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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 FREEDOM OF PAYMENTS

1. INTRODUCTION

World capital flows remained volatile in 2013-14, continuing the trend that started in the aftermath of the financial crisis. At the same time, global flows of financial resources showed some sign of recovery, thus partially reversing the post-2008 collapse. This recovery was, however, uneven across world regions and countries, and mainly resulted in a shift away from the EU towards emerging markets.

There was also a significant change in the composition of global capital flows, and the impact of this change on the EU was particularly important. EU capital flows intermediated by banks retreated behind national borders, and this decrease in cross-border bank flows was not fully compensated by other sources of private capital, such as equity and debt investment, in which more integrated capital markets can play an important role. In particular, cross-border investment within the EU Single Market continued to plummet in 2013 and in the first half of 2014.

Following the crisis, G20 members agreed on several policy reforms, with two main thrusts: firstly, to promote financial stability; secondly, to support strong, sustainable and balanced growth. In this context, the EU has implemented an ambitious programme of financial reforms to overcome fragmentation of its banking market while safeguarding financial stability. Looking forward, the Investment Plan for Europe proposed by the Commission on 26 November 2014 and the Capital Markets Union will make an important contribution to long-term investment in the real economy.

The free movement of capital underpins all these efforts. It is one of the four fundamental freedoms of the Single Market and its ultimate objective is to create a truly integrated, well-functioning and stable Single Market for capital, thus fostering investments between EU Member States and attracting financial flows from third countries. This should ensure that capital is able to flow to where it is most needed and can be most productive, which will be important in sustaining Europe's economic recovery.

The free movement of capital should underpin integrated, open, competitive and efficient European financial markets. It allows citizens to perform many operations abroad, as diverse as opening bank accounts, buying shares in non-domestic companies, investing where the best return is, and purchasing real estate. It enables companies to invest in and own other European companies and take an active part in their management.

In the light of the importance of achieving a Single Market for capital, this Commission staff working document describes the trends in EU capital movements in 2013 (and 2014, where data are available).[1] It gives an overview of the legal framework for the freedom

[1] This report is part of annual stocktaking contributing to the Economic and Financial Committee's (EFC) examination of capital movements and the freedom of payments under Article 134 of the Treaty on the Functioning of the European Union.

of capital movements and payments. The document also reports on recent developments in relation to monitoring and enforcing the relevant rules.

Overall, the year 2014 saw several developments highlighting the importance of making sure that public policy boosts private investment flows so that saving surpluses are matched with investment needs in the most effective way within the Single Market, in order to foster economic growth and create new jobs.

2. TRENDS IN EU CAPITAL FLOWS IN THE GLOBAL CONTEXT IN 2013-14[2]

2.1. Main trends and drivers of capital flows[3]

The pace of the recovery lacked momentum in 2014, as Europe continues to struggle to leave the legacies of the crisis behind it. But on balance, as the legacy of the crisis gradually abates, the labour market continues to improve and structural reforms implemented so far start bearing fruit, an acceleration of GDP growth is expected this year and next.

EU gross domestic product (GDP) is expected to have increased by 1.3% in 2014 and is forecast to accelerate to 1.7% in 2015 and to 2.1% in 2016, while growth in the euro area, which is expected to have been 0.8% in 2014, is forecast to be 1.3% in 2015 and 1.9% in 2016.[4]

The global financial crisis resulted in a collapse of both net and gross financial flows across all countries and the subsequent recovery in capital flows was uneven. By the first quarter of 2010, capital flows reached nearly pre-crisis levels in some emerging markets and developing regions (e.g. Latin America, small countries in the Association of Southeast Asian Nations (ASEAN), and Sub-Saharan Africa), and even continued to grow in 2013 and early 2014. The same, though to a lesser extent, can be observed for larger emerging economies (including Brazil, Russia, India, China and South Africa — BRICS) and non-EU advanced economies. However, the EU continued to show low levels of capital flows even in 2013.

In 2013, the start of the renormalisation of monetary policy conditions in the United States triggered capital reallocation and disturbances in capital flows. This volatility was mainly due to movements of funds that had flowed into emerging markets in search of higher yields, and then quickly reversed as the United States Federal Reserve announced that it might start ‘tapering’ its purchase of assets. The global turbulence in capital flows in 2013 has been a reminder of the vulnerability of the global economy, even as growth and trade may be accelerating.

