the international sphere.

Capital flows in the reporting period were impacted by several factors sometimes working in opposite directions like: (i) economic developments (the ongoing modest global growth recovery), (ii) political factors and (iii) policy measures (for instance the efforts to boost investment and cross-border flows in the EU, the ECB actions to step up accommodating monetary policy and the US FED decision to start increasing interest rates).

EU gross capital flows of all types were lower in the first two quarters of 2016 compared to 2015. Portfolio investment and banking flows registered the sharpest declines. All of this occurred in a context of heightened uncertainty and slow global growth and trade. Although European cross-border investment also remained lacklustre from the beginning of 2016, foreign direct investment (FDI) flows continued to be the most stable source of cross-border financing. Intra-EU FDI was even less dynamic and continued to be well below the pre-crisis level.

High-frequency data¹ shows that in the fourth quarter of 2016 global net portfolio investment fund flows turned sharply negative. This came after further normalisation of monetary policy conditions in the United States and was due to accelerating outflows of mutual funds.

In contrast, European companies in 2015 increased their cross-border investment. Europe as a region² and the EU as a group became the biggest source of FDI in the world. This was helped by favourable financing conditions and corporate reorganisations.

¹ Some private data sources permit to have data updates at shorter frequency, i.e. one week, which gives information for capital flows movements much earlier than the Balance of Payments statistics that is published with significant lags. In this case, the EPFR database provides data regarding fund flows which can be used to anticipate portfolio investment flows.

² Including intra-EU FDI. For more details, see: WIR 2016, UNCTAD.

After several quarters of net capital outflows, the EU stock of accumulated net external liabilities started to shrink in the second quarter of 2015 and declined from almost 13 % of EU gross domestic product (GDP) in 2008 to close to 5 % of GDP in the second quarter of 2016. The Member States of the euro area contributed the most to the adjustment, followed by Denmark, Sweden and the United Kingdom. The reduction of EU's external liabilities will contribute to decreasing macroeconomic imbalances, moving the EU closer to an externally balanced economy.

Against this background, policy initiatives in support of investment, like the Investment Plan for Europe and its European Fund for Strategic Investments (EFSI), have a major role to play. In light of the encouraging results of the Investment Plan's first year of operation,³ the Commission has proposed to extend the duration of EFSI to 2020 and bring its level of investment to a total of half a trillion euros.⁴ In order to increase not only the quantity but also the quality and the strategic nature of the investments, The EFSI will increasingly target projects that help to achieve the ambitious goals agreed by the EU at the Paris Climate Conference (COP 21) and earmark an even larger share of financing for SMEs.

Free movement of capital is essential to build truly integrated, open, competitive and efficient European financial markets, which is also the objective of the Capital Markets Union initiative. To consolidate the single market for capital and support projects and investments in key areas, it is also crucial to remove remaining national barriers to cross-border investment.

A fully-functioning Banking Union and efficient banking sector are indispensable to ensure an effective implementation of the single monetary policy, better risk diversification across Member States and adequate financing of the economy. In light of this, the Commission made proposals in November 2015 and in November 2016 to complete the post-crisis regulatory reform of financial sector rules. More specifically, it proposed reforms aimed at risk reduction and risk sharing (the European Deposit Insurance Scheme) as well as a combination of measures designed to ensure that the regulatory framework addresses any outstanding challenges to financial stability so that banks can continue to support the real economy (amending the Capital Requirements Directive, the Capital Requirements Regulation and the Bank Recovery and Resolution Directive).

In the reporting period covered by this report, Greece and Iceland (the two European Economic Area countries that introduced capital controls as a result of the economic and financial crisis) undertook steps to lift them. On the one hand, the Icelandic authorities adopted measures to lift restrictions to outward FDI and alleviate controls on several other types of investment as of September 2016. On the other hand, the Greek authorities took measures to alleviate the impact of controls. However, they will have to decide on further relaxations, provided financial and economic conditions are positive.

Looking forward, the following factors are likely to impact capital flows in the next reporting period:

- *Political fragmentation and uncertainty* would affect negatively economic growth, trade, investment and the linkages in the global economy.

³ https://ec.europa.eu/priorities/publications/commission-evaluation-first-year-efsi_en

⁴ http://europa.eu/rapid/press-release_IP-16-3500_en.htm

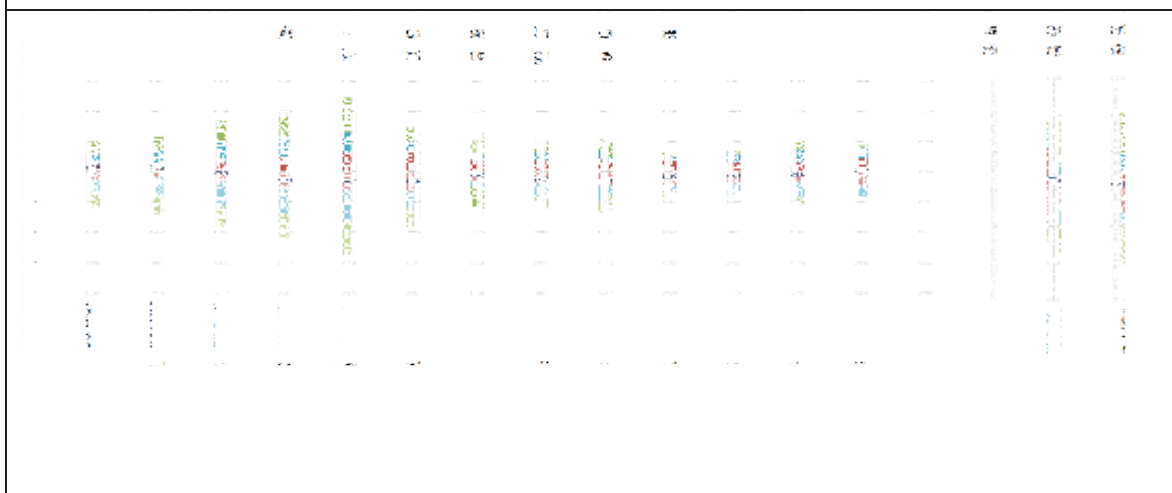
- *Asymmetric monetary policy conditions across the globe* are likely to continue influencing capital flows and to weigh on the exchange rate of the euro.
- *Compressed earnings of multinational companies and downscaled global growth prospects* are likely to constrain cross-border investment.
- *Commodity prices* are expected to remain important drivers of capital flows, despite their recent increases, as their recovery seems to be gradual and only partial compared to the levels reached a few years ago.
- *Cross-border bank deleveraging and balance sheet repair* are expected to continue weighing on international financial integration in Europe, despite some signs of it slowing down.

2. TRENDS IN EU CAPITAL FLOWS IN THE GLOBAL CONTEXT IN 2015-2016

2.1. Global and EU capital flows⁵

Global⁶ gross capital flows were moderating since the beginning of 2015 and still remain at lower levels compared to the pre-crisis period (see Figure 1). After declining sharply in 2008-09 global gross flows have broadly recovered by the second quarter of 2016, although they have never reached again their pre-crisis level.

Figure 1. Gross capital flows in the world (per cent of GDP)



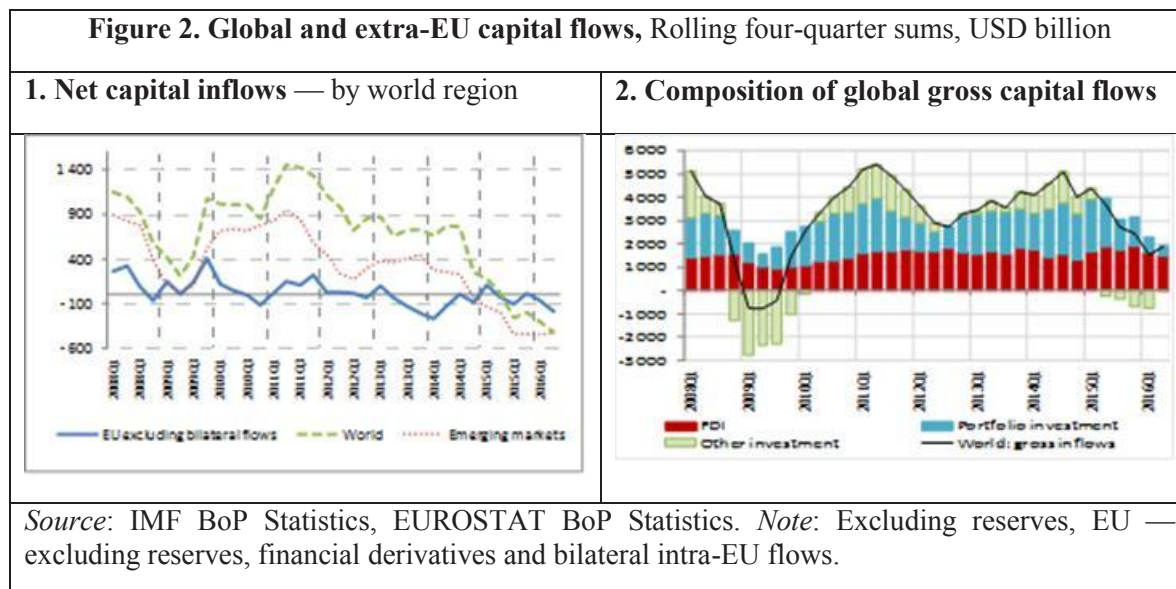
Source: Bruegel calculations based on data from the IMF International Financial Statistics (quarterly capital flows) and IMF World Economic Outlook (annual GDP).

Notes: the values shown are the aggregate of 77 countries, including all large economies. Therefore, the combined financial account of these countries (indicated by the solid line) should be close to zero and the significant deviations from zero in 2006-13 likely indicate reporting errors. The left panel shows the ratio of the 4-quarter moving average capital flows to the 4-quarter moving average GDP level. 4-quarter averages are used to reduce short-term noise and to be able to highlight key tendencies. The right panel shows the ratio of actual quarterly capital flows (i.e. no moving average) to the 4-quarter average GDP level. Thereby, the magnitudes in the two panels are comparable to the ratio of annual capital flows to annual GDP. Liabilities are represented multiplied by minus one. Negative values for assets, and positive values for liabilities, indicate retrenchment of earlier investments.

⁵ This section incorporates some of the results of a study carried out for the European Commission by Bruegel: ‘*Analysis of developments in EU capital flows in the global context*’.

⁶ Global flows are approximated in this section by a sample of 77 countries including both advanced as well as emerging economies, and the EU excluding intra-EU bilateral flows (extra-EU flows only).

After turning negative in the third quarter of 2015, global net capital inflows⁷ continued to decline in the first half of 2016 (see Figure 2, Panel 1). Emerging markets⁸ recorded the most significant decline in net capital inflows with a continuing downward trend as of the second quarter of 2011. Regarding the composition of the downward adjustment, it was mostly attributable to portfolio investment outflows (Figure 2, Panel 2).



Among the three main components of capital flows, FDI declined the least. While it is still below the levels observed in 2005-07, the 2013-15 average is actually higher than in the period preceding the pre-crisis peak in 2002-04. On the contrary, gross portfolio investment in 2013-15 was about half its level in 2005-07 and also below values observed in 2002-04. Gross other investments (comprising mostly cross-border loans) fell even more, and in several quarters of 2012-15 there was a retrenchment⁹ of earlier other investment flows. These developments highlight that FDI remained comparatively more stable during the global reduction of gross flows in the aftermath of the 2007-08 global financial and economic crisis.

While these trends prevailed in 2013-15, there was a slowdown in global FDI flows and a large retrenchment of other investments in the last quarter of 2015 and the first two quarters of 2016. It remains to be seen whether these developments were a temporary setback to global capital flows or the beginning of a major slowdown in global FDI and other capital flows.

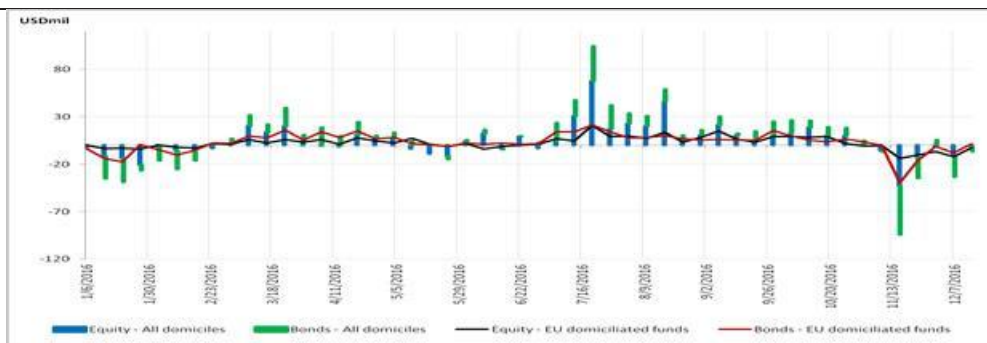
⁷ Gross capital inflows are defined as net changes in domestic resident liabilities to non-residents. Gross capital outflows are defined as net changes in foreign assets owned by domestic residents, excluding reserves. Net capital inflows are defined as gross inflows minus gross outflows.

⁸ Approximated by a sample of 56 emerging market economies. For more details and the sample see: ‘Recent experiences in managing capital flows’, IMF, 2015, Annex I.

⁹ In this context, retrenchment means negative values due to the unwinding of previously made cross-border investments.

Another major change was the switch from large portfolio investment inflows to outflows in 2015; the changed behaviour of former reserve-accumulating central banks may have contributed to this. High-frequency data show that in the fourth quarter of 2016, global net investment fund flows fell sharply (see Figure 3) after the US elections and the further normalisation¹⁰ of monetary policy conditions by the US Federal Reserve System in December. Both equity as well as bond flows declined with EU-domiciliated funds contributing to almost half of the adjustment. Net outflows from investment funds domiciliated in the EU were more significant for bonds than for equity (see Annex III).

Figure 3. Net bond and equity fund flows, weekly data 01/01/2016 – 14/12/2016



Source: EPFR Global

Extra-EU net capital inflows¹¹ followed a similar downward pattern and turned negative on a rolling four-quarter basis as of the second quarter of 2015 (see Figure 2, Panel 1). The euro area has been characterised by capital outflows since the end of 2012, predominantly driven by bank-related outflows (loans and deposits) in 2013-14. In 2015 the euro area experienced portfolio investments outflows practically for the first time since 2001. This reflected to some extent the impact of the European Central Bank's asset-purchasing programme.

The central and eastern European countries¹² net financial inflows have receded substantially since the height of the financial crisis; these countries eventually turned into being net capital exporters in 2015-16. Net pre-crisis inflow of other investment switched to outflows, net portfolio inflows went down to zero, and FDI inflows fell significantly.

In contrast to the euro area and central and eastern European countries, Sweden, Denmark and the United Kingdom experienced substantial net capital inflows from 2014 to the first quarter of 2016. This was driven by strong portfolio and FDI inflows, while bank-related outflows over the same period offset somewhat the observed inflows. In the UK, in the first two quarters of 2016, negative banking inflows were compounded by

¹⁰ More specifically, after slashing rates to almost zero amidst the 2008 economic and financial crisis, on 14 December 2016 the US FED increased its key interest rate by 0.25% as a result of improving prospects for the US economy.

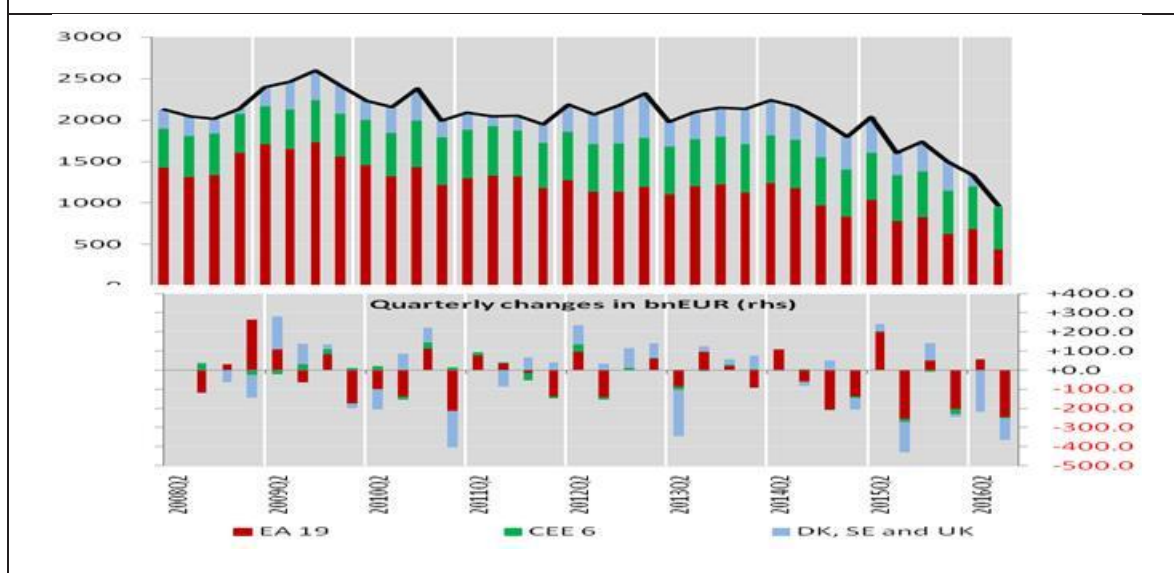
¹¹ Extra-EU net inflows are net capital flows coming from outside the EU. They are equal to gross extra-EU inflows minus gross extra-EU outflows, excluding reserves, financial derivatives and bilateral intra-EU flows.

¹² CEE includes the 11 most recent EU Member States from Central and Eastern Europe: Bulgaria, Croatia, the Czech Republic, Hungary, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

bank-related outflows. This forced the financial account into a net outflows position for the first time in the post-crisis period.

The contraction of the accumulated stocks of the EU's net external liabilities accelerated in the reporting period (see Figure 4). The EU has accumulated a negative foreign assets (positive net external liabilities) position that broadly represents the accumulated deficits that the EU has accrued with the rest of the world. After reaching close to 13 % of the EU's GDP in 2008, the EU's foreign assets position has been shrinking since 2014 and stood at around 5 % of GDP in the second quarter of 2016. While the stock of net external liabilities declined in all groups of Member States, the euro area contributed most to the adjustment (67 % of the quarterly reduction). Denmark, Sweden and the UK also contributed substantially (31 % of the quarterly adjustment), with the UK having the highest contribution of a single country (almost 26 % of the quarterly decline for the EU). The improvement of the net international investment position for the euro area was due primarily to transactions (flows), favourable exchange rates and valuation developments as well as acquisitions of foreign assets.¹³

Figure 4, EU net external liabilities position by main groups of Member States, billion EUR,



Source: EUROSTAT, BoP Statistics. *Notes:* EU data include bilateral flows between EU Member States. The net external liabilities position equals the stock of EU external liabilities (foreign-owned assets in the EU) minus the stocks of EU external assets (EU residents' holdings of foreign assets).