The following factors were driving capital flows in 2014 and are likely to continue to play a role in the coming months:

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2 The analysis in this chapter is based on a study carried out for the European Commission by Bruegel: ‘*Analysis of developments in EU capital flows in the global context*’.

3 See Annex I for an in-depth analysis of the determinants of bilateral financial linkages and the role of the euro and the EU Single Market.

4 European Economic Forecast, Winter 2015.

- *Monetary policy divergence in the euro area, the United Kingdom, Japan and the United States*. Divergent monetary policy developments were one of the key drivers of capital flows in 2014, and may continue to play an important role in 2015. On the one hand, the United States Federal Reserve is continuing to accelerate the withdrawal of its accommodating monetary policy conditions. On the other hand, the Bank of England may continue to keep its monetary policy unchanged and the European Central Bank has taken a number of measures in recent months to provide additional monetary policy accommodation. The Bank of Japan signalled that it may also consider further monetary easing.

- *Reassessment of the prospects for economic performance of advanced economies and emerging markets*. The gradual withdrawal of accommodative monetary policy in some advanced economies (notably the United States) has triggered a re-evaluation of the growth potential of several emerging economies and especially those with accumulated external imbalances, which have been increasingly seen as a potential source of vulnerabilities. In addition, growth in corporate earnings in emerging markets has been negative since 2011, and forward price/earnings ratios in emerging markets remain below those in advanced economies.

- *The continuing deleveraging in the European banking sector.* This was an important driver of a decrease in cross-border capital flows in 2014, and is likely to continue to play a role in the coming quarters.

2.2. Net and gross capital flows

The financial crisis resulted in a highly synchronised collapse of both net and gross financial flows globally, but there have been significant differences across regions in the recovery of capital flows[5] in the post-crisis period (see Figure A.1 in Annex II).

On the one hand, net flows (i.e. the difference between gross inflows and outflows) are important because they are frequently viewed as the financial counterparts to savings and investment decisions. Therefore, net flows represent the key variable to gauge countries' external borrowing requirements. On the other hand, it is also important to look at gross flows. The last decade has seen a rapid increase in gross flows, but this increase is not always evident in net capital flows. For most countries, net capital flows are small relative to GDP, whereas gross capital flows were in the double-digit range as a percentage of GDP.[6]

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5 'Capital flows' are defined as cross-border financial transactions recorded in a country's external financial accounts, which produce a change in the assets and liabilities of residents vis-à-vis non-residents. Inflows arise when external liabilities are incurred by the recipient economy, or when external assets are reduced (inflows with a negative sign). Capital outflows arise through purchases of external assets from the viewpoint of the reporting economy (outflows with a negative sign), as well as through deleveraging of the country's assets (outflows with a positive sign). A net flow is calculated by summing up gross in- and outflows, where outflows are recorded with a negative sign.

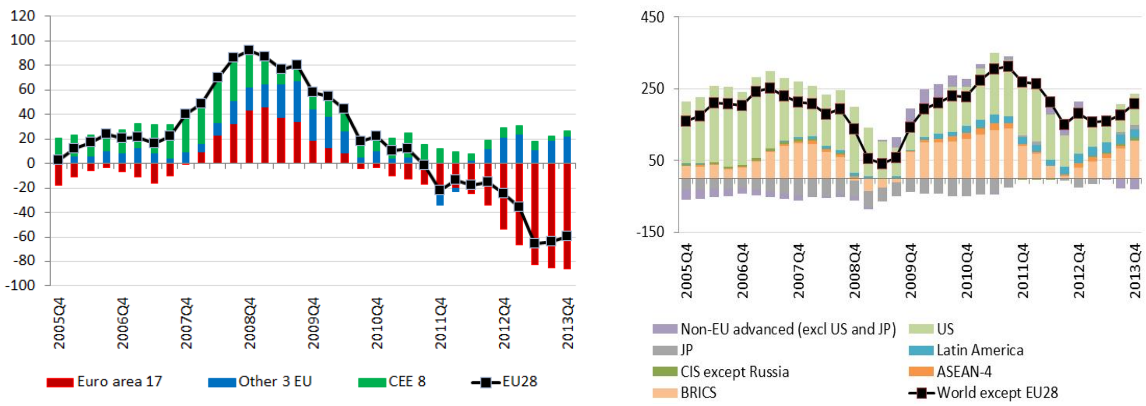
6 The euro area is a striking example of this, as its aggregate financial account position remained mostly balanced over the ten years preceding the crisis despite very large gross flows. The main driver behind this expansion is the growth of international cross-border banking activity, whose effects are especially evident in the increase of portfolio and other investment flows.

To better understand the dynamics of capital flows, the EU's capital account can be analysed by distinguishing between: the 17 Member States that were part of the euro area (EA) up until the end of 2013;[7] and the 11 non-euro area Member States (Other EU) that can be disaggregated into a group of three non-euro area northern Member States (non-EA-3)[8] and eight Central and Eastern European (CEE) Member States.[9]

Net flows were positive in most regions of the world in 2013-14, with the notable exception of the EU (Figure 1 and Figure A.1 in Annex). The euro area had a more or less balanced net financial account both before and during the height of the global crisis, but after the crisis intensified in 2011 it started to experience sizeable capital outflows. In spite of less turbulent financial markets in 2013-14, capital was still flowing out in net terms. Other Member States outside the euro area show quite different patterns. Net flows remained positive in CEE Member States and in the non-EA-3 Member States.

Figure 1: Net financial account balance for different country groups (in USD billions)

1.A The EU-28 **1.B The global outlook — except EU-28**



Source: Bruegel calculations using International Monetary Fund (IMF) Balance of Payments Statistics and Eurostat for the EU, which exclude intra-EU flows.

Note: A positive value indicates net capital inflows into the country/country group. Four-quarter moving averages are reported. The 75 countries included in the analysis account for 92% of GDP of the countries included in the IMF World Economic Outlook. Excluding financial derivatives.

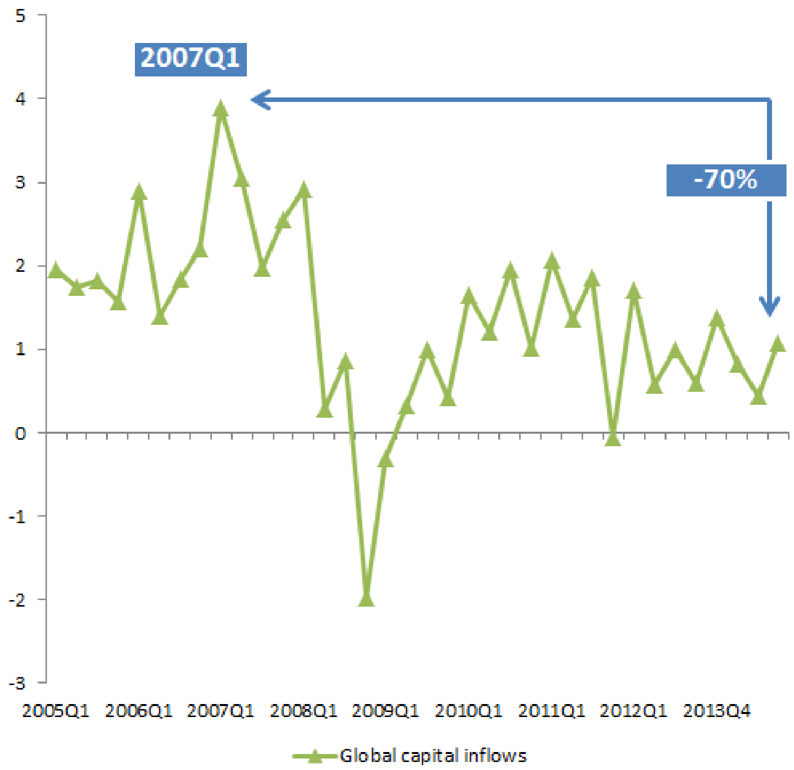
Moreover, the major reduction in gross flows relative to the pre-crisis period continued in 2013-14 and these flows remained subdued (Figure 2). Overall, at the end of 2013 global capital inflows remained almost at 70 % below their pre-crisis peak in the first quarter of 2007 and are now at levels similar to those in 2005.