The recovery of capital flows in the post-crisis period has been uneven across regions and EU Member States (see Annex I, II and IV). By the first quarter of 2010, gross capital inflows reached nearly pre-crisis levels in Latin America, in the ASEAN-4¹⁴, and in Sub-Saharan Africa. However, gross capital inflows remained subdued in CEE and in Commonwealth of Independent States (CIS) countries¹⁵. In 2015, gross flows into Latin America and Sub-Saharan Africa stabilised at much higher levels than before the crisis, while the Asean-4 and the BRICS¹⁶ experienced capital outflows in recent quarters. This

¹³ For more details see: <https://www.ecb.europa.eu/press/pr/stats/bop/2016/html/bq161007.en.html>

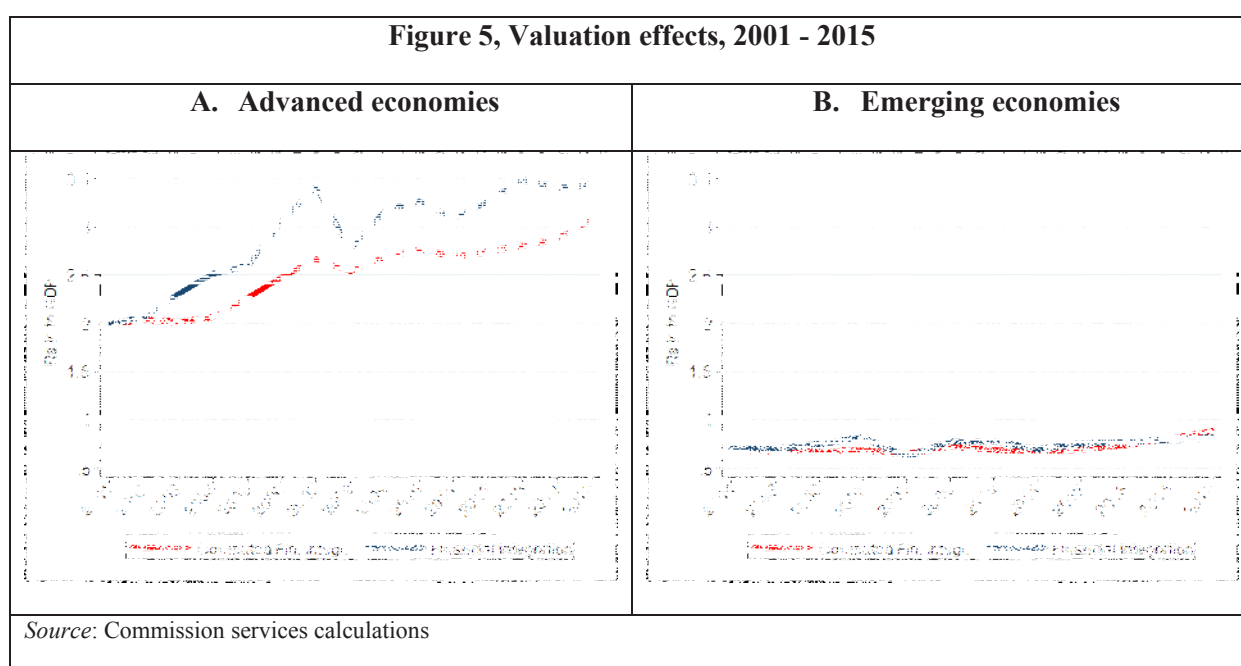
¹⁴ ASEAN-4 countries are: Indonesia, Philippines, Thailand and Vietnam.

¹⁵ CIS countries are: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldova, Tajikistan, Ukraine, Turkmenistan and Uzbekistan.

¹⁶ BRICS countries are: Brazil, the Russian Federation, India, South Africa and China.

suggests that there is no general trend of capital outflows from emerging countries, and even two large regions continue to experience large-scale capital inflows. In CEE, CIS and advanced countries, gross flows continue to stay well below pre-crisis levels.

Regarding trends in the gross international investment positions of the G20 economies, calculations show that there are significant positive valuation effects across advanced economies which are at times as large as 75 % of GDP (see Figure 5) being the difference between the actual international financial integration (IFI) and a computed indicator for international financial integration excluding valuation effects (CIFI).¹⁷ On the other hand, the size of valuation effects in EMEs is marginal. More specifically, there are large positive valuation effects on the US stocks of foreign assets and liabilities which appear to be the main driving force behind the developments observed across advanced economies. This might raise concerns regarding financial stability. This is especially true if global financial integration turns out to be not as ‘global’ as perceived and if a significant amount of external assets and liabilities is held by a limited number of advanced countries.



2.2. Global and European banking industry outlook

Given the importance of the banking system for financial integration in Europe,¹⁸ this report looks at capital flows from the perspective of the banking sector as reported by the Bank for International Settlements.¹⁹ Gross foreign claims of EU and non-EU advanced country²⁰ banks followed different patterns: while claims of EU banks declined

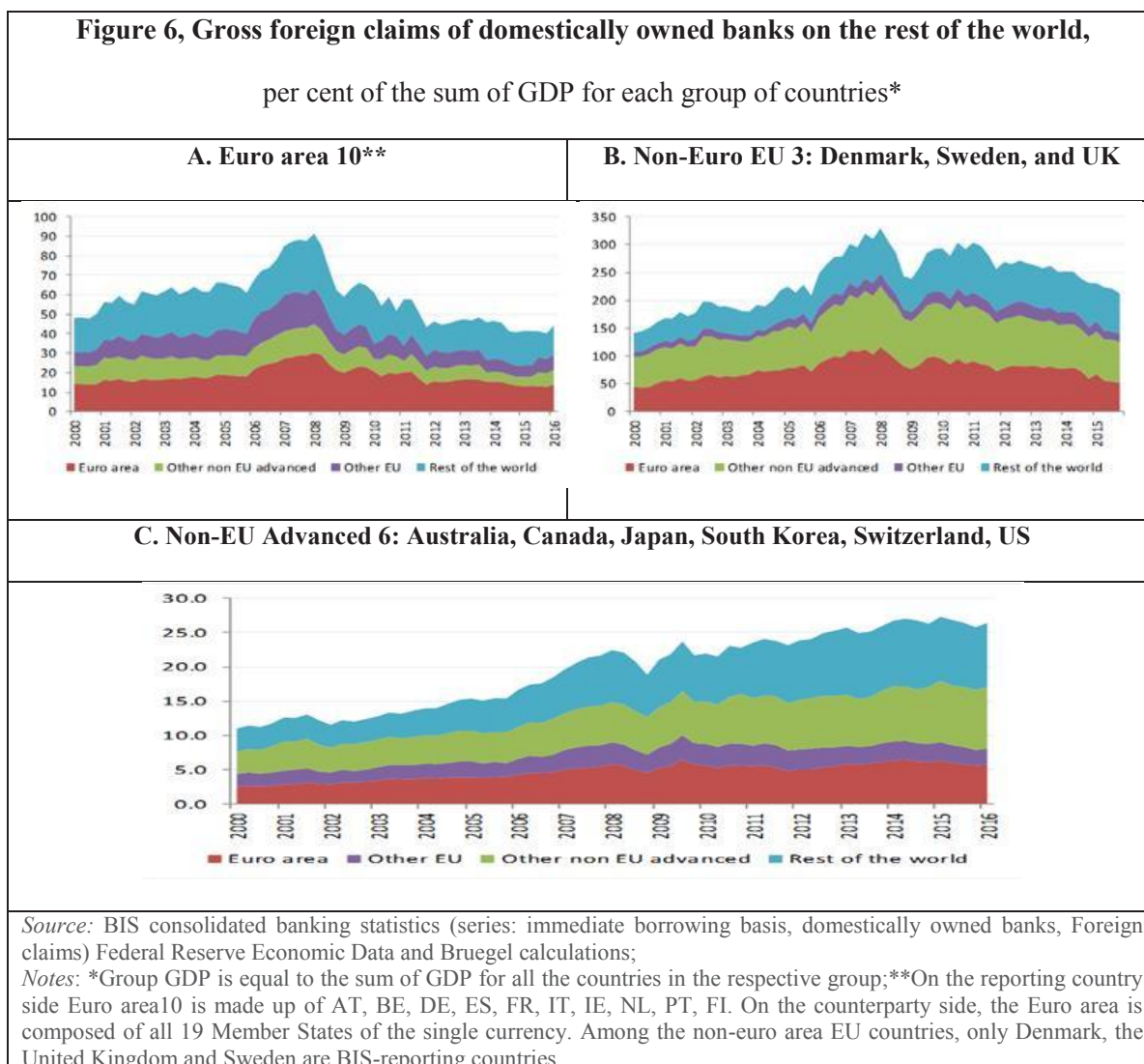
¹⁷ For more details see Annex IV and Bogdanov and Filippeschi (2017) "Financial Integration: Globalisation or Americanization", forthcoming European Commission Discussion Paper.

¹⁸ As reported in the 2015 edition of the Staff Working Document on the Free Movement of Capital and the Freedom of Payments, the share of bank-intermediated claims in the total external liabilities had been declining in the post-crisis period. Nevertheless, it stood as of 2014 at almost 35 % for the CEE 9, 30 % for the euro area 17 and 45 % for the UK, Denmark and Sweden.

¹⁹ It should be noted, however, that not all countries are reporting to the Bank of International Settlement, even in Europe.

²⁰ The non-EU advanced economies considered here are: Australia, Canada, Japan, South Korea, Switzerland and UK.

significantly since 2007-08 (even halved for euro area banks), claims of non-EU banks (after some volatility in 2007-09) continued to increase even after 2009 (see Figure 6).



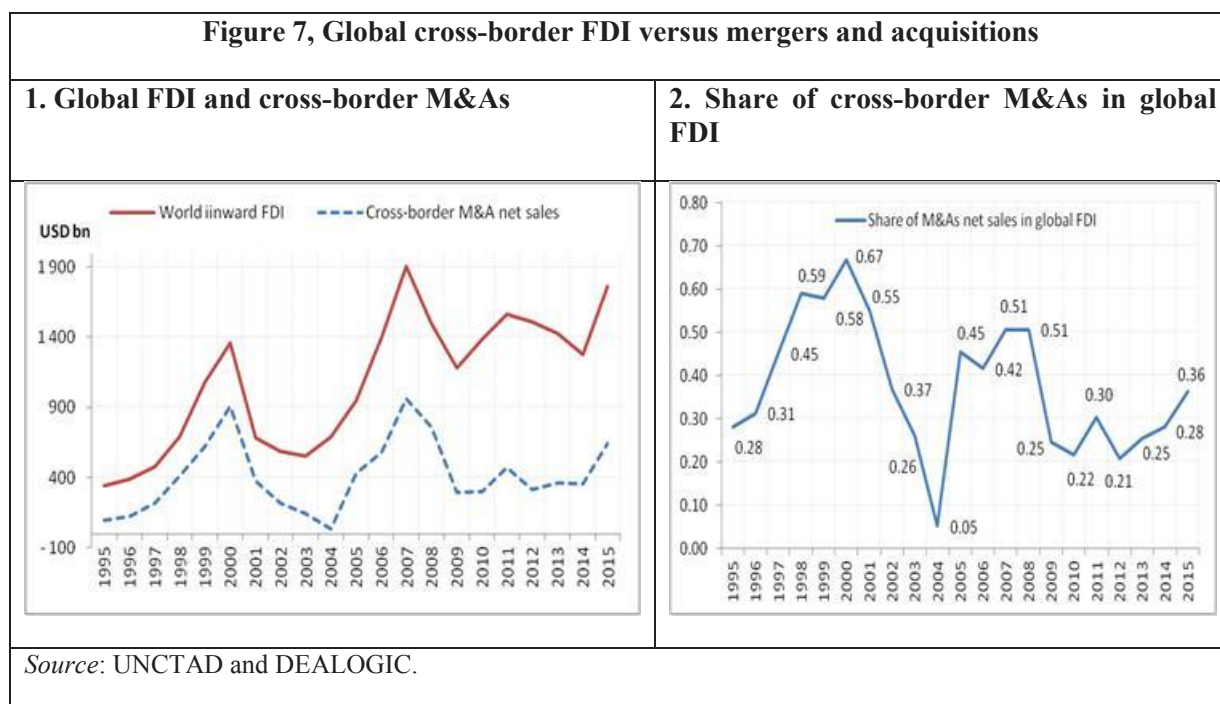
Euro area banks exhibited the largest claims on other euro area banks (amounting to 30 % of group GDP in the fourth quarter of 2014) followed by claims on other non-EU advanced (20 % of group GDP). The deleveraging of euro area banks for all other country groupings seems to have reached a plateau at a lower level in mid-2012. However, from mid-2014 to end 2015, a further slowdown of claims on the rest of the world can be observed, while claims on other non-EU advanced and other non-euro area EU Member States increased temporarily. The non-euro area countries Denmark, Sweden and the United Kingdom report most claims on other non EU advanced. A financial retrenchment process is ongoing, and claims on the euro area have fallen from highs of over 46 % of group GDP in 2012 to 26 % of GDP currently. Finally, in contrast to the European regions, banks in the six non-EU advanced economies of Australia, Canada, Japan, South Korea, Switzerland, and the US continued to increase their cross-border exposures to banks within the same country grouping until the end of 2015. That said, claims on both European groups have fallen slightly over 2014 and 2015.

2.3. FDI developments

2.3.1. Global FDI developments and the EU²¹

Global FDI flows rebounded strongly in 2015 by almost 38 % compared to 2014, surpassing their 2000 level and approaching the level reached in 2007. The recovery of global investment flows after the 2007 crisis, however, remains slower. It is taking much more time compared to the period after the 2001 crash when global flows started to rise sharply only two years after the slump. According to the United Nations Conference on Trade and Development (UNCTAD) forecast, the 2015 pick-up in global FDI is likely to be temporary, and global investment is expected to reach again USD 1.8 trillion only in 2018.²²

As demonstrated in Figure 7, corporate and financial restructuring played a large role in the 2015 rebound in global FDI.²³ More specifically, the share of merger and acquisition deals (M&As) in global inward FDI increased from 21 % in 2012 to more than 36 % in 2015. For the EU this share was even higher. Corporate restructuring deals can have positive growth impact indirectly through knowledge and productivity spill-over. However, they do not have such direct impact in increasing the stock of international production as greenfield investment and do not always involve flows of new financial resources for the domestic economies.²⁴



EU-28 FDI inflows were higher in 2015 and their share in global FDI inflows increased to 25 % compared to 23 % in 2014. However, the share of EU-28 FDI abroad increased even more from 25 % in 2014 to 33 % in 2015 (see Figure 8, Panel 2), and the EU as a bloc has become the largest investor in the world.

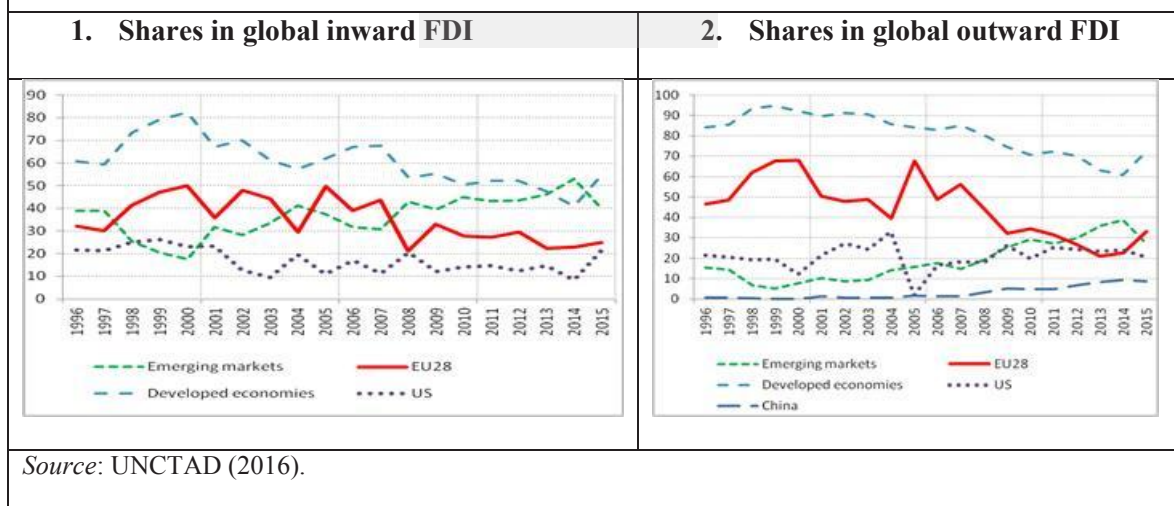
²¹ Unless otherwise indicated, this section uses UNCTAD data for FDI based on the directional principle and excluding investment through resident Special Purpose Entities (SPEs). Data availability by the cut-off date of this report is up to the end of 2015.

²² UNCTAD, World Investment Report 2016.

²³ <http://www.oecd.org/daf/inv/investment-policy/FDI-in-Figures-April-2016.pdf>

²⁴ In some cases M&As may involve only exchange of shares without cash payments.

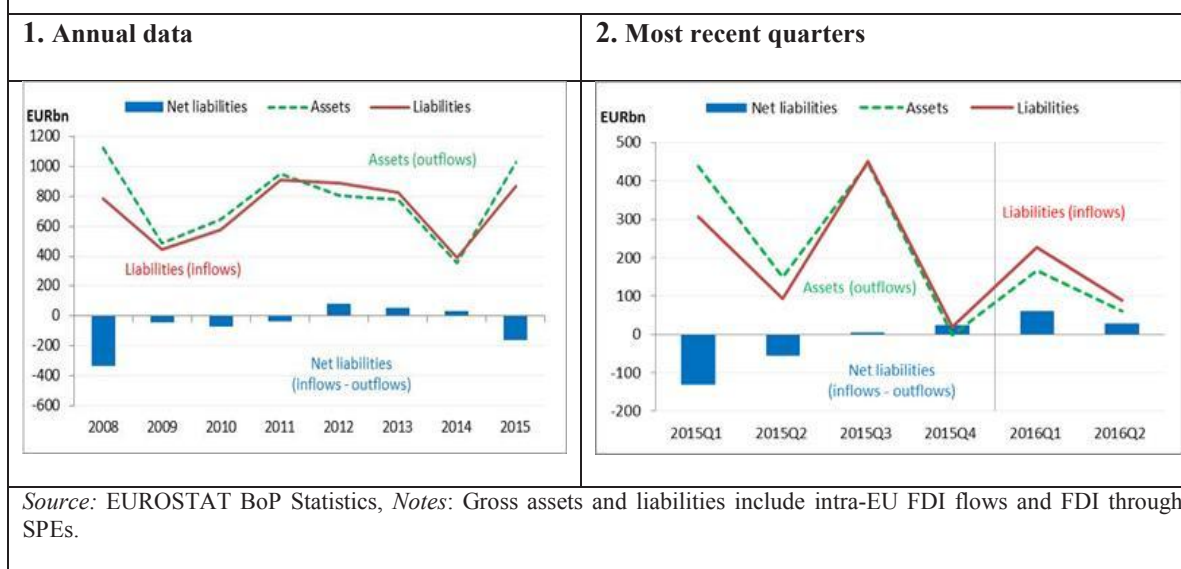
Figure 8, Share in global inward and outward FDI, 1996-2015, in %



2.3.2. *European FDI developments*²⁵

After three consecutive years of positive net FDI liabilities, in 2015 net cross-border investment into the EU turned negative as outward FDI exceeded inward investment. European inward FDI rebounded in 2015 from an exceptionally low level in 2014, and FDI inflows into the EU more than doubled reaching EUR 870 billion (see Figure 8, Panel 1). However, FDI investment abroad increased even more, and for the first time since 2008 it surpassed EUR 1 trillion in 2015. Behind the surge of corporate investment abroad was a strong increase in cross-border M&As.

Figure 9, EU FDI assets and liabilities flows, 2008 Q1 - 2016 Q2



In the first two quarters of 2016, however, FDI inflows dwindled and were almost 20 % lower compared to the same period in 2015 (see Figure 9, Panel 2). FDI investments

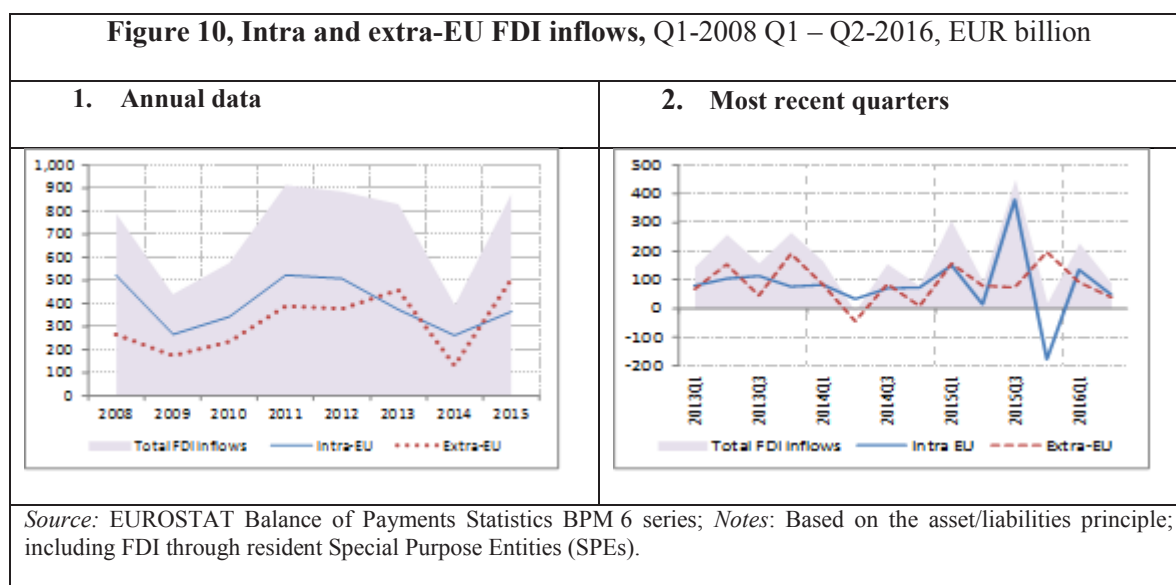
²⁵ Unless otherwise indicated, this section refers to EUROSTAT data based on the assets/liabilities principle and including flows through special-purpose entities (SPEs).

abroad declined even more and were almost 60 % lower in the first half of 2016 compared to 2015.