7 Since the most recent data generally stops at end 2013, and Latvia became a euro area member on 1 January 2014.

8 Denmark, Sweden and United Kingdom.

9 Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania, plus Latvia and Lithuania.

Figure 2: Global gross capital inflows are well below their pre-crisis (2007) peak levels



Source: Commission services' calculations based on IMF BOP database.

Notes: in USD trillions; based on a changing sample of up to 169 countries; capital inflows — including foreign direct investment (FDI), portfolio and other investment liabilities.

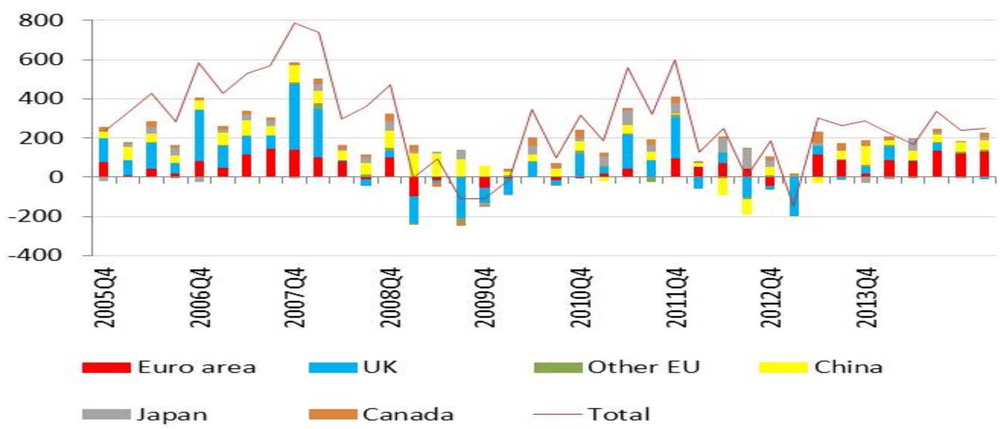
At the same time, the global aggregates mask considerable variation and the post-crisis recovery of capital flows was uneven across regions and countries (Figure A.1 in Annex). By the first quarter of 2010, gross capital flows reached nearly pre-crisis levels in Latin America, in a number of small ASEAN economies (Indonesia, Philippines, Thailand, and Vietnam) and in Sub-Saharan Africa, and continued to grow in 2013 and early 2014. The same, albeit to a somewhat lesser extent, can be observed for the BRICS and non-EU advanced economies. The euro area and EU CEE Member States continued to display depressed levels of gross inflows and outflows of capital also in 2013. Gross capital inflows were volatile for the non-EA-3 Member States, but the trend was overall positive.

The magnitude of gross flows relative to GDP is several factors higher now in every non-European emerging and developing country region than in the euro area, in sharp contrast to pre-crisis developments. These developments suggest that global capital flow patterns may have changed significantly.

While several factors had a bearing on these developments in global capital flows, higher GDP growth in emerging markets relative to growth in advanced economies has improved the systemic attractiveness of the former as destinations for investments. In particular, weak economic performance and growth prospects in the EU and the euro area, as well as the continuing deleveraging, have had a negative impact on foreign investment.

The geographical breakdown of capital inflows into the United States reveals that the EU was one of the main sources of external financing for the US economy, and that the United States was one of the main destinations of capital outflows from the euro area and the United Kingdom (Figure 3). After declining and even turning negative in 2012, capital inflows into the United States originating from the euro area increased steadily in 2013 and 2014.

Figure 3: US – gross capital inflows by region, USD millions



Note: US BEA, not seasonally adjusted

2.3. Capital flows by financial instruments

2.3.1. Overview of direct investment, portfolio investment and other investment

Capital flows can also be analysed according to different instruments, namely direct investment,[10] portfolio investment[11] (equity and debt securities, the latter of which can be broken down further into bonds and money market instruments), other investment[12] and, whenever available, financial derivatives. The breakdown shows that these instruments play very different roles in driving capital flows across regions and countries (Figure A.3 in Annex):

- **Direct investment**: the CIS-8 (excluding Russia), Latin America, Middle East and North Africa and Sub-Saharan Africa benefited mostly from direct investment flows both before and after the economic crisis. Direct investment

[10] 'Direct investment' covers financial flows between resident and non-resident firms that are under a direct investment relationship. A direct investment relationship is established when a resident firm holds at least 10 % in the share capital of a non-resident firm, or vice versa.

[11] 'Portfolio investment' covers financial flows related to transactions between residents and non-residents that affect their assets and liabilities vis-à-vis each other related to securities and derivatives. Securities are distinguished between equities and debt securities, namely bonds and money market instruments.

[12] 'Other investment' covers financial flows stemming from transactions between residents and non-residents related mainly to loans and deposits.

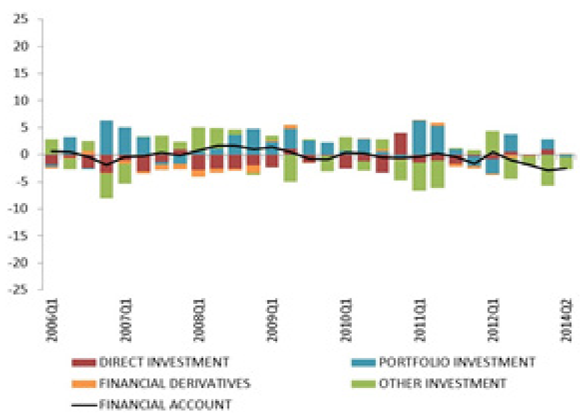
also played an important role in the overall capital flows of the EU CEE Member States and the BRICS during the same period. Direct investment from the euro area to the rest of the world was mostly higher than direct investment flowing into the euro area, while direct investment played a relatively minor role in the total financial flows of the non-EA-3 EU Member States (except for the first quarter of 2013).

- **Portfolio investment**: Before the financial crisis, cross-border investment in debt and equity played a major role in the euro area and the non-EA-3 Member States, as well as in the non-EU advanced economies and in small ASEAN countries. After the outbreak of the crisis, the entire EU experienced volatile portfolio investment flows, although these flows remained broadly positive. In 2013 net portfolio investment in the euro area remained volatile and positive, although it turned negative in the second quarter of 2014, due to portfolio outflows exceeding inflows. In the rest of the EU, net portfolio flows remained positive and more subdued in 2013, mostly reflecting more contained inflows in the CEE Member States.

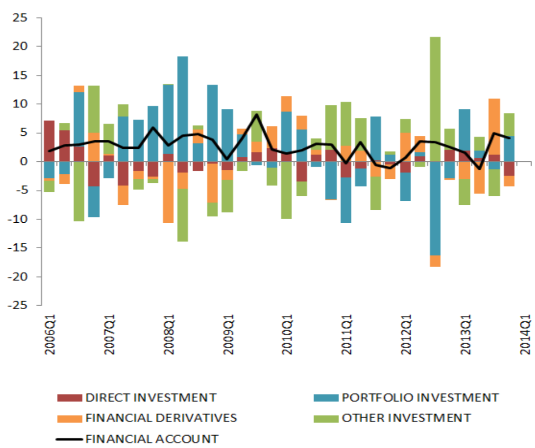
- **Other investment:** This category of capital flows (which largely consists in cross-border bank loans) dominated cross-border flows within and out of the euro area and the non-EA-3 Member States, reflecting the bank-based nature of finance in Europe. Bank flows were very substantial also in the EU CEE Member States before the crisis, which is an indication of the importance of credit provided by foreign-owned banks. After the financial crisis and until early 2014 these flows have been very volatile and mostly negative in net terms in the euro area. The decline of gross flows in the EU and the euro area reflected mostly a reversal in bank-intermediated flows as indicated by the downscaling of other investments as well as a drop in FDI, which was only partially offset by a recovery in portfolio investments (Figure 4).

Figure 4: Composition of the net financial account, % of GDP

4.A Euro area



4.B Other EU



Source: IMF BoP, Bruegel's and Commission services calculations.