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

Since 2012 intra-EU FDI inflows had been on a downward path and for the first time in 2013 they fell below extra-EU FDI inflows. In 2015 intra-EU FDI inflows increased by 40 % and reached EUR 365 billion. However, extra-EU FDI inflows increased even more (almost tripling, although from a lower level in 2014) and surpassed again intra-EU FDI inflows (see Figure 10, Panel 1).²⁶

In the pre-crisis period and until 2011 intra-EU FDI inflows have been consistently exceeding extra-EU FDI inflows. However, the ongoing post-crisis unwinding of intra-EU FDI and the macroeconomic adjustment seem to be happening mostly through a curtailment of intra-EU cross-border investment. In some years between 2013 and 2015, it even fell below extra-EU FDI inflows.



Extra and intra-EU FDI inflows are likely to stabilise at relatively equal levels with shares of around 50 % in total FDI inflows. For the moment it is not clear whether intra-EU FDI would sustain its recent increase and surpass again extra-EU FDI inflows.

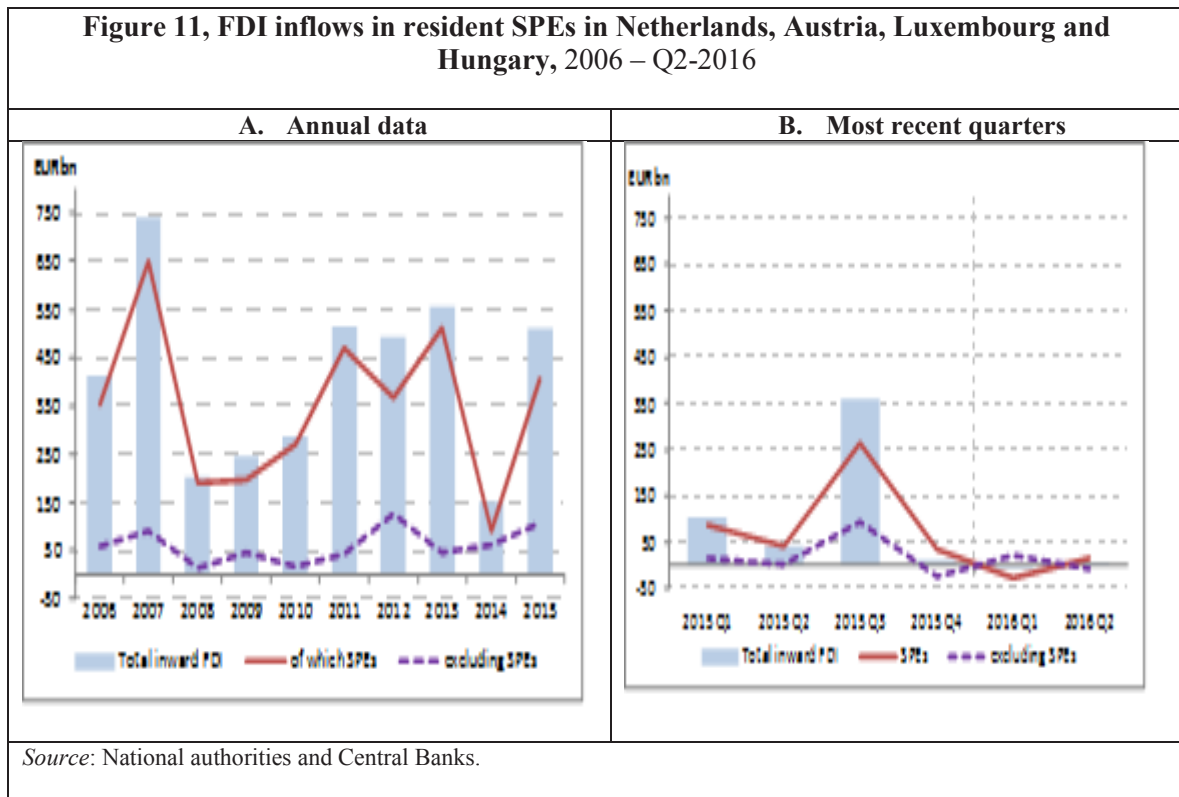
2.3.4. *FDI through resident Special Purpose Entities (SPEs)*

After declining abruptly in 2014 and recovering in 2015, FDI liabilities in resident SPEs²⁷ were again on a downward path in the first two quarters of 2016. For instance FDI inflows in SPEs in four EU countries with traditionally significant shares of FDI

²⁶ The switch to new statistical reporting methodology and principles in 2014, based on the revised International Monetary Fund (IMF) Balance of Payments Manual (BPM 6) and the 4th edition of the Organisation for Economic Co-operation and Development (OECD) Benchmark Definition of Foreign Direct Investment, does not permit a consistent comparison over several years in the past.

²⁷ SPEs are entities with minor physical presence in the host economies. However, SPEs provide important services for multinational companies in the form of financing or holding of assets.

flows through SPEs, namely, Austria, Hungary, Luxembourg and the Netherlands, increased by 22 % year-on-year in 2015 (see Figure 11). However, in the first quarter of 2016 even this indicator turned negative for those four countries.

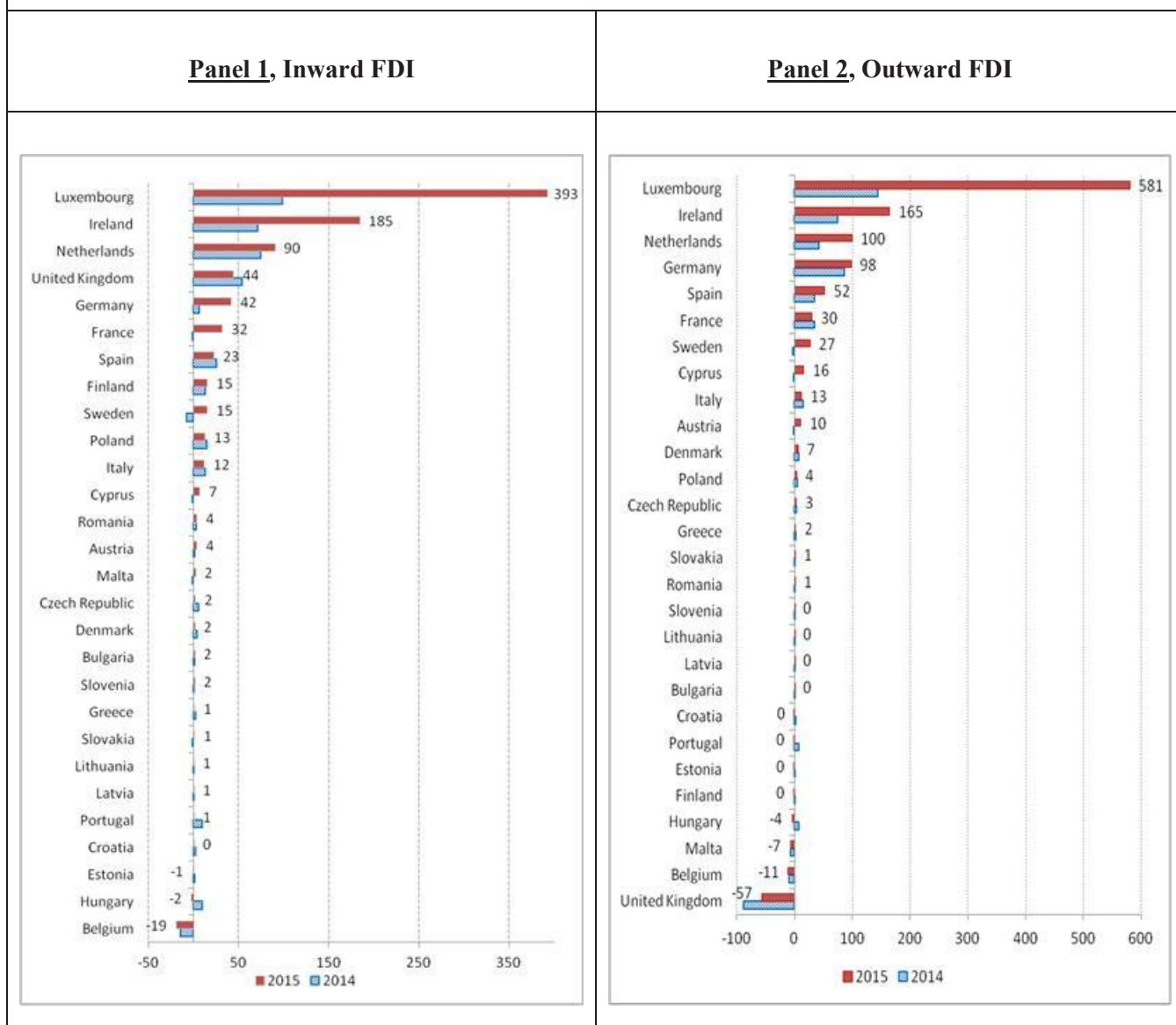


2.3.5. *FDI performance by Member States*

In 2015 FDI inflows increased in 15 Member States and declined in 13 Member States, while FDI abroad was split equally, increasing in 14 Member States and decreasing in the other 14 Member States (see Figure 12). Luxembourg was both the largest EU FDI host country and the biggest EU investor country in 2015. It also had the top ranking in 2014. However, the volume of investment flows increased significantly compared to the exceptionally low levels of cross-border investment in the previous year. Ireland and the Netherlands followed Luxembourg in the rankings for both FDI inflows and outflows. In fact the ranking of the first three countries was exactly the same for both inflows and outflows. This highlighted the importance of round-trip investment. The UK took fourth place in the host countries ranking, while Germany was the fourth biggest investor country in the EU.

The UK registered significant negative outward FDI (-EUR 57 bn) as a result of divestment. Other countries with negative outflows were Belgium (-EUR 11 bn) and Malta (-EUR 7 bn). Negative inward FDI (net divestment) were recorded in Belgium (-EUR 19 bn), Hungary (- EUR 2 bn) and Estonia (-EUR 1 bn).

Figure 12, Ranking of EU Member States as recipients and sources of FDI, 2014-15, EUR billions



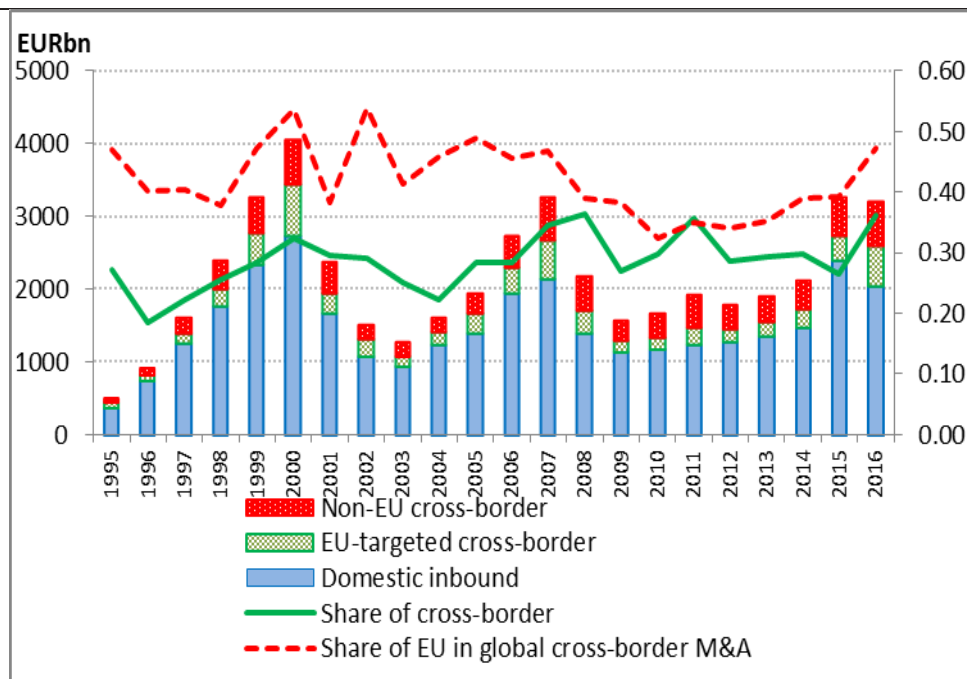
Source: EUROSTAT, quarterly BoP Statistics.

2.3.6. Mergers and acquisitions

Global value of M&A deals

Global cross-border merger and acquisitions (M&As) increased by 36 % in 2015 and by further 33% in 2016 reaching EUR 1158 billion and surpassing the pre-crisis 2007 peak of EUR 1132 billion (see Figure 13). The share of EU-targeted deals increased in 2016 and reached almost 47%. Domestic deals, however, moderated in 2016 declining by almost 15% and thus contributing to an overall lower value of deals in 2016.

Figure 13, Global M&As - value of deals, 1995-2016



Source: Dealogic, Notes: Final stakes higher than 10 %, rank eligible deals.

Chinese outbound M&As continued increasing strongly in 2015 and 2016 (see Figure 14). It resumed its growth in the fourth quarter of 2016, after declining briefly in the third quarter perhaps as a result of the re-introduction of some administrative restrictions for outward FDI adopted by the authorities towards the end of 2016.²⁸ The sharp increase in outward Chinese FDI has been underpinned by recent efforts in liberalization. In September 2014 China further liberalised outbound acquisitions, meaning domestic companies will no longer be required to obtain approval from China's Ministry of Commerce for their acquisitions abroad except in sensitive countries or for sensitive sectors.²⁹ Instead, they will just need to register with the Ministry of Commerce. Progress in the liberalisation of inbound foreign investment remained more limited.

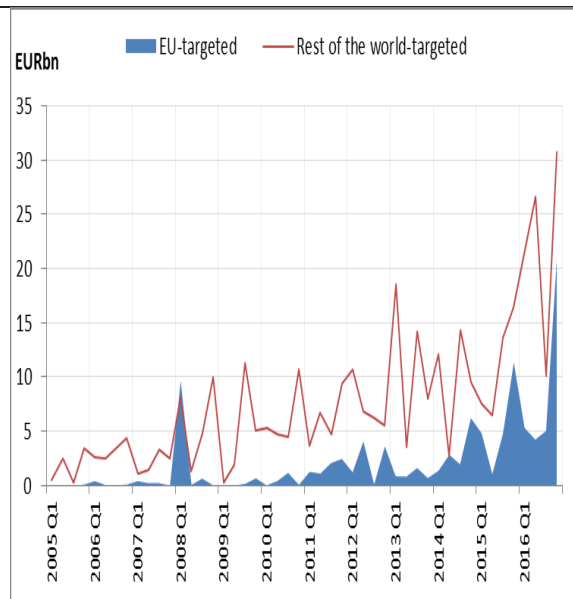
The share of acquired European companies surpassed 40 % in the fourth quarter of 2016. The most targeted European countries in 2016 were UK, Germany, Italy and France. The most targeted sectors in Europe were financial services, healthcare and pharmaceutical. Almost all of the deals in Europe were strategic with only few leveraged buyouts.

²⁸ The recently adopted measures restricting outward FDI, however, were not meant to affect investment in strategic sectors which continues to be viewed positively by the authorities.

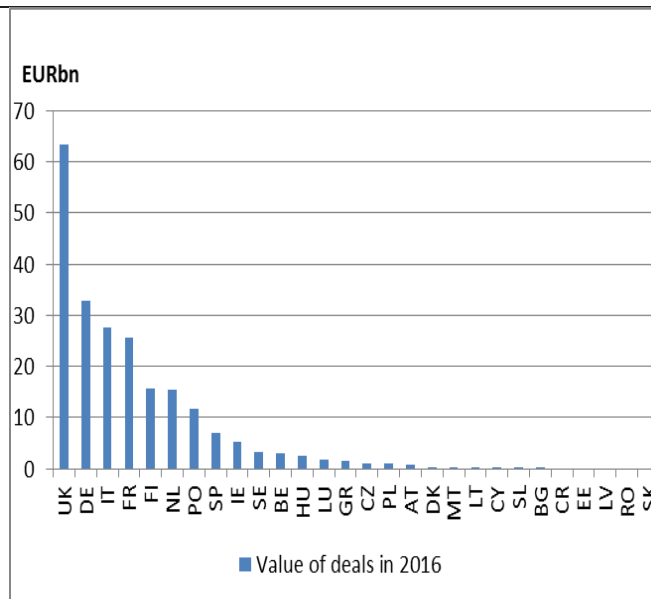
²⁹ 'Sensitive countries or regions' are considered as those that have not established diplomatic relationships with China or those that are under United Nations' sanctions. 'Sensitive sectors' are considered sectors involving any product or technology for which China has imposed restraints on exports and those involving the interests of multiple countries or regions.

Figure 14, Chinese outbound and EU-targeted cross-border M&As, 2005Q1-2016Q4

A. Value of deals



B. Ranking of most targeted EU countries in 2016



Source: DEALOGIC M&As Analytics

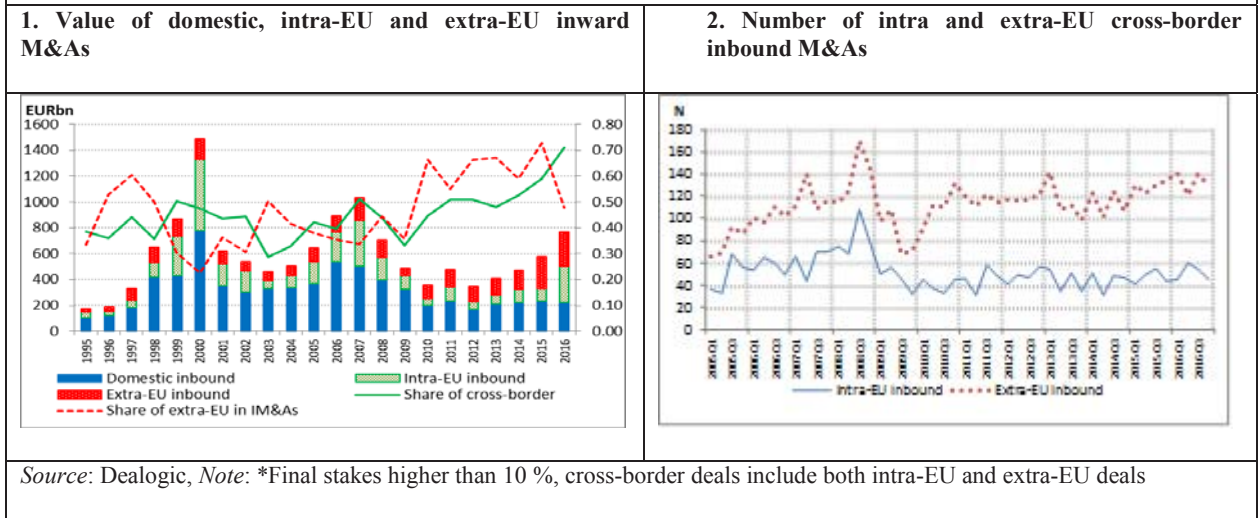
EU-targeted mergers and acquisitions

Corporate restructuring activity is on the rise in the EU since 2012 although it is still far from the pre-crisis levels (see Figure 15). In this period the total volume of deals (domestic plus cross-border) almost doubled from EUR 350 billion in 2012 to more than EUR 770 billion in 2016. While all types of deals increased, the rise of extra-EU inward M&As was especially strong, while domestic deals were almost stagnating. In 2016 intra-EU deals increased sharply, reaching almost 50% of all cross-border deals. In the previous years in 2012-15 their value was lower than that of extra-EU deals.

After declining by 10 % in 2015, intra-EU inward M&As were sharply higher in 2016 as a result of some very large deals (i.e. the acquisition of UK’s SABMiller by a Belgian company, the world’s largest brewer Anheuser-Busch InBev, in the third quarter of 2016³⁰). The volume of cross-border deals (including both extra and intra-EU) has increased in the post-crisis period. Their share in the volume of all inward EU M&As increased from 33 % in 2009 to more than 70 % in 2016 year-to-date.

³⁰ Reportedly, the price offered to the shareholders (predominantly from the US) had to be increased to GBP 79 bn after the sharp depreciation of the pound in the second half of 2016. The deal was finalised in October, after almost one year of regulatory clearance, including through the Commission Competition authorities. For more details, see for instance: FT from 27 July 2016.

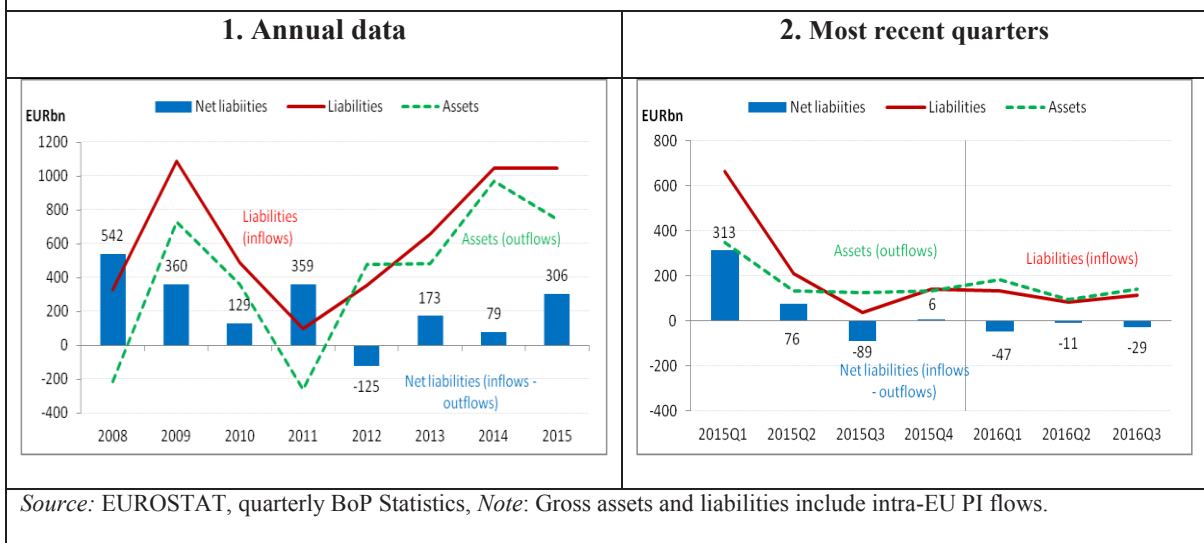
Figure 15, EU inward M&As, 1995 - 2016



2.4. Portfolio investment developments

In 2015 gross portfolio investment flows into the EU remained almost unchanged, while gross portfolio investment abroad declined by more than 22 %. This left net portfolio investment inflows in positive territory (see Figure 16). The EU traditionally has had a positive balance for portfolio investment inflows; outflows exceeded inflows on an annual basis only in 2012. However, from the second quarter of 2015 both gross portfolio investment assets and liabilities compressed and net portfolio investment into the EU turned negative from the third quarter of 2015.

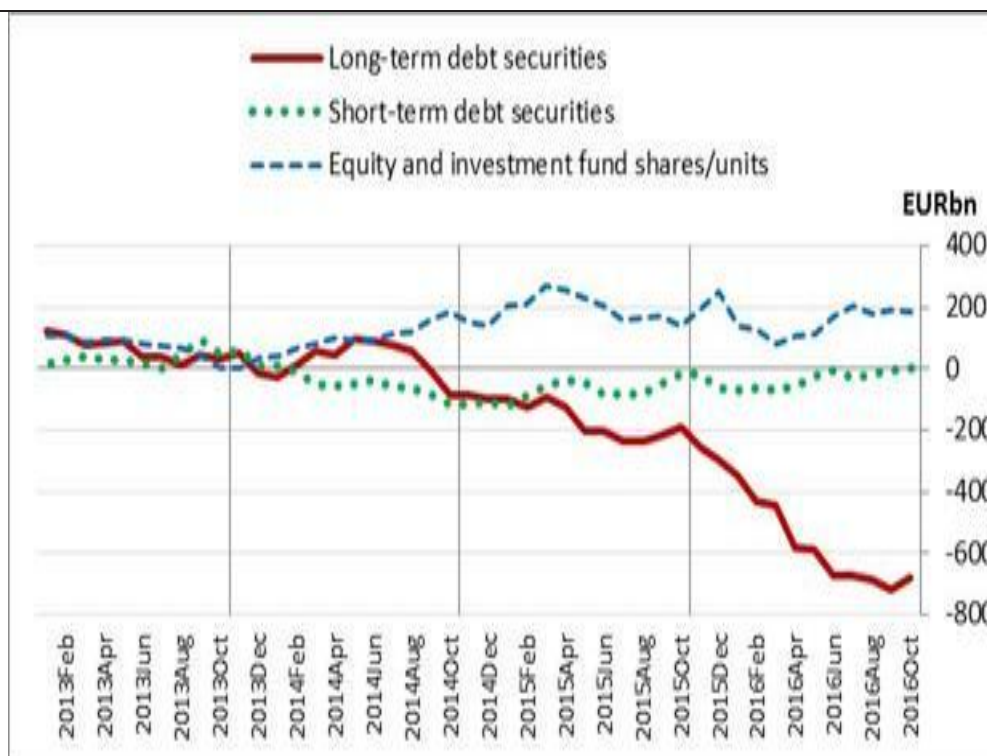
Figure 16, Portfolio investment flows, 2008-2016 Q3



This shift in sign was primarily attributable to a decline in portfolio investment inflows and to developments in the euro area (see Figure 17). Non-residents had been reducing their holdings of euro area long-term debts securities since June 2014. And the process

had accelerated after the start of the extended ECB bond buying programme in the second quarter of 2015. In this context, increases of central banks holdings of sovereign debt had been offset by disposals of debt securities by other institutional sectors or by non-residents.³¹ Thus, the decline in non-residents holdings of debt securities may have translated into lower gross portfolio investment inflows.

Figure 17, Euro area net portfolio investment liabilities flows,
rolling 12-month sums, January 2013 — October 2016



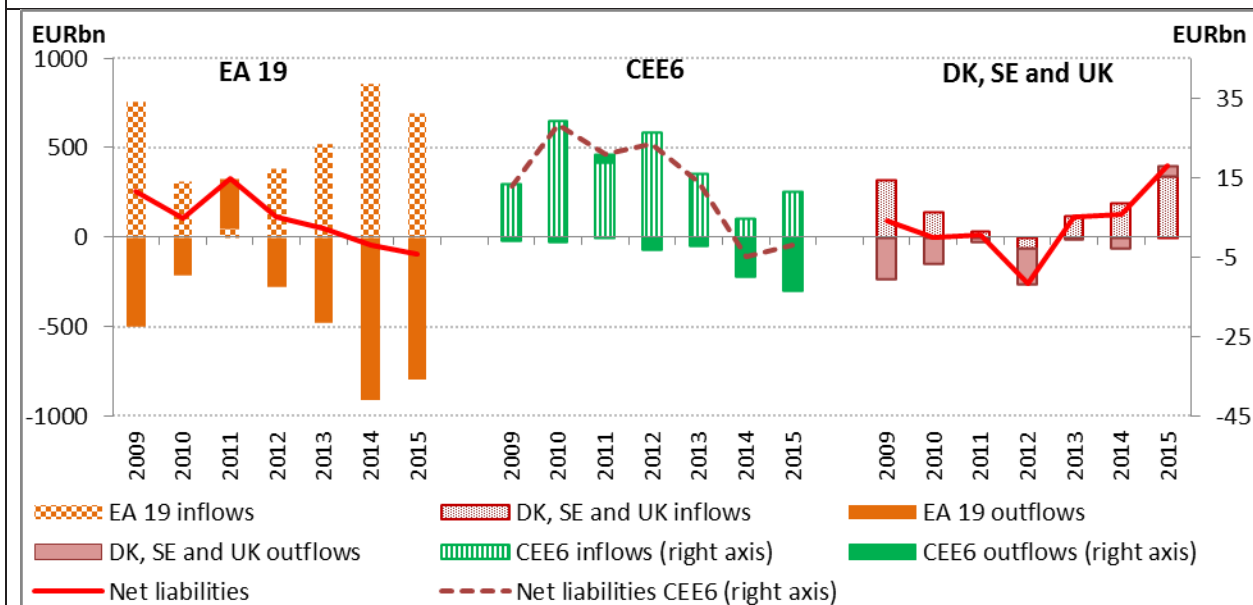
Source: ECB balance of payments monthly statistics, *Note:* Portfolio investment assets and liabilities include intra-EU portfolio investment flows.

Gross portfolio investment inflows increased in Denmark, Sweden and the UK, while the sharpest upturn was recorded in CEE 6³², albeit from a very low level in 2014 (see Figure 18). Gross portfolio investments abroad were lower in the euro area (-12 %), while residents of the United Kingdom, Denmark and Sweden disinvested their holdings of foreign securities in 2015. In contrast to their traditional pattern of being recipients of portfolio investment inflows, CEE 6 also recorded an increase in portfolio investment outflows in 2015 (+38 %).

³¹ For more details, see: Hüttl and Merler (2016), available at: <http://bruegel.org/2016/05/sovereign-bond-holdings-in-the-euro-area-the-impact-of-qe/>.

³² CEE 6 are the non-euro recent Member States: Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania.

Figure 18, Net portfolio investment inflows by groups of Member States, 2009-2015



Source: EUROSTAT balance of payments statistics, Notes: Including bilateral intra-EU portfolio investment flows; Portfolio investment assets are represented multiplied by minus one. CEE 6 are the six non-euro recently acceded Member States Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania.

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

3.1. Legal framework at EU level

The principle of free movement of capital is at the heart of the single market and is one of its four fundamental freedoms. The scope of application of the free movement of capital rules is broad. The Treaty on the Functioning of the European Union (TFEU) does not contain an explicit definition of capital movements.³³ However, in its jurisprudence the Court of Justice of the European Union has consistently confirmed a broad definition of capital movements.³⁴ According to this jurisprudence, they cover:

- FDI, real estate investments or purchases;
- securities investments (for instance in shares, bonds, bills and unit trusts); and
- granting of loans and credits, and other operations with financial institutions; including personal capital operations such as dowries, legacies, endowments.

The objective of freedom of capital movements is to ensure openness towards other Member States and non-EU countries. To this end, Article 63 of the TFEU prohibits all restrictions on capital movements and payments. However, this openness is not unconditional, as the TFEU provides the possibility to restrict capital movements under specific conditions.

³³ On the basis of the nomenclature annexed to Council Directive 88/361/EEC.

³⁴ On the basis of the nomenclature annexed to Council Directive 88/361/EEC.

In general, such restrictions include national measures to prevent infringements of national laws and regulations in the field of taxation and the prudential supervision of financial institutions and measures justified on grounds of public policy or public security³⁵ (Art. 65 1(b)), and other overriding reasons in the general interest³⁶ as recognised by the CJEU. The exceptions provided in the TFEU must not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments (Art. 65.3). All measures must be suitable and proportionate.³⁷

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

There is no secondary EU legislation harmonising the general rules on the free movement of capital.³⁸ Therefore, the enforcement of the free movement of capital Treaty provisions by the Commission services is mainly based on the monitoring of developments in Member States and ensuring the application of the principles of free movement of capital across the Member States.

3.2. Framework for investment in the Member States

Several Member States — 12 so far, according to information available to Commission staff³⁹ — 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.⁴⁰ 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.

In 2016, Poland implemented the ‘Act on the control of certain investments’ of 2015 by identifying the list of companies which are subject to the investment review mechanisms provided for in that law. 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 received, the competent authority may oppose investment on

³⁵ 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 (Case C-36/75 *Rutili v Minister for the Interior*; and Case C-348/96 *Calfa*). Moreover, those derogations must not be misapplied so as, in fact, to serve purely economic ends (*Rutili*, cited above).

³⁶ Examples of overriding reasons in the general interest include: the need to safeguard the energy supply (Case C-174/04 *Commission v Italy*); the protection of consumers (Case C-442/02 *Caixa-Bank France v Ministère de l'Économie*, para. 21); the protection of the good reputation of the national financial system (Case C-384/93 *Alpine Investments*, 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 (C-271/09 *Commission v Poland*).

³⁷ C-163/94 *Sanz de Lera and Others*, para. 23.

³⁸ However, at EU level there is extensive sectorial legislation on financial services, as well as secondary legislation on specific aspects of capital movements and payments in financial markets.

³⁹ Austria, Denmark, Finland, France, Germany, Italy, Lithuania, Poland, Portugal, Slovenia, Spain and the UK.

⁴⁰ 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.

specific public interest grounds, in line with Article 65 TFEU. Commission staff have engaged in an informal dialogue with the Polish authorities to seek clarifications on the practical implementation of the law.

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

Most of the barriers to capital movements are solved through collaboration with Member States, either through formal dialogue as a way of problem-solving procedure before starting infringement procedures, or through other informal bilateral or multilateral contacts. When these pre-litigation phase contacts do not resolve the concerns raised, the infringement procedure is used as a last resort tool to preserve the integrity of the single market including, notably, free movement of capital.

In 2016, the Commission closed one infringement case following satisfactory measures taken by the Member State concerned. The Commission took further steps in 14 infringement cases:

- two on national laws imposing voting limits and acquisition caps in energy transmission system operators (TSOs);
- one on the national law on the privatisation of the energy company Industrija Nafta d.d.;
- five on national laws regulating the acquisition of agricultural land (see section (5.3); and
- six on intra-EU bilateral investment treaties between Member States (see section 4.4).⁴¹

Two Member States were notified by the Commission in a letter of formal notice about the identified restrictions of their national laws on energy TSOs, while the other twelve Member States were requested in the reasoned opinions to bring an end to the identified breaches.

In addition, the Commission opened one infringement case against Croatia concerning amendments to the Consumer Credit Act and Credit Institution Act on the conversion of foreign exchange loans.

The Commission also brought a case against Hungary to the Court of Justice of the EU (CJEU) for failure to bring national rules terminating certain usufruct rights on agricultural land in line with EU law.⁴² In this respect, the Hungarian Court of Final Appeal has also requested a preliminary ruling by the CJEU.⁴³

Another area where the Commission undertook action as a guardian of the Treaties to ensure free movement of capital was direct taxation. Although direct taxation is primarily

⁴¹ 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).

⁴² IP/16/2102.

⁴³ C-52/16.

the responsibility of Member States, they must act in compliance with EU law, including the laws on free movement of capital. During the reporting period⁴⁴ the Commission launched three infringement proceedings under Article 63 of the TFEU and Article 40 of the European Economic Area (EEA) Agreement against the Member States in this area. During the same period, the Commission closed 29⁴⁵ proceedings on tax restrictions to the free movement of capital, without counting closed parallel proceedings on the same grievances. By the 1st of October 2016, there were 37 open infringement proceedings against the Member States for violations in the field of direct taxation in relation to free movement of capital.

In 2016, the Commission brought a case against Greece to the CJEU because of a lower tax rate for bequests of which the beneficiaries are non-profit-making legal persons resident in Greece. Under the Greek law, the low tax rate is not applicable to bequests to equivalent foreign legal persons, unless the relevant States themselves grant a reciprocal favourable tax treatment with respect to bequests to Greek non-profit-making legal persons.⁴⁶

In the same year, the CJEU ruled in one tax case on a restriction on free movement of capital following an infringement proceeding on the basis of Article 258 of the TFEU. It considered that Greece failed to fulfil its obligations under Article 63 of the TFEU and Article 40 of the EEA Agreement by enacting and maintaining in force the legislation providing for an exemption from inheritance tax relating to the primary residence; such legislation applies solely to nationals of EU Member States who are resident in Greece.⁴⁷

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

4.1. Accelerating the Capital Markets Union

As part of the third pillar of the Investment Plan for Europe,⁴⁸ which aims at removing regulatory and non-regulatory barriers to investment through complementary EU and national actions, the Capital Markets Union is essential to delivering on the Commission's priority to boost jobs and growth. By supporting economic convergence and helping to cushion economic shocks in the euro area and beyond, the Capital Markets Union seeks to remove obstacles to the free flow of capital across borders. This will strengthen the EMU and make the European economy more resilient.

On 14 September 2016, the Commission adopted a Communication on '*Capital Markets Union — Accelerating reforms*'.⁴⁹ In this Communication the Commission outlined how to ensure that the CMU has a tangible impact on the ground as soon as possible.

The Communication calls for the rapid completion of the first measures proposed under the CMU action plan. These include:

⁴⁴ The reporting period is from 1 January 2015 to 1 October 2016.

⁴⁵ 16 proceedings closed in 2015 and 13 proceedings closed in 2016 before 1 October 2016.

⁴⁶ *Commission v Greece*, C-98/16.

⁴⁷ *Commission v Greece*, C-244/15.

⁴⁸ More details are available at: https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en

⁴⁹ COM(2016) 601 final.

- the modernisation of the prospectus rules⁵⁰;
- the proposal to strengthen venture capital markets and social investments; and
- the measures proposed to revive simple, transparent and standardised securitisation markets which will free up capacity on banks' balance sheets and provide investment opportunities for investors.

The acceleration also concerns the next phase of the Capital Markets Union projects. Key actions include a proposal on business restructuring and insolvency to speed up recovery of assets and give companies a second chance if they fail the first time around.

In this context the Commission presented on 22 November 2016 a proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.⁵¹

The proposal focuses on minimum harmonisation measures on preventive restructuring for viable business and second chance and debt discharge for bankrupt entrepreneurs. It also includes provisions establishing common reporting requirements regarding the outcome of restructuring and insolvency procedures, and some elements to enhance national courts efficiency and pertinent data collection obligations on Member States.

The second phase of the Capital Markets Union project also includes measures to remove withholding tax barriers and encourage best tax practices in promoting venture capital and business angels investment into start-ups and innovative companies. Addressing the preferential tax treatment of debt over equity would encourage more equity investments and create a stronger equity base in companies. The Commission issued a proposal on addressing the debt-equity bias in October 2016, in the context of its proposal on the CCCTB (for more details see section 4.8 on direct taxation and free movement of capital).

Finally, the Communication mentions further priorities, such as the development of personal pensions markets and other retail financial services, to encourage Europeans to put their savings to better use. An expert group is tasked to develop a comprehensive European strategy on sustainable finance, and actions will be taken to develop a coordinated policy approach that supports the development of financial technology (FinTech) in an appropriate regulatory environment.

4.2. Deploying further the Investment Plan for Europe

The Investment Plan for Europe comprises of three pillars. First, the EFSI allows the leveraging of scarce public resources by attracting private investors and supporting projects in Europe that deliver tangible results for jobs and growth. Second, the European

⁵⁰ On 7 December 2016 the European Parliament and the Council reached political agreement on a compromise text of the Prospectus Regulation in the trilogue. This compromise text was endorsed by the COREPER on 20 December 2016 and approved by the ECON Committee of the European Parliament on 25 January 2017.

⁵¹ COM(2016) 723. More details are available at: http://europa.eu/rapid/press-release_IP-16-3802_en.htm

Investment Advisory Hub and the European Investment Project Portal help investment projects reach the real economy by providing technical assistance and greater visibility of investment opportunities. Third, structural reform measures remove regulatory barriers to investment both nationally and at EU level, like the Capital Markets Union and its action plan. Combined, the Investment Plan for Europe has already helped substantially to increase investments and raise additional finance in its first year of operation.