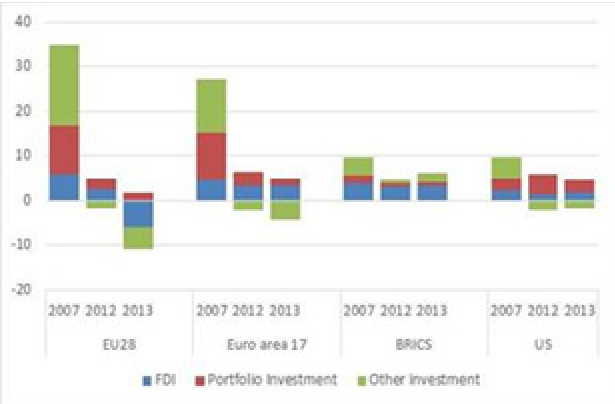
Note: A positive value indicates net capital inflows into the country/country group. Four-quarter moving averages are reported. The 75 countries included in our country groups account for 92 per cent of GDP of the countries included in the IMF World Economic Outlook. Excluding financial derivatives.

Examining the dynamics of gross capital inflows and outflows helps to better understand changes in the net financial account. To this end Figure 5 illustrates the changes in the composition of gross capital inflows and outflows between the start of the crisis (2007) and 2013, and between the previous reporting period (2012) and 2013 for different groups of countries in the EU and globally.

Figure 5: Gross capital inflows and outflows –

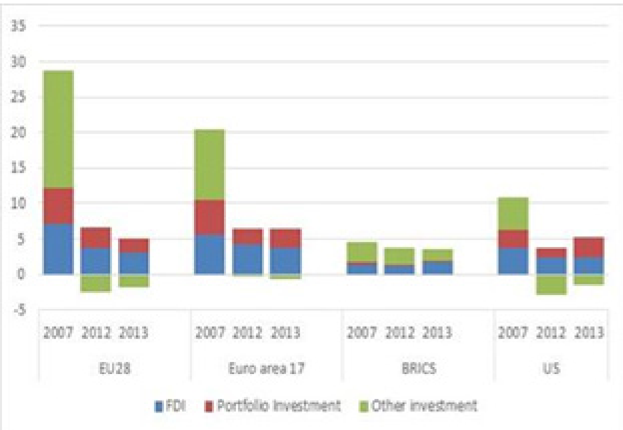
changes relative to the pre-crisis levels and to 2012

A. Components of gross capital inflows in 2007, 2012 and % of GDP 2013, % of GDP



B. Changes in gross capital inflows to GDP ratios in 2007-13, in pps

C. Components of gross capital outflows in 2007, 2012 and 2013, % of GDP



D. Changes in gross capital outflows to GDP ratios in 2007-13, in pps

Source: IMF, BoP, Bruegel's and Commission services calculations. Note: excluding financial derivatives.

The post-crisis downscaling of gross capital flows affected all countries considered in this report. However, the EU and the euro area underwent the most sizeable decline in the magnitude of gross capital inflows and outflows as a percentage of GDP and in 2013 capital inflows in these countries were still the furthest away from their pre-crisis peaks in 2007.

All the three major components of gross capital inflows in the EU and the euro area were lower in 2013 than in 2007 (Figure 5, Panels A and B). However, 'other investment', which mostly consists of bank-intermediated claims, has contributed the most to the shrinking of gross capital inflows since 2007. The magnitude of its decline as a ratio to GDP was the highest in the EU-28 and the euro area, where almost 70 % of the post-crisis decline in capital inflows was related to the downscaling of cross-border bank-intermediated claims.

The contribution of 'other investment' to the adjustment was the most significant also in the United States, where almost 85 % of the decline in gross capital inflows was due to lower bank-related inflows. However, the overall magnitude of the decline in capital inflows and in bank-intermediated claims was much smaller and in 2013 gross capital inflows were almost at the same levels as in 2007 with the exception of other investment.

Portfolio investment and FDI inflows were also lower than in 2007 in the EU and in the euro area. FDI inflows in the United States almost reached 2007 levels, while the most significant decline in relative terms in this component was recorded in the euro area and especially the EU. Only portfolio investment inflows in the United States already surpassed the pre-crisis levels and were higher in 2013 than in 2007, though only marginally.

Panels C and D of Figure 5 show the evolution of gross capital outflows as a ratio to GDP in 2013 compared to 2007 and 2012. They highlight that both decreasing capital inflows and increasing outflows contributed to the adjustment of the net financial account balance in 2007-13, and to the reversal in its sign from positive to negative in the third quarter of 2011 for the euro area and in the fourth quarter of 2011 for the EU. In a more recent perspective, since 2011 increasing capital outflows seem to gain in importance, especially for the euro area.