The European Commission's proposal for a reinforced EFSI ('EFSI 2.0') will help mobilise further finance from a variety of sources.⁵² The draft legislation proposes to extend the life of the EFSI and to increase the investment target from EUR 315 billion to at least EUR 500 billion of public and private investments by the end of 2020. In this respect, the Commission proposes to increase the EU guarantee from the initial EUR 16 billion to EUR 26 billion. In addition, the EIB intends to increase its contribution to the EFSI from EUR 5 billion to EUR 7.5 billion for the full investment period.

EFSI 2.0 also proposes that the EFSI focuses even more on projects that help to achieve the ambitious goals that the EU agreed to at the Paris Climate Conference (COP 21). Energy interconnection priority projects and energy efficiency projects will be increasingly targeted. In addition, a larger share of financing – 40% of the increase of the EFSI's risk-bearing capacity – is proposed to be geared towards increasing access to financing for SMEs given the exceptional market demand for SME financing under the EFSI.

Measures launched under the CMU should help to achieve the Investment Plan's ambitious targets. To further facilitate investments in infrastructure assets by institutional investors, the Commission adopted on 30 September 2015 with date of effect on 2 April 2016 an amendment to the Solvency II Delegated Act to reduce the capital charges attached to investments by insurance companies in infrastructure projects. Further to that and as part of the review of the Capital Requirement Regulation and Directive, the Commission adopted on 23 November 2016 a proposal to reduce capital requirements for loans to SMEs and for investments in infrastructure projects ('qualifying infrastructures'). The co-legislators have also agreed in December 2016 to the revised Prospectus legislation to make it easier to access capital markets for companies.

Synergies between EFSI finance and Capital Markets Union measures could be achieved for SME finance. For venture capital, the Commission is reforming the relevant frameworks — European venture capital funds (EuVECA) and European social entrepreneurship funds (EuSEF) — to make them more attractive for fund managers. Also, a new Pan-European Fund-of-Funds initiative supported by EU budget resources and EFSI finance should attract larger amounts of private capital to the EU venture capital asset class.

4.3. Addressing unjustified national barriers to the free movement of capital

As part of the CMU, the Commission has worked with the Member States to map national barriers to the free movement of capital. The Commission will soon publish a Report taking stock of the results of the mapping and inviting Member States to proactively tackle unjustified barriers stemming from national legislation or

⁵² COM(2016) 597 final.

administrative practices which either go beyond EU rules ('gold-plating') or are in areas mainly of national competence. This work complements other initiatives on existing obstacles to investment identified by the Commission in the context of the European Semester. It should result in a roadmap, developed jointly by the Commission and Member States, for the removal of these barriers.

In 2016, Commission services worked with an expert group of Member States' financial experts on a first list of national barriers. This included burdensome withholding tax relief ('WHT') procedures; barriers to cross-border distribution of investment funds; residence requirements for the managers of financial institutions; limitation to cross-border investment by pension funds; and the lack of financial literacy of consumers and SMEs.

Most Member States acknowledged that the current procedures for the refund of the tax withheld in another Member State pose major barriers to cross-border investment (an opinion widely shared by capital market participants). The cost of such procedures was estimated at EUR 8.4 billion per year⁵³ due to foregone claims, cost of reclaiming the tax and opportunity cost. In addition to mapping existing barriers, the expert group discussed a number of best practices that exist in the Member States. These include having a 'quick refund' procedure in place, setting up a single point of contact for handling claims or allowing completion of the whole refund process online. Further steps will involve working with national tax administrations.

On the cross-border distribution of investment funds, the expert group discussed a series of national requirements imposed in addition to the requirements of the Directive on Alternative Investment Fund Managers (AIFM) and the Directive on Undertakings for Collective Investment in Transferable Securities (UCITS). Such national requirements include diverging national marketing rules, administrative arrangements imposed by host countries, regulatory fees and barriers to the online distribution of funds. On marketing rules, the discussion in the expert group focused on defining the notions of pre-marketing and reverse solicitation. The aim here was to ensure that these practices are not subject to the same constraints as those applicable in case of marketing of funds. The need for more clarity, accessibility and transparency of fees for cross-border distribution was also stressed.

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

4.4. Towards the termination of intra-EU Bilateral Investment Treaties (BITs)

Bilateral investment treaties between Member States (intra-EU BITs) are infringing EU law. The Commission has consistently pointed out to all Member States that intra-EU BITs are incompatible with EU law on several grounds, in particular that their provisions

⁵³ *Source:* Joint Research Centre.

overlap and conflict with the EU regulatory framework applicable to cross-border investments and that the arbitration mechanism foreseen in the intra-EU BITs exclude both national courts and the Court of Justice and create a situation where these courts are not able to ensure the full effect of EU law. These treaties should, therefore, end as soon as possible. However, most Member States have taken no action to terminate them.⁵⁴

The violation of EU law by Member States who continue to apply 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.⁵⁵ In addition, there have been concerns that certain interpretations by arbitral tribunals may be in conflict with EU law.⁵⁶ The procedures in place allow the Commission to intervene in such cases on matters of EU law by submitting *amicus curiae* briefs (an impartial adviser), including on the jurisdiction of the arbitral tribunals. In practice, however, the impact of such submissions has been limited. Besides constituting a violation of EU law, this situation creates 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 launched the first stage of infringement proceedings against five Member States⁵⁷ and entered into an administrative dialogue with the remaining 21 Member States that still have intra-EU BITs in place.⁵⁸ In September 2016, the European Commission moved to the second stage of the infringements and sent a formal request to Austria, the Netherlands, Romania, Slovakia and Sweden to terminate their intra-EU BITs.⁵⁹

In parallel, as announced in the action plan on Building a Capital Markets Union,⁶⁰ the Commission will continue to explore whether additional action is needed to further strengthen safeguards for investors and thus reinforce the attractiveness of the single market as an investment destination.

4.5. Green paper on retail financial services and insurance

Despite significant progress in recent years, the EU market for retail financial services and insurance is still fragmented with little cross-border transactions and low use and cross border roll out of on-line financial products. There is still no genuine single market in this area. Consequently, EU consumers do not always receive the benefits of improved competition — including cheaper prices and greater choice — that prevail in other sectors (e.g. air transport). Residual problems in domestic markets reduce consumer confidence in retail financial services and discourage them from using these services.

⁵⁴ Only two Member States — Ireland in 2012 and Italy in 2013 — ended all their intra-EU BITs. Other Member States have started the termination process.

⁵⁵ According to UNCTAD, intra-EU cases accounted for about one third of global investment arbitrations initiated in 2015. This is similar to the two preceding years. The majority (19 out of 26) of such cases were initiated in 2015 pursuant to the Energy Charter Treaty (ECT) and the rest on the basis of intra-EU BITs. The overall number of known intra-EU investment arbitrations reached 130 by the end of 2015. This represents approximately 19 % of all known cases globally <http://investmentpolicyhub.unctad.org/Upload/ISDS%20Issues%20Note%202016.pdf>.

⁵⁶ 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*).

⁵⁷ Austria, the Netherlands, Romania, Slovakia and Sweden.

⁵⁸ See IP/15/5198.

⁵⁹ See MEMO/16/3125.

⁶⁰ Action Plan on Building a Capital Markets Union, COM(2015) 468 final, 30.09.2015 .

To this end, the Commission published a Green Paper on Retail Financial Services and Insurance in December 2015. It launched a public consultation seeking stakeholders' views on how to bring about better outcomes for consumers and businesses. The Commission was looking for ideas on how to achieve better access, more transparent markets, increased competition as well as greater consumer choice and improved consumer protection across the EU in an increasingly digital environment.

The main purpose of the initiative was to investigate issues and gaps not yet addressed in previous legislation and identify the real barriers and the nature of obstacles that prevent or are likely to prevent businesses from providing services across Member States and domestic consumers from enjoying the benefits of the single market. This was intended to contribute to the further development of an open, fair and competitive retail financial services and insurance markets between and within EU Member States.

Based on the responses to the Green Paper, the Commission is developing an action plan aimed to build a single market in retail financial services. The feedback received during the Green Paper consultation has made it clear that there is a need for further work in three main areas: increase consumer trust and empower consumers, such as ensuring that consumers have enough information to make the right choices, reduce legal and regulatory obstacles, which lead firms to avoid cross-border trading and support the development of an innovative digital world, which makes cross-border offers easier.

The action plan will be published in March 2017. This initiative complements the Commission's work on creating a Capital Markets Union by encouraging the 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 sector inquiry into e-commerce.

4.6. Entry into force of the legislative package for an EU-wide market for e-payments

The Interchange Fee Regulation⁶¹ entered into force on 9 June 2015. The new rules are expected to improve competition in the market for card based payments by lowering the costs for payments with consumer debit or credit cards. Retailers and consumers will be offered more transparency to allow them to make better informed choices. The IFR, combined with the revised Payments Services Directive (PSD 2),⁶² introduces maximum levels of interchange fees for transactions based on consumer debit and credit cards, and bans surcharges on these types of cards. Capping the interchange fees will reduce costs for retailers and indirectly for consumers, and surcharging will no longer be permitted for those cards when the PSD 2 becomes applicable in January 2018. The caps are set at 0.2 % of the value of the transaction for debit cards and 0.3 % for credit cards and became applicable in December 2015. The IFR includes measures to foster competition in the market for card based payments, such as a ban on scheme rules obliging retailers to accept all cards of the same payment card scheme ('honour all cards rules') and a rule that payment licences should cover the EU as a whole.

PSD 2 entered into force on 13 January 2016. Member States have two years to transpose the Directive into their national legislation. In the course of 2016, four workshops were

⁶¹ Regulation (EU) 2015/751 of the European Parliament and of the Council of 29 April 2015 on interchange fees for card-based payment transactions.

⁶² Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

held with Member States to facilitate their transposition of the directive, and the European Banking Authority (EBA) pursued its drafting and consultations on a number of Regulatory Technical Standards (RTS) and Guidelines mandated by the Directive. Among those is the RTS on strong customer authentication and secure communication. This is key to achieving the PSD 2 objective of enhancing consumer protection, promoting innovation and competition as well as improving the security of payment services across the EU. This RTS is due to be submitted by EBA for adoption by the Commission in the first quarter of 2017 followed by scrutiny of the European Parliament and the Council.

4.7. Fostering the resilience of cross-border banking

The last years have seen major efforts by regulators to stabilise economies, contain the negative effects of the financial crisis and improve regulation to handle future crises.

The first EU regulatory reform efforts have focused on strengthening the prudential regulatory framework and providing a comprehensive framework for recovery and resolution. The Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR) lay down the framework for taking up and pursuing the business of credit institutions and streamline prudential requirements for credit institutions and investment firms. The CRD also lays down the rules underpinning the freedom of establishment for banks and free movement of banking services within the single market. Furthermore, the Single Supervisory Mechanism (SSM) was set up, entrusting the ECB with the direct supervision of significant institutions.

The Banking Recovery and Resolution Directive (BRRD), for which Member States have already communicated full transposition, complemented by the Single Resolution Mechanism Regulation (SRMR) for the Banking Union, lays out a comprehensive set of measures to ensure that failing banks and investment firms can be resolved in a timely and orderly manner without the support of taxpayer money.

The BRRD provides banks and authorities with the adequate tools to prepare for crises (by drawing Recovery and Resolution Plans). National authorities are equipped with the necessary policy instruments to intervene in a troubled institution at a sufficiently early stage to address problems that are arising. They have harmonised resolution mechanisms and powers (including the bail-in) to take rapid and effective action when bank failure cannot be avoided, and banks contribute to resolution financing arrangements to support the costs of restructuring.

The BRRD takes into account the cross-border nature of some banks. It provides for strong coordination between national authorities under the leadership of the group resolution authority to ensure that resolution tools are applied to a cross-border financial group in a coherent manner across different jurisdictions. With the Single Resolution Mechanism such coordination has been strengthened by the creation of the Single Resolution Board and by the granting decision powers to the Commission in case of resolution of cross-border groups established in the Banking Union.

Another recent package ⁶³ aims to incorporate further the progress made at international level on the design of the leverage ratio, the net stable funding ratio, the treatment of the

⁶³ The Commission proposal was adopted in November 2016. For more details, see: http://europa.eu/rapid/press-release_IP-16-3731_en.htm?locale=en.

trading book and the binding minimum TLAC (total loss absorbing capacity) standard into EU legislation as well as the ranking of creditors in resolution.

These measures and further risk reduction policies included in the proposals on the Capital Requirement Regulation and Directive (CRR/CRD) and of the BRRD are meant to support progress on the adoption of a pan-European deposit insurance scheme. Such a scheme aims to ensure an equal treatment of depositors irrespective of their location and thus prevent volatile capital flows related to deposits.

Moreover, Member States have agreed to start technical work on a common backstop to the Single Resolution Fund. By fostering the effectiveness of crisis management for all banks irrespective of their Member State of establishment, such backstop would improve the level playing field for cross-border groups in the single market.

This is complemented by a proposal for a Regulation on the recovery and resolution of central clearing counterparties (CCPs) in 2016.

The reforms achieved and proposed to date mark important steps towards the completion of the Banking Union. They are setting the ground for a more stable, integrated and resilient cross-border financial sector.

4.8. Direct taxation and free movement of capital

Recent policy initiatives in the field of taxation will also contribute to more integrated capital markets in the EU.

From January 2016, financial institutions in 27 of the 28 Member States (a derogation for one year was granted to Austria) have started the customer due diligence of their account holders in compliance with the national measures implementing Directive 2014/107/EU on mandatory automatic exchange of information in the field of taxation. This is in order to apply the OECD's Global Standard for Automatic Exchange of Financial Account Information. The first automatic exchanges of information between tax administrations will take place in 2017. This closer cooperation will allow the tax administrations in the EU to better ensure that taxpayers of each Member State comply with their national tax obligations for accounts held in other Member States. Improved tax compliance rules, in particular the self-certification procedures for tax residence envisaged in the due diligence procedures to be applied by financial institutions under the Directive, may help to address the concerns of some Member States about the application of withholding tax relief and refund procedures.

The Commission has signed 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. Two of the revised agreements with Liechtenstein and San Marino entered into force from 1 January 2016, for first exchanges to take place in 2017. The three other revised agreements apply from 1 January 2017 for first exchanges to take place in 2018.

In the context of the Capital Markets Union, the Commission is also taking action to encourage Member States to address withholding tax refund procedures and encourage best tax practices in promoting venture capital and business angel investment into start-ups and innovative companies. A study on tax incentives for venture capital and business angels was launched in January 2016. A meeting to allow Member States to exchange best practice on this issue took place in October 2016.

The Commission's agenda to tackle tax evasion and avoidance has also advanced with notable success. This work for fairer taxation is important to remove distortions that many companies face due to the aggressive tax planning of their competitors. A coordinated EU approach also helps to prevent a patchwork of national anti-abuse measures from creating new obstacles for businesses in the single market.

All of the initiatives announced in the 2015 action plan for a Fair and Efficient Corporate Tax System in the European Union have now been launched, so that every company pays tax where it makes its profits.

In July 2016, Member States agreed to legally binding anti-abuse measures in the Anti-Tax Avoidance Directive⁶⁴ (ATAD) in order to combat some of the most common forms of profit-shifting.

In October 2016, the Commission proposed new measures to counteract hybrid mismatches involving non-EU countries. These aim to further reinforce EU anti-abuse provisions in the ATAD and address external risks of base erosion and profit shifting.

In October 2016, the Commission proposed to re-launch the Common Consolidated Corporate Tax Base (CCCTB)⁶⁵. The CCCTB will provide Member States with a growth-friendly, efficient and fair corporate tax system, while ensuring that businesses in the Single Market have a simple, less costly and more stable tax environment. The re-launched CCCTB directly contributes to the goals of the Capital Markets Union. It redresses the current debt-bias in taxation which can make companies more fragile and de-stabilise the economy. An Allowance for Growth and Investment (AGI) will be offered to companies within the CCCTB, to give equity similar tax benefits to debt, creating a more neutral and investment-friendly tax environment.

Member States also agreed on two new transparency proposals presented by the Commission in 2016. The first concerns the automatic exchange of country-by-country reports between tax authorities on multinationals' tax information.⁶⁶ The second will allow tax authorities to access anti-money laundering information used by financial institutions in their due diligence procedures for reporting under the exchange of information agreements and for which are needed to ensure the correct functioning of international cooperation in tax matters.⁶⁷ This follows the agreement in 2015 on a Directive for the automatic exchange of information on tax rulings.⁶⁸ In addition, the Commission has proposed public country-by-country reporting to provide better public access to information on the tax practices of large multinationals.

In July 2016, the Commission published a Communication on further measures to improve transparency and the fight against tax evasion and avoidance.⁶⁹ As announced in that Communication, the Commission has started to examine the most appropriate framework to implement the automatic exchange of information on beneficial ownership

⁶⁴ Council Directive (EU) 2016/1164.

⁶⁵ For more details see: http://europa.eu/rapid/press-release_IP-16-3471_en.htm.

⁶⁶ Council Directive (EU) 2016/881.

⁶⁷ Council Directive (EU) 2016/2258.

⁶⁸ Council Directive (EU) 2015/2376.

⁶⁹ COM(2016) 451.

at European level. The Commission is also exploring measures to increase oversight of enablers and promoters of aggressive tax planning schemes.

On 25 October 2016, the Commission proposed a Directive on Double Taxation Dispute Resolution Mechanisms⁷⁰ which lays down rules to resolve disputes between Member States on how to eliminate double taxation of income from business and ensure the rights of taxpayers in this context. Double taxation on income or capital has a negative impact on cross-border investment and leads to economic distortions and inefficiencies.

Taxation is one of the policy areas monitored through the European Semester, the yearly cycle of economic policy coordination in the EU. The main taxation priorities for the 2017 European Semester cycle are stimulating productive investment, supporting employment, improving tax compliance and promoting social fairness. In 2016, the Commission provided country-specific recommendations in the area of taxation to 16 Member States.

5. OTHER IMPORTANT CHALLENGES REQUIRING REGULAR MONITORING

5.1. Capital controls in Greece and Iceland

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

5.1.1. Capital controls in Greece

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

In the reporting period, the Greek authorities took some measures to alleviate the impact of the controls, especially on certain categories of citizens. 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 840 every two weeks. Other examples of alleviation include the possibility to open a new account for Erasmus students or for pensioners who are residents abroad. The early repayment of loans is now allowed, and depositors are allowed to withdraw any amount deposited in cash after 22 July 2016, subject to the existing provisions on anti-money laundering.

Commission staff will continue to monitor developments related to the capital controls in Greece. Further relaxations will have to be decided by the Greek authorities, subject to positive financial and economic conditions and progress on the adjustment programme review.

⁷⁰ Proposal for a Council Directive (EU) 2016/686.

5.1.2. *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 having difficulties with its balance of payments.

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

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

In the reporting period, the Icelandic authorities adopted decisive measures to move away from the capital controls. On 11 October 2016 the Icelandic Parliament adopted a law to ease capital controls in two stages. The Parliament based this law on the composition agreements signed with the creditors of failed banks' estates and on a series of currency auctions to reduce the stock of *offshore krona*.

As a first stage, from September 2016, outward FDI became unrestricted subject to confirmation by the Central Bank of Iceland. Investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans are allowed up to a given amount (ceiling), to be increased in stages. Such investment is subject to authorisation which, in turn, is subject to conditions concerning beneficial ownership and financing of the transaction.

Moreover, the investment must be held with a domestic custodian until 1 January 2017. The purpose of this is to enable the Central Bank to oversee and supervise properly the transactions covered by the provision so that, among other things, it can take informed decisions on raising the ceiling when conditions allow. Individuals are also allowed to purchase one piece of real estate abroad per calendar year, subject to prior confirmation by the Central Bank.

As a second stage, from 1 January 2017, transfers of deposits abroad will be permissible but subject to the same ceiling as financial instruments issued in foreign currency. The domestic custodianship requirement for foreign securities investments will be revoked, and foreign currency purchases in cash will only be limited by the ceiling. This will enable residents and non-residents to transfer deposits and securities to and from Iceland, to trade in securities abroad, and purchase or withdraw foreign currency in cash up to the ceiling.

Overall, these steps should lead to a considerably lower impact of the capital controls on most households and businesses in the course of 2017.

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

Lending in foreign currencies, cross-border lending or lending by foreign-owned institutions are considered capital movements that fall under the scope of the free

movement of capital and the freedom of establishment. In particular, national measures interfering with existing loan contracts, or more specifically with outstanding foreign currency loans, may be regarded as restrictions to these freedoms. In principle, these restrictions are prohibited by the TFEU. However, such measures may be acceptable if they are duly justified by the need to protect legitimate public interests and if they do not go beyond what is necessary in order to attain their objective, in accordance with the principle of proportionality.

In this case, measures necessary to help vulnerable consumers avoid the social consequences of over-indebtedness and a debt crisis may justify certain restrictions to the Treaty freedoms. However, when assessing whether a particular measure can be regarded as proportionate to its objective or whether other, less restrictive measures could achieve the same results, various aspects need to be taken into account. These include:

- the scope of such restrictions;
- the extent of burden sharing among the parties affected;
- the potential impact on financial and macroeconomic stability, and
- the potential impact on legal certainty, lending activity and on future foreign investments in the country.

The financial crises, related currency fluctuations and, most of all, the sharp appreciation of the Swiss franc in September 2011 and January 2015 turned foreign currency loans into a serious problem in some countries. Several Member States (Hungary, Croatia, Poland and Romania) have since adopted or are envisaging measures to ease the increased financial burden of the foreign currency loan borrowers.

The Commission is closely monitoring the developments related to foreign currency loans in the concerned Member States and has taken action to ensure that EU law is complied with. It has to strike a balance between helping vulnerable consumers and making sure that measures are respecting EU law and avoiding moral hazard.

The Mortgage Credit Directive [2014/17/EU](#) (MCD)⁷¹ entered into force on 20 March 2014 and became applicable on 21 March 2016. It ensures that risks associated with foreign currency loans are better managed. The MCD is only applicable to credit agreements signed after 21 March 2016, so the Swiss franc loans concluded before do not fall within the scope of the MCD. The Commission assesses national measures dealing with foreign exchange loans concluded before that date or regulating aspects not covered by the MCD in the light of the Treaty freedoms. However, the MCD can serve as a comparative benchmark, since it aims at protecting borrowers while ensuring legal certainty for credit institutions.

The cross-border mortgage lending has been limited, and an integrated market has been far from being reached. The MCD provides for an EU standardised pre-contractual information sheet (ESIS). This will make it easier for consumers to compare offers across borders. The Commission is observing market developments in this area.

⁷¹ Directive [2014/17/EU](#) of the European Parliament and of the Council on credit agreements for consumers relating to residential immovable property and amending Directives [2008/48/EC](#) and [2013/36/EU](#) and Regulation (EU) No [1093/2010](#), OJ L 60/34, 28.2.2014, p. 34-85.

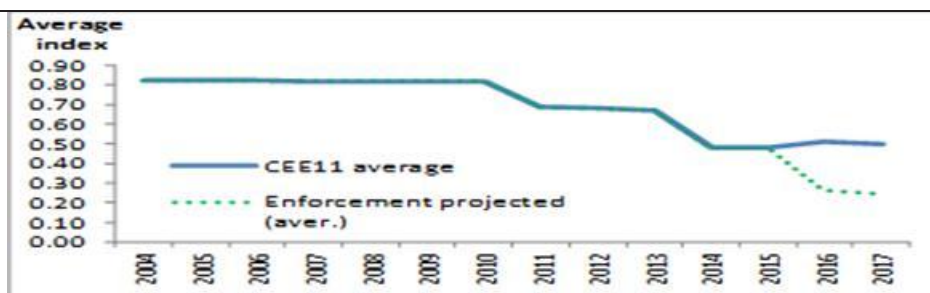
5.3. Investments in real estate and agricultural land

Within the meaning of Article 63 of the TFEU, capital movements include cross-border transactions between residents and non-residents. According to the explanatory notes of the Annex to Directive 88/361/EEC,⁷² in the context of real estate, these transactions include acquisitions, rights of usufruct, easements and building rights.

The national laws regulating these capital movements, when applied to cross-border situations must respect EU law, including the principle of free movement of capital.⁷³ The rules on the free movement of capital allow Member States to impose restrictions to the Treaty freedom, provided these restrictions pursue an objective in the public interest, are proportionate and non-discriminatory. The restrictions may differ from one Member State to another. The Commission is assessing the national provisions with cross-border impact on capital movements on a case-by-case basis.

On the acquisition of agricultural land, Member States can apply - during a transition period - derogations from the rules on the free movement of capital, as provided for in their Accession Treaties. Croatia is the only country for which the transition period is still ongoing. It will expire on 1 July 2020, with the possibility for a three-year extension. The transitional derogations granted to Bulgaria, Romania, Hungary, Slovakia, Latvia and Lithuania by their Accession Treaties expired in 2014, whereas Poland benefited from such derogation until 2016.

Figure 19, Regulatory restrictiveness for intra-EU acquisition of agricultural land in CEE 11



Note: CEE 11 includes the 10 Member States that acceded to the EU in 2004 except Malta and Cyprus plus Bulgaria, Romania and Croatia.

Following the expiry of the transitional derogations, these countries adopted new laws regulating the acquisition of agricultural land. The new land laws generally pursue policy objectives such as preserving farming on agricultural land, supporting agricultural communities and preventing land speculation. Such objectives may justify restrictions on the Treaty freedom. Nevertheless, concerns arose regarding certain provisions of five new land laws and the compatibility of these provisions with EU law, in particular in relation to the principle of proportionality. As a result, infringement proceedings were initiated in 2015 against Bulgaria, Hungary, Lithuania, Slovakia and Latvia. In May

⁷² Council Directive 88/361/EEC for the implementation of Article 67 of the Treaty of 24 June 1988, OJ L 178, 08/07/1988,

⁷³ Case C-302/97, Konle [1999] ECR I-3099 and Case 182/83 Fearon [1984] ECR 3677.

2016, the Commission requested that these countries take the necessary measures to eliminate the restrictions in their land laws on the acquisition of agricultural land and thus to bring their national laws in line with EU law.⁷⁴

Based on an index developed by the Commission on the regulatory restrictiveness on the intra-EU acquisition of agricultural land in the central and eastern European countries (CEE 11), it can be concluded that there was progress towards liberalisation after the end of the transitional derogations. Overall regulatory restrictiveness declined in 2014 by approximately 42 % compared to 2004. If the restrictions which triggered the infringement proceedings are successfully addressed by the Member States concerned, liberalisation may progress even further. In such case, overall restrictiveness is projected to go down by almost 70 % in 2017 compared to 2004, the year when most of these countries joined the EU (see Figure 19).

In June 2016, the Commission referred Hungary to the CJEU for failure to bring national rules terminating certain usufruct rights on agricultural land in line with EU law.⁷⁵ The contested law had the effect of terminating certain usufruct rights. As a result, foreign investors lost the value of their investments without compensation.

On the acquisition of secondary residences, Denmark, Malta and Finland (the Åland Islands) are the only Member States which have permanent derogations from the free movement of capital principle. The previously existing temporary derogations in other Member States to the acquisition of secondary residences have already expired.

The Commission regularly monitors national legislation regulating the acquisition of real estate by EU/EEA nationals and by non-EU countries. The Commission also deals with complaints against national laws and measures in Member States.

5.4. Macro-prudential measures

Macro-prudential measures are a useful tool to address systemic risks. However, to the extent that capital movements may also be a source of such risks, capital movements may in some cases overlap with capital flows management measures. The financial crisis highlighted the need for system-wide oversight. It led to the development of macro-prudential policy as a new EU policy area whose objective is to prevent or mitigate systemic risk. In this vein, the Capital Requirements Directive and the Capital Requirements Regulation (CRDIV⁷⁶/CRR⁷⁷) provide for a number of instruments for macro-prudential use in the banking sector. The framework aims at accommodating the need for Member States to have national flexibility while providing appropriate safeguards to prevent undermining the single market.

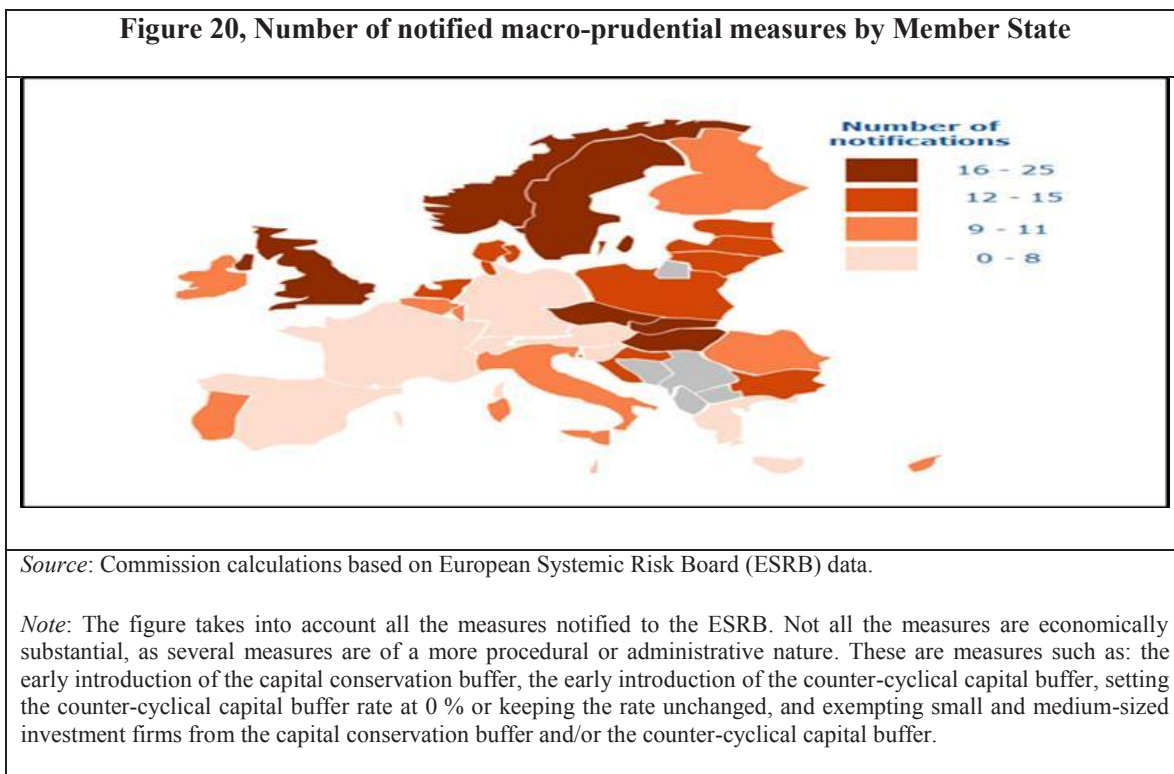
⁷⁴ [IP-16-1827](#)

⁷⁵ [IP-16-2102](#)

⁷⁶ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institution and the prudential supervision of credit institution and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

⁷⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Several Member States have complemented the EU macro-prudential toolset for the banking sector with purely national macro-prudential instruments. Most of these instruments relate to mortgage lending. They include instruments such as caps to the loan-to-value ratio, loan-to-income/debt-to-income ratios, debt-service-to-income ratios and maturity limits.



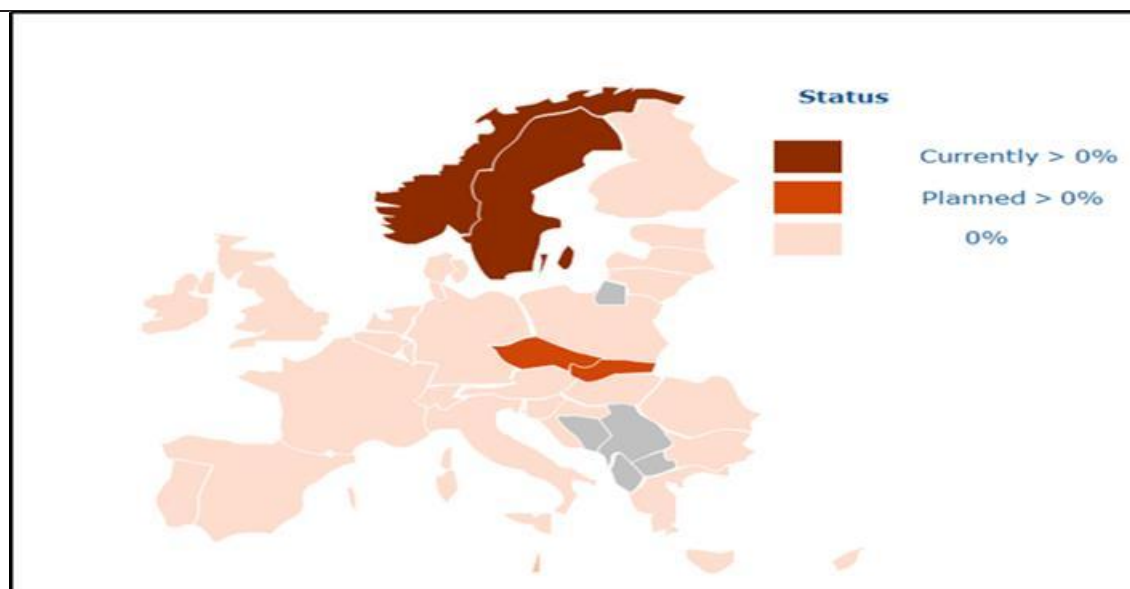
Since end-2015, the degree of activity in the macro-prudential area has become more balanced across Member States. This may be explained to a large extent by the fact that since 2016, the counter-cyclical buffer (CCB) and the buffer for global systemically important institutions (G-SII buffer) have been mandatory and the buffer for other systemically important institutions (O-SII buffer) has become available. Figure 20 gives an overview of the number of measures notified by each Member State (although not all the measures are of economic significance) from November 2016.

At the outset all measures were either of a neutral/procedural or a tightening nature (e.g. the setting of the CCB rate at 0 %, the identification of O-SII/G-SIIs or a systemic risk buffer requirement). However, in 2016 for the first time two authorities decided to loosen announced macro-prudential measures (United Kingdom, Portugal).⁷⁸

Looking at the most frequent types of measures, the CCB clearly dominates, since the CCB rate has to be set on a quarterly basis. At this stage, a buffer rate other than zero is applicable only in Sweden (1.5 %). Two other countries (Czech Republic, Slovakia) legislated a CCB higher than zero as of 2017. Figure 20 below summarises the application of the CCB.

⁷⁸ The fact that measures only began to be eased in 2016 does not necessarily mean that the economic or financial conditions in the Member States did not warrant easing measures earlier. However, buffers first need to be built up before they can be released.

Figure 21, Activation of the CCB by Member State



Source: Commission services calculations based on ESRB data.

Note: Sweden is the only EU Member State with a counter-cyclical capital buffer higher than zero in 2016 (1.5 %). Sweden's CCB is planned to increase to 2 % in 2017. Czech Republic and Slovakia legislated in 2016 for an increase of the CCB in 2017 from 0 % to 0.5 %. Norway, from the EEA, has a CCB of 1.5 %.

So far, around 190 G-SIIs and O-SIIs have been identified in the EU. The additional capital buffer requirements for such institutions vary from 0 % to 3 % (subject to phasing-in). The systemic risk buffer is currently used in 10 Member States for a wide range of purposes.

The real estate sector continues to be a highly relevant area for macro-prudential policy action. An increasing number of Member States (17 out of 28) have implemented borrower-based measures based on national law. These are measures such as loan-to-value caps and debt-service-to-income limits to address the impact of low interest rates on their housing market. Borrower-based measures appear to be particularly effective due to the strong link between the housing market and credit growth, which makes the housing market a source of potential systemic risk. In practice, the borrower-based measures are therefore reducing vulnerabilities on balance sheets of both banks and households. Except for the CCB, capital-based measures seem to have had a more indirect, limited effect on cyclical adjustments and the cost of loans. This may make them less effective in restraining excessive credit demand if housing prices appreciate.

Overall, 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. However, the 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 CRDIV/CRR pre-date the Banking Union, the framework for macro-prudential surveillance has become more complex. In light of recent developments and concerns expressed by stakeholders, the Commission has started a comprehensive revision of the EU macro-prudential framework. During the second half of 2016, a public consultation was carried out and a

feedback statement document has been published.⁷⁹ 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.

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

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

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

This report is not exhaustive. Therefore, it does not cover unilateral actions taken by non-EU countries that affect the free movement of capital, of which many are currently in force, or have recently been adopted. Such measures include screening mechanisms — of a soft or hard nature — the prohibition of foreign investment in certain sectors, and a series of intermediate steps such as joint venture obligations, foreign equity caps, etc.⁸⁰

6.1. Investment protection agreements with non-EU countries

Following the entry into force on the 1st of December 2009 of the Treaty of Lisbon, Article 207 of the TFEU grants the EU exclusive competence for FDI under the common commercial policy. Until then, the negotiation and conclusion of Bilateral Investment Treaties (BITs) was a matter of national competence. BITs contain disciplines on free movement of capital and, indirectly, support international investment by reinforcing the protection of assets abroad ('investment protection'). This newly expanded competence has allowed for the development of a comprehensive EU policy for investment. This includes the replacement at EU level of BITs previously entered into by Member States with different non-EU countries.

The European comprehensive investment policy is being introduced progressively through investment negotiations, which are gradually replacing at EU level the BITs concluded by Member State with non-EU countries. For those non-EU countries where no immediate EU-wide investment negotiations are scheduled, a Regulation⁵² on transitional arrangements creates a mechanism to empower Member States — under certain conditions — to negotiate BITs.

⁷⁹ http://ec.europa.eu/finance/consultations/2016/macprudential-framework/index_en.htm

⁸⁰ Additional information on measures adopted by third countries can be found in http://trade.ec.europa.eu/doclib/docs/2015/march/tradoc_153259.pdf. Regarding screening mechanisms or measures adopted by EU Member States, please refer to section 3.2.

Under the Regulation, Member States must ask for an authorisation to negotiate, sign or maintain post-Lisbon BITs. New notifications for the opening of negotiations with non-EU countries are submitted on a continuous basis to the Commission, which assesses their compatibility with EU law and consistency with EU investment policy. Authorisations are granted in consultation with Member States through the comitology procedure.

In 2012, the EU started negotiations on investment-related provisions with Canada, India and Singapore. Since then, other EU bilateral trade negotiations have included investment liberalisation and investment protection provisions, which directly and indirectly support free movement of capital, as explained above.

Some progress has been made in 2016 on the ongoing negotiations and the launching of negotiations with new countries.

The Commission proposed the signature of the EU-Canada Comprehensive Economic and Trade Agreement (CETA) to the Council of the EU in July 2016. CETA was adopted by the Council on 28 October 2016 and signed at the EU-Canada Summit on 30 October 2016. The intention is to provisionally apply CETA⁸¹, at a date to be determined, to allow European and Canadian businesses and consumers to reap the benefits of the agreement early on.

Negotiations were also concluded on free trade agreements with Singapore (discussions concluded in October 2014, an opinion of the CJEU will clarify whether the EU is competent to sign and conclude the agreement) and with Vietnam (text published on 1 February 2016).

In 2016, the EU and the United States held four rounds of negotiations on the Transatlantic Trade and Investment Partnership (TTIP).

Also in 2016, negotiations on a free trade agreement continued with Japan, and good progress was made.

The 12th round of the negotiations for a comprehensive EU-China investment agreement took place in September 2016. The aim of these negotiations is to provide for progressive liberalisation of investment and the reciprocal elimination of restrictions for investors in both markets. It will provide a simpler and more secure legal framework for investors on both sides by securing predictable long-term access to EU and Chinese markets and giving strong protection to investors and their investments. In 2016 negotiations also continued on the investment protection agreement between the EU and Myanmar, a country with which there is no Member State BIT in place.

Following the launch of negotiations on a free trade agreement with Philippines in December 2015, the first round was held in May 2016. Negotiations with Mercosur were relaunched after a break of more than two years but negotiations currently do not cover investment protection.

⁸¹ Provisional application covers notably Articles 8.1 to 8.8, Article 8.13 (transfers) and Articles 8.15 and 8.16, in so far as FDI is concerned, but not other investment protection standards such as expropriation, treatment of investors and covered investments, compensation for losses. See also carve-outs for financial services (<http://data.consilium.europa.eu/doc/document/ST-10974-2016-INIT/en/pdf>).

On 18 July 2016, negotiations for an EU-Indonesia free trade agreement were launched. The first negotiating round for a Deep and Comprehensive Free Trade Area (DCFTA) between the EU and Tunisia took place in April 2016.

The EU and Mexico held a first negotiating round to modernise the trade pillar of the EU-Mexico Global Agreement in June 2016, followed by a second round in November 2016.

6.2. International organisations and fora

6.2.1. *Free movement of capital and the OECD*

In 2016, the OECD continued its regular work on the OECD Code of Liberalisation of Capital Movements, assessing the compatibility of regulations introduced by its members with their obligations under the Code. Meanwhile, the organisation actively contributed to ongoing international discussions about the need to reform the international financial architecture.

In parallel, the OECD launched a review of the Code which should ensure its continued relevance in an environment that has substantially changed since the last major review in 1992. The Commission participates actively in this work, supporting greater coherence at European level of positions on the Code. This work takes place in the Advisory Task Force on the OECD Codes of Liberalisation (ATFC) and is open to non-adherent countries and international organisations. The work is planned to last for at least two years.

In 2016, the OECD also continued its work to advance the implementation of the guidelines on corporate governance of state-owned enterprises (SOEs). These guidelines were last updated in 2015. This is being done in a context where SOEs have an increased role in the world economy. The Commission is taking part in the dialogue launched by the OECD on this issue which aims to develop stronger understanding on how to address growing policy concerns with regard to the internationalisation of SOEs.

6.2.2. *International Forum of Sovereign Wealth Funds*

Sovereign wealth funds (SWFs) continued to capture attention as a result of their ever growing assets and corresponding influence on global financial markets. In 2016 the total assets of sovereign wealth funds topped EUR 5.8 trillion, up by 3 % compared to 2015 despite sustained low oil prices.

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

The Commission attended, as an observer, the 8th annual meeting of the International Forum of Sovereign Wealth Funds (IFSWF) on 8-11 November 2016. It was hosted by the *New Zealand Super Fund* in Auckland.

The meeting focused on the challenges for long-term investments in times of uncertainty and the implications of climate change for institutional investors. It also focused on the efforts taken to lower investment exposure to carbon dioxide emissions.

6.3. Other developments

6.3.1 Preventing terrorist financing

The Commission presented a series of measures in its action plan on terrorist financing on 2 February 2016. As an immediate action, the Commission provided increased support to Member States for ensuring effective transposition of the Fourth Anti-Money Laundering (AML) Directive. It also accelerated the adoption of the list of ‘high risk third countries’ which was adopted on 14 July 2016 — while carrying out a supranational assessment of risks of money laundering and terrorist financing. As a major initiative, the Commission decided to reinforce preventive measures by proposing a revision of the Fourth AML Directive on 5 July 2016. This new legislative proposal seeks not only to tackle terrorist financing risks but also to provide a policy response to the ‘Panama paper’ scandal by increasing transparency of and access to beneficial ownership information.

6.3.2 Economic and financial sanctions to non-EU countries

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

The most prominent of the EU’s existing sanctions regimes during the reporting period were those relating to Russia. Those restrictive measures were first introduced on 31 July 2014 in response to the illegal annexation of Crimea and ongoing destabilisation of Ukraine. They include bans targeting Russian interests in the financial, oil and defence sectors.⁸² The EU’s restrictive financial measures aim to cut off strategic state-owned Russian companies from EU financing sources, thus imposing an indirect financial cost on the Russian state.

In March 2015, the European Council linked the lifting of EU sanctions to the implementation of the Minsk peace agreements. On 1 July 2016, the European Council prolonged the EU economic sanctions against Russia until 31 January 2017. On 20 December 2016 the Council prolonged the sanctions until 31 July 2017.

⁸² The financial services measures in relation to Russia list five banks, three oil companies and three defence companies and their non-EU subsidiaries and entities acting on their behalf or at their direction. The measures prohibit EU persons from dealing in any way whatsoever 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.

7. CONCLUSIONS

The main economic trends identified in this document — sluggish investment landscape in the EU with a persistent decline in both FDI outflows and inflows and EU cross-border investments still below their pre-crisis level — make a prompt implementation of the Investment Plan for Europe even more necessary.

This implementation should be based on an effective free movement of capital and freedom of payments, underpinning a well-functioning single market for capital.

Year 2016 saw a number of major policy initiatives to support this objective. First and foremost was the commitment to accelerate the creation of the Capital Markets Union. The Capital Markets Union should better connect savings to investment and strengthen the European financial system by improving private risk-sharing, providing alternative sources of financing and increasing options for retail and institutional investors.

Since building a Capital Markets Union is also a national task, the Commission has been working with Member States in 2016 on mapping and removing national barriers to free movement of capital (e.g., burdensome procedure for withholding tax relief or barriers to the cross-border distribution of investment funds).

Other main initiatives supporting the free movement of capital and freedom of payments included:

- the steps taken with Member States to end their intra-EU BITs;
- the follow-up to the Green Paper on Retail financial services; and
- the legislative package for an EU-wide market for electronic payments.

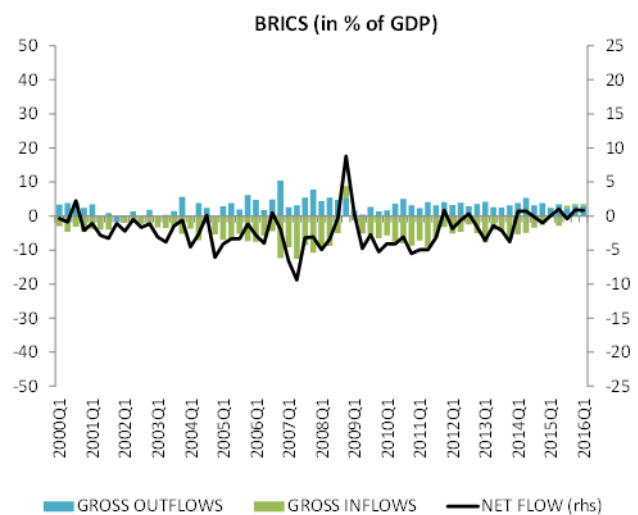
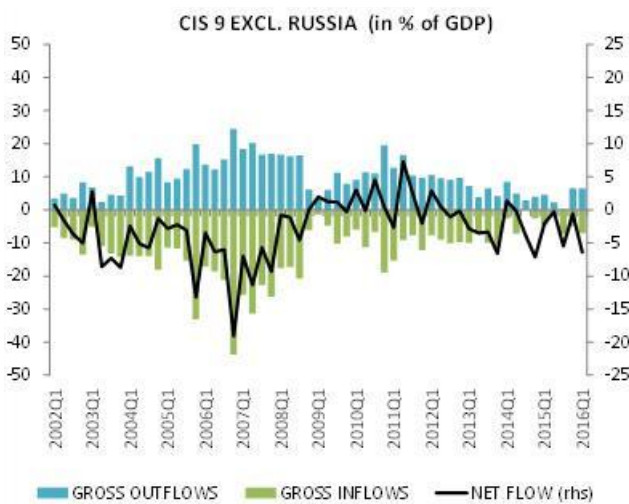
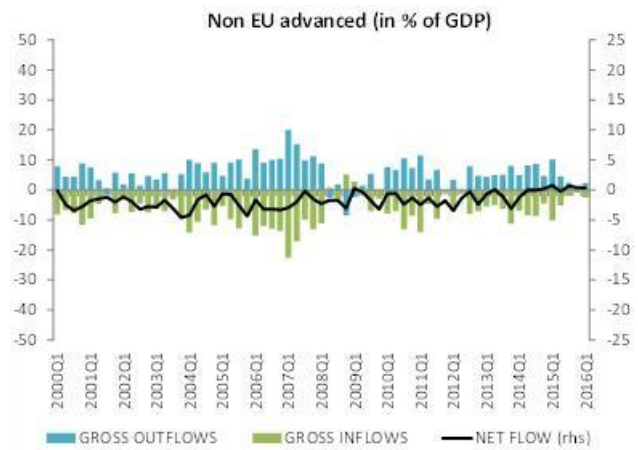
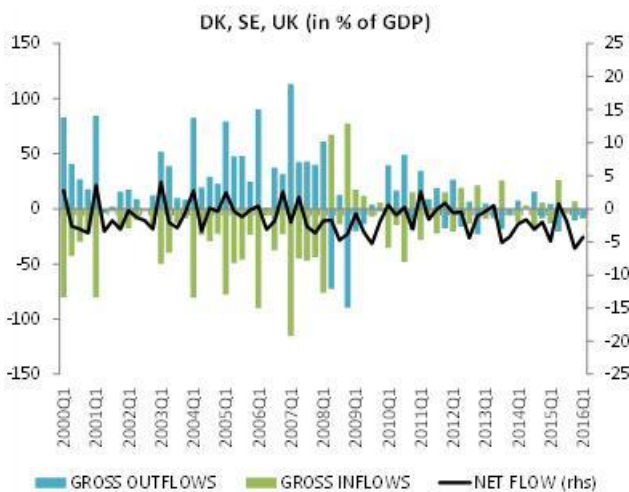
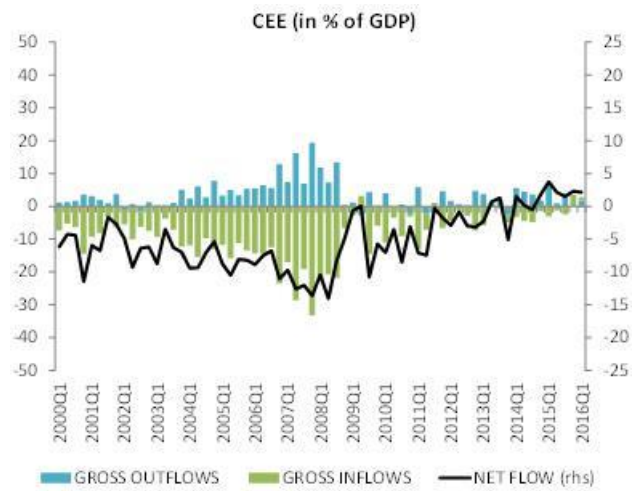
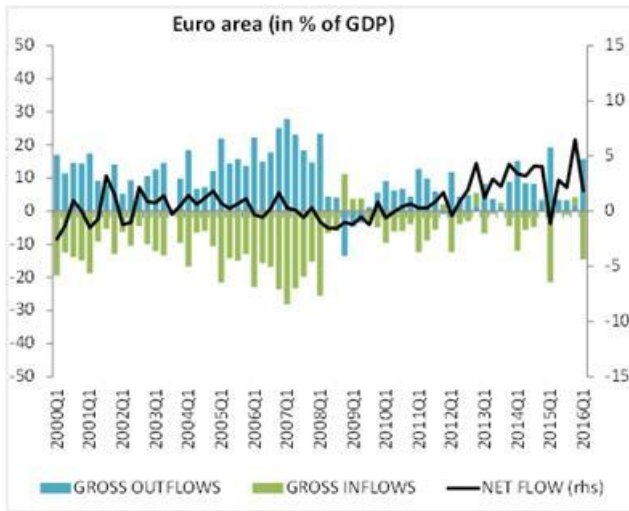
A number of initiatives were also taken in the field of taxation, contributing to more integrated capital markets and a more level playing field.

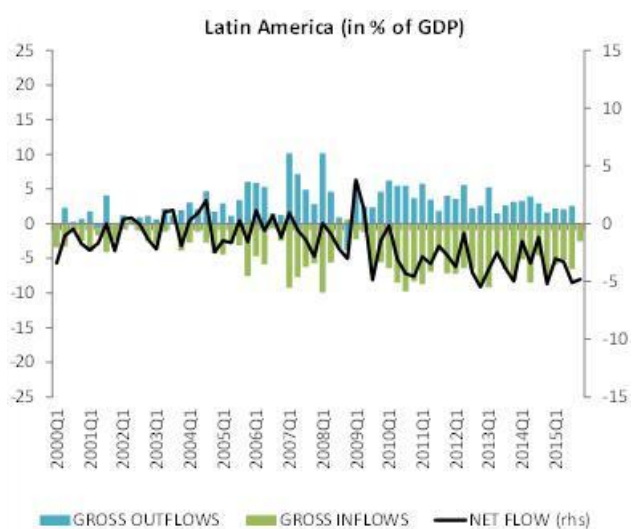
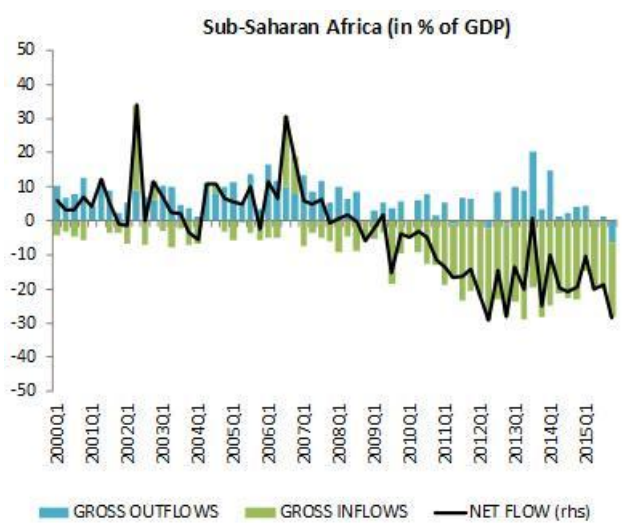
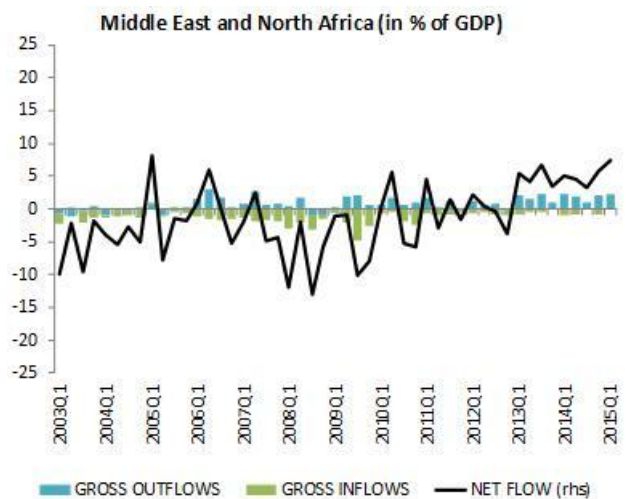
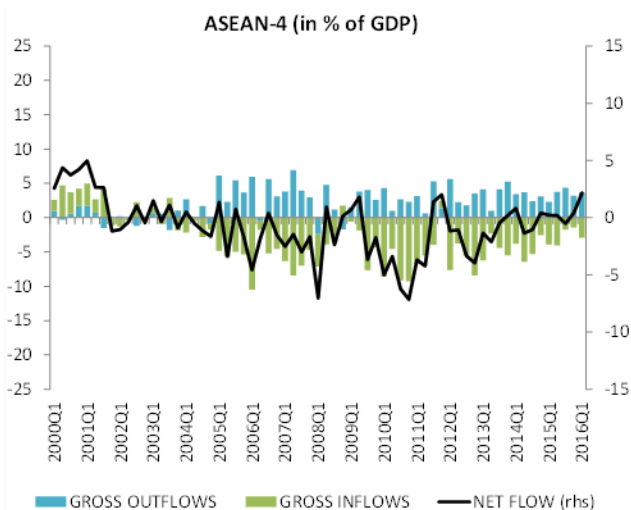
Alongside these key initiatives, the free movement of capital in Europe was ensured through:

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

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

ANNEX 1 THE EVOLUTION OF GROSS AND NET CAPITAL FLOWS IN THE WORLD (PERCENT OF GDP)

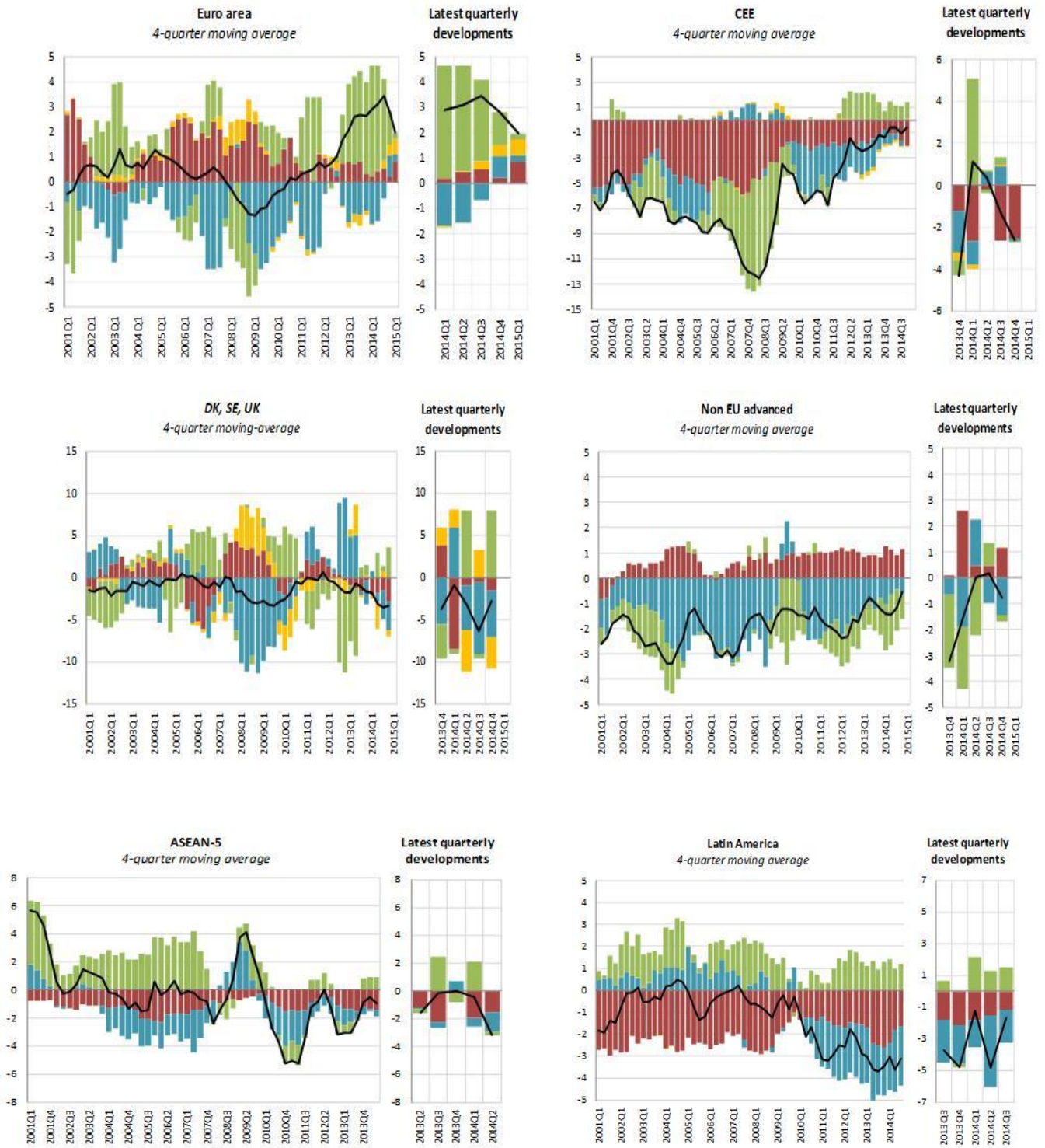


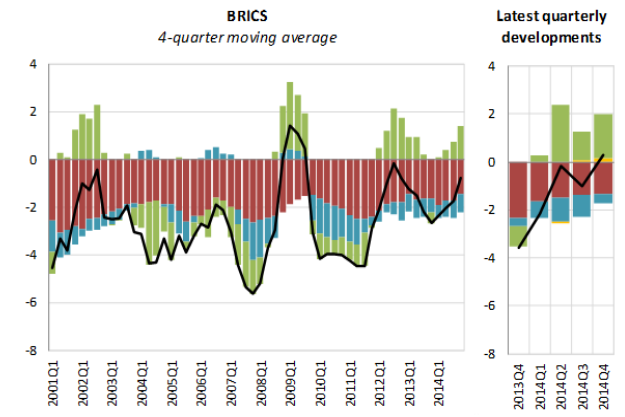
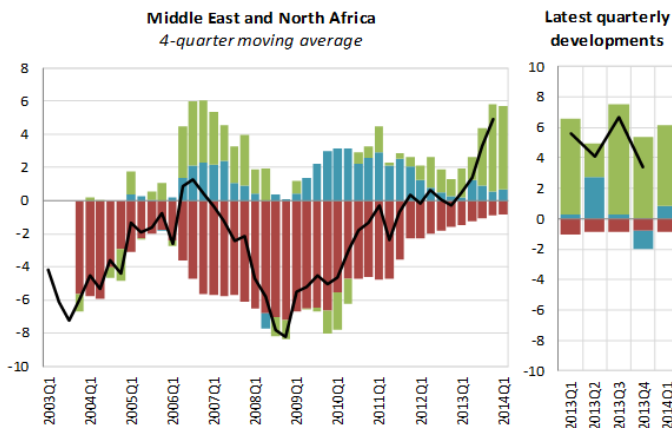
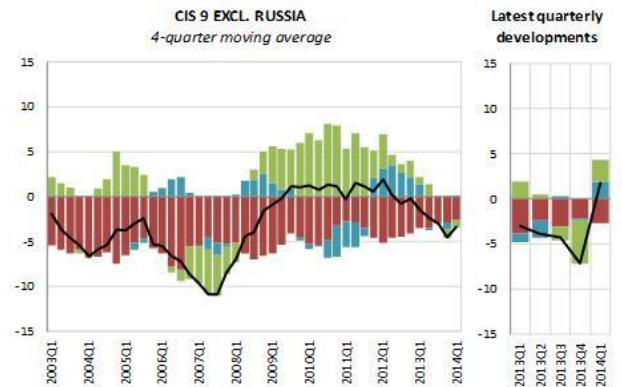
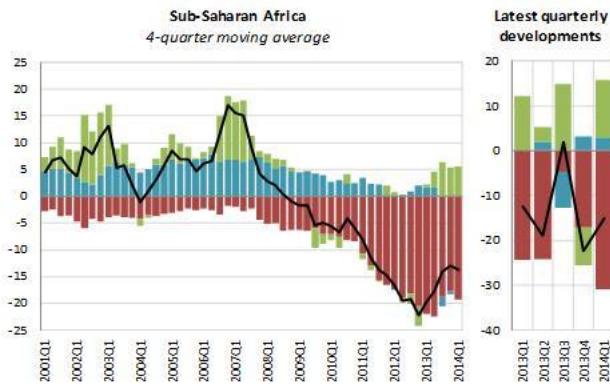


Source: IMF IFS (quarterly capital flows); WEO (annual GDP). Note: The country groups are as follows: Euro area = EA 17; other EU 3 = United Kingdom, Sweden, Denmark; CEE7 = Bulgaria, Czech Republic, Croatia, Latvia, Lithuania, Hungary, Poland and Romania; non-EU advanced = Canada, Japan, United States, Australia, Hong Kong, Iceland, Israel, Korea, New Zealand, Norway, Switzerland; BRICS = Brazil, Russia, India, China, South Africa; 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-4 = Indonesia, Philippines, Thailand, Vietnam; 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. See Box 1 for the definition of capital flow components. Note that gross flows can be negative, which means disposing earlier cross-border investments. Changes in official reserves and NEO are excluded from the financial account for better readability.

ANNEX II COMPOSITION OF NET CAPITAL FLOWS IN THE WORLD

(IN PERCENT OF GDP)





■ DIRECT INVESTMENT ■ PORTFOLIO INVESTMENT
■ FINANCIAL DERIVATIVES ■ OTHER INVESTMENT
— FINANCIAL ACCOUNT

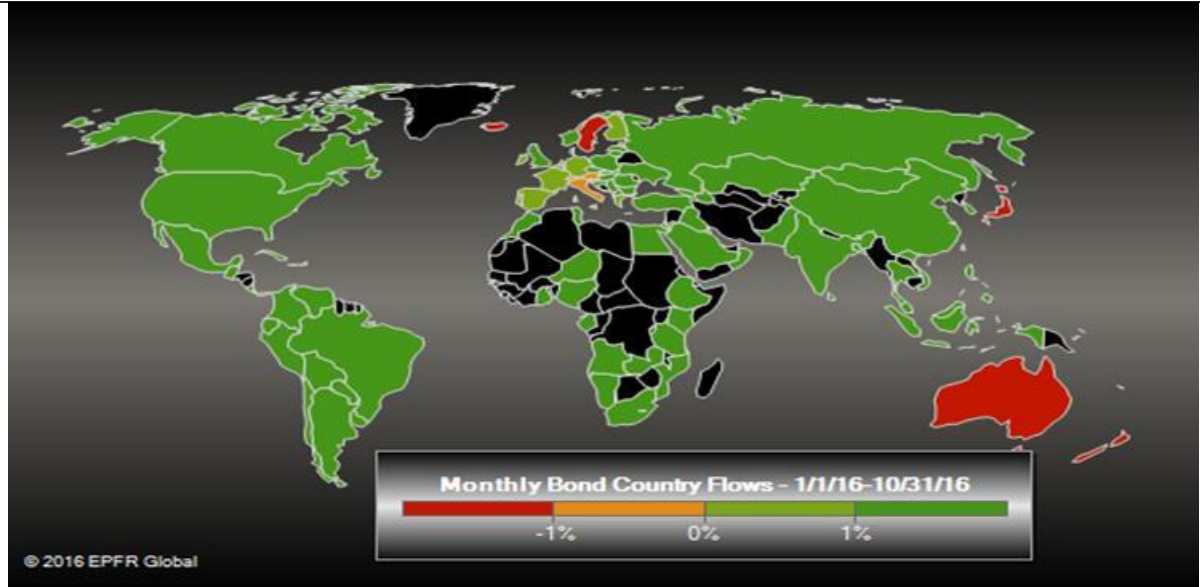
Source: IMF IFS (quarterly capital flows) and WEO (annual GDP); Note: see the definition of the country groups in the note to Annex 1.

ANNEX III NET BOND AND EQUITY CAPITAL FLOWS BY WORLD REGIONS

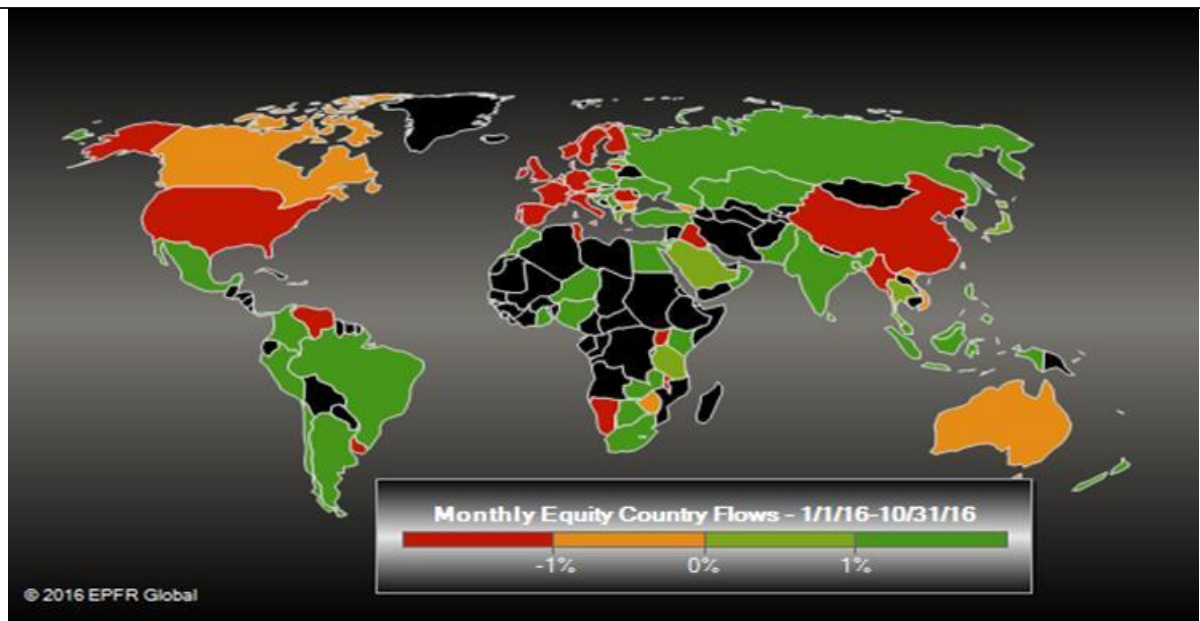
Heat maps –bond and equity net capital flows to investment funds,

1 January 2015 – 31 October 2016

1. Bond flows



2. Equity flows



Source: EPFR Global

ANNEX IV GLOBAL IMBALANCES – DO VALUATION EFFECTS MATTER?⁸³

This section looks at global imbalances from the perspective of the financial account. Specifically, it studies the evolution of the gross international investment positions of the G20 economies and identifies valuation effects, which are measured as the change in gross foreign assets and liabilities minus the conventional financial account components.

Our calculations show that there are significant positive valuation effects across advanced economies (AEs), at times as large as 75% of GDP. There are large positive valuation effects on the US stocks of foreign assets and liabilities, which appear to be the main driving force behind the developments observed across AEs. These findings might be a reason for concern with regard to financial stability as our analysis also suggests that global financial integration may be not as "global" as perceived. On the contrary, a significant amount of external assets and liabilities is held by a limited number of advanced countries. Thus, a few countries might be exposed to sizeable valuation effects (especially true for the largest financial counterparts of the US).

7.1.1. *Global imbalances from the perspective of the financial account*

In the decade before the global financial crisis, the Advanced Economies' (AEs)⁸⁴ financial markets and banking sectors experienced rapid integration, quickly accumulating record-high levels of foreign assets and liabilities. The financial crisis triggered significant volatility in capital flows reflecting a correction in the value of external assets and liabilities as well as sizeable cross-border withdrawals of banking flows. After 2009, the cumulative stock of AEs external assets and liabilities started to recover quickly, while gross capital flows remained subdued. Therefore, it is likely that sizeable valuation effects have been at play in the post-crisis period.

7.1.2. *What are the valuation effects?*

There are two main reasons behind valuation effects – changes in exchange rates and/or domestic asset prices. Multiple domestic factors can have an indirect impact on valuation effects through these two channels. For example, fiscal and monetary policies can directly affect interest rates and nominal exchange rates, which in turn affect asset prices. External factors could also have effect on exchange rates and domestic asset prices, most prominently through surges of capital flows.

There are different ways to measure valuation effects. In this analysis, the year-on-year change in the sum of the gross stock of foreign assets and liabilities (also called international financial integration (IFI)) is defined as equal to the sum of all financial flows plus (FF_t) and the valuation effects (VAL_t). In other words, in any given period t , the measured change in the gross international investment position can be written as:

$$IFI_t - IFI_{t-1} = (FF_t + VAL_t)$$

Therefore, valuation effects can be computed as:

⁸³ This section is based on: Bogdanov and Filippeschi (2017) "Financial Integration: Globalisation or Americanization", forthcoming European Commission Discussion Paper.

⁸⁴ Advanced economies are defined as Australia, Canada, France, Germany, Italy, Japan, the UK and the US.

$$VAL_t = (IFI_t - IFI_{t-1}) - FF_t$$

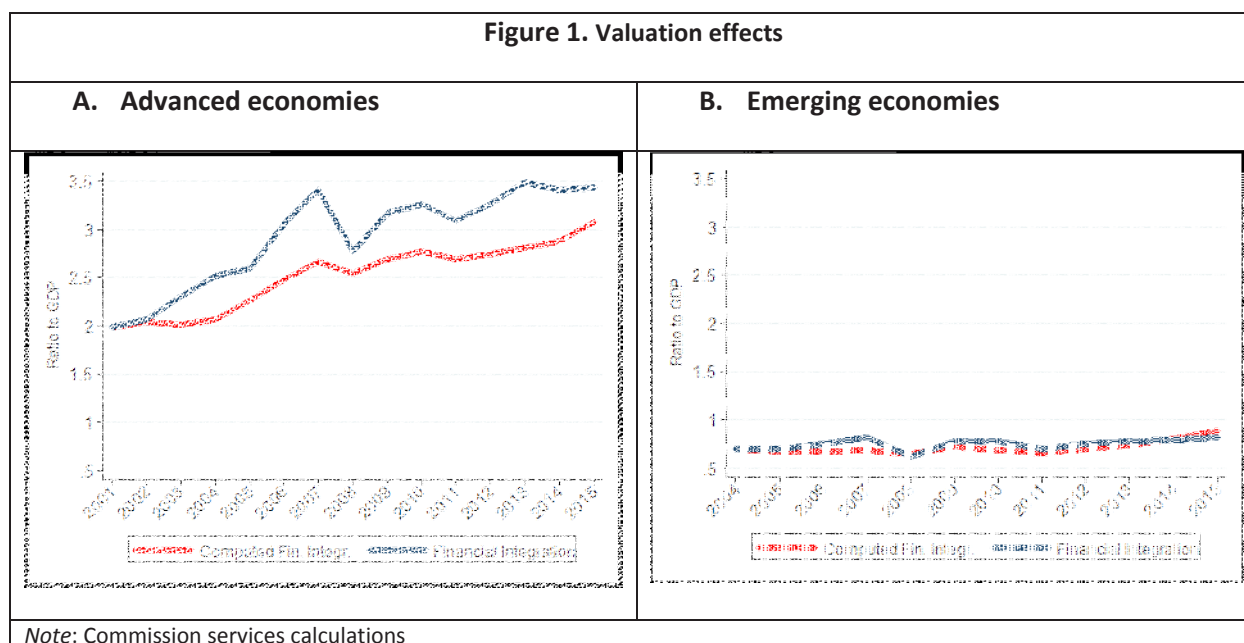
To better visualise the importance of valuation effects for the change in stocks is computed a variable called “Computed International Financial Integration” (CIFI) as a counterfactual to IFI. This series projects the path that IFI would have had if it was only driven by financial flows:

$$CIFI_t = CIFI_{t-1} + FF_t$$

Therefore, valuation effects can be illustrated as the difference between IFI and CIFI.

7.1.3. Source countries of valuation effects

Figure 1 compares IFI and CIFI for AEs and emerging market economies⁸⁵ (EMEs). The aggregate sum of the stock of foreign assets and liabilities of EMEs is significantly lower than that of AEs. While EMEs also experienced global financial integration, it is around 3 times lower compared to AEs at the end of 2015. Moreover, sizeable valuation effects are observed across AEs, at times as large as 75% of GDP (being the difference between IFI and CIFI). On the other hand, the size of valuation effects in EMEs is marginal.

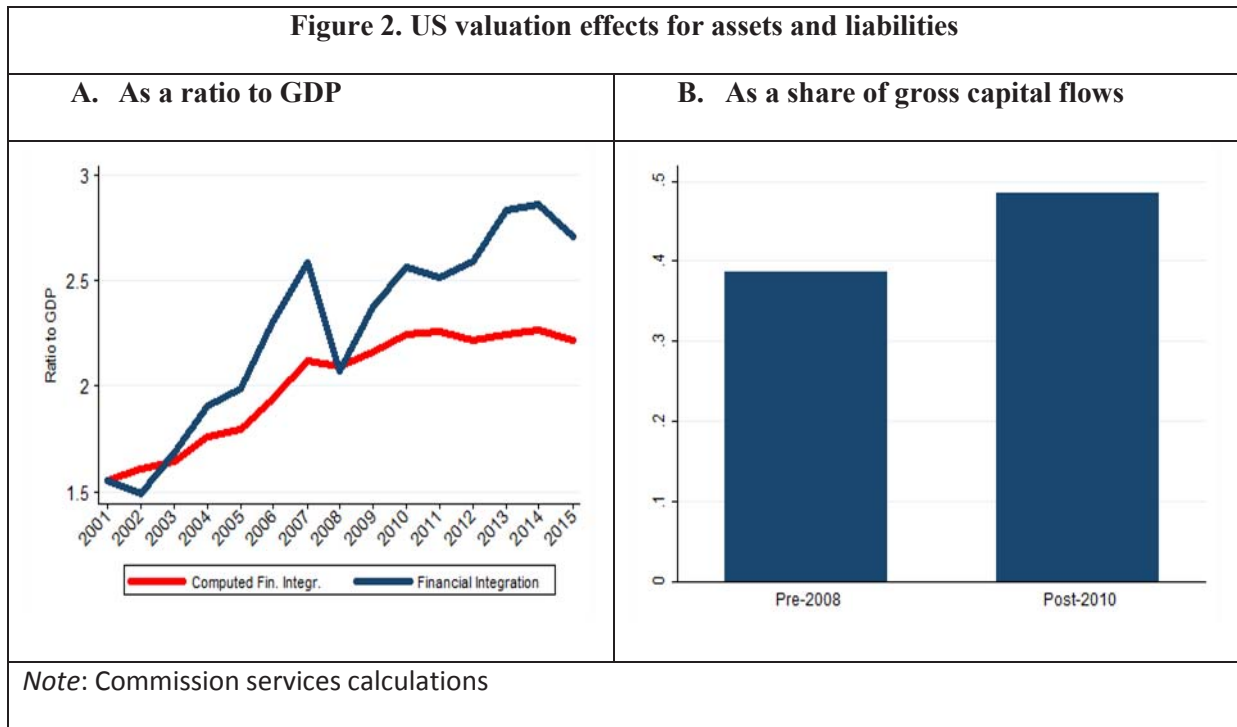


Amongst AEs the US appears to be the main driving force behind the expansion of the aggregate sum of the stock of foreign assets and liabilities. This is due to the significant economic weight of the US (almost 1/3 of the total AEs' capital flows throughout 2001-2015) as well as the experienced large positive valuation effects (see Figure 2 Panel A).

More specifically, the valuation effects in the US have been large and pronounced, especially after the crisis. To put the observed valuation effects into perspective, the measured valuation effects are divided by gross flows. If this ratio equals zero, it would mean that there were no valuations effects. If the ratio is positive, in a perfect world, it would mean that for each dollar of capital flows there is a positive valuation effect (and

⁸⁵ Emerging market economies are defined as Brazil, China, Korea, Mexico, Russia, South Africa and Turkey. India, Indonesia and Argentina do not have data for 2015 and thus have been excluded from the aggregate.

vice-versa for a negative ratio). In the case of the US this ratio is positive. In fact, the valuation effect per dollar of capital flows increased from 38 to 54 cents per dollar after the crisis, meaning that the US valuation effects have been stronger compared to the pre-crisis period (see Figure 2 Panel B).



Historical experience and international evidence have demonstrated that large and persistent volatility of asset prices and exchange rates could have sizable and long-term negative effects on the real economy. In this context, it is important not only how the observed financial integration and the underlying valuation effects have developed over time, but also how they are spread across countries. If they are spread proportionately across countries the risks associated to the volatility of asset prices and exchange rates would be diversified. On the other hand, if financial integration is not so "global", but rather contained to a limited number of countries holding most international assets and liabilities, risk would be higher.

For instance in the case of the US, more than half of all US external assets and liabilities are held by Japan, the UK, Canada and the Netherlands. Around 60% of Canada's total bilateral financial flows (and stocks) are with the US, while for Japan and the UK, this share is approximately 30%. For emerging markets, financial exchanges with the US have also gained importance. Thus, potential risks coming from disorderly movements of US capital flows as well as valuation corrections might be concentrated in a few countries.