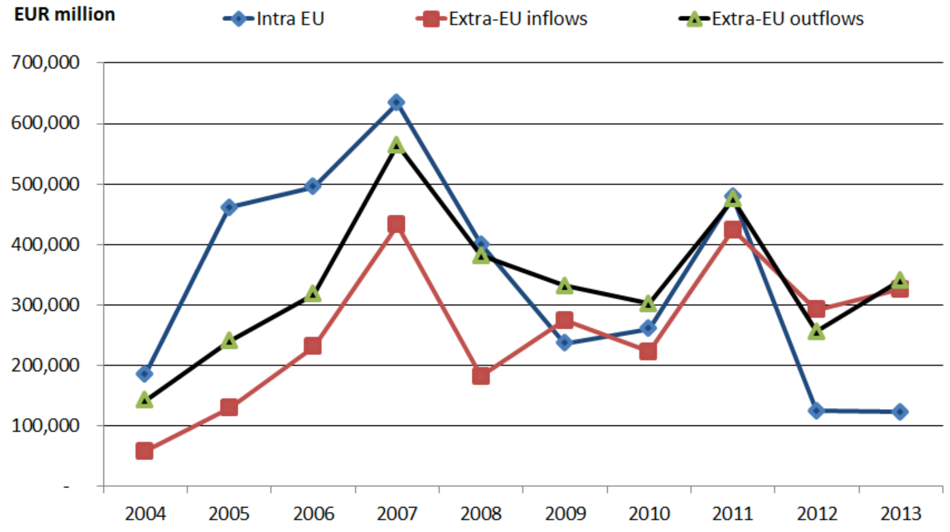
In contrast, both capital inflows and outflows in the BRICS almost reached the pre-crisis levels in 2013 as a ratio to GDP.

2.3.2. The special case of intra-EU cross-border direct investment

Cross-border direct investment has the objective of establishing a lasting interest in a business where the investor wants a strategic long-term relationship with that business. Therefore, by its nature, cross-border direct investment is a crucial source of long-term financing for the European economy, and even more so since many companies have financial constraints and experience difficulties in accessing financing via conventional channels. Cross-border direct investment is also more sustainable and resilient to adverse economic shocks than other categories of capital flows.

While global international investment collapsed during the financial crisis,[13] the EU has been the worst affected region. Before the financial crisis, intra-EU cross-border direct investment was robust, as was foreign direct investment into and out of the EU (Figure 6).

Figure 6: Intra-EU cross-border investment and intra- and extra-EU FDI flows, 2004-13



Source: Commission services' calculations based on: Eurostat bop_fdi and bop_fdi_main

Note: Intra-EU direct investment flows are based on inflows. 2013 data are preliminary.

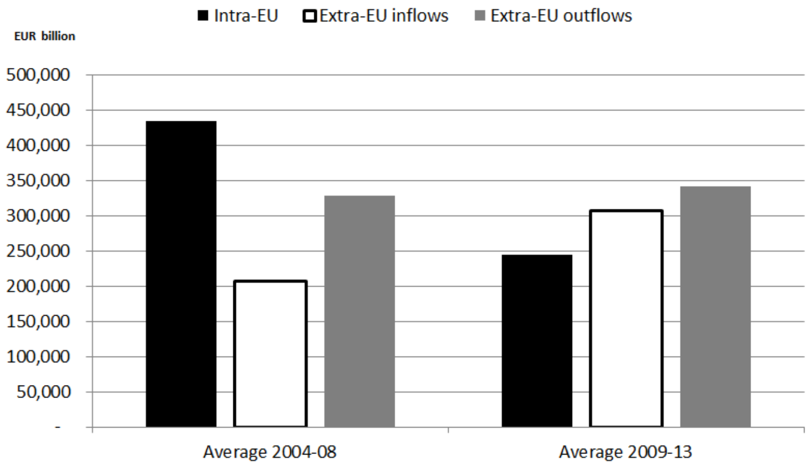
In the aftermath of the financial crisis, all EU direct investment collapsed, and then went back to growth again in 2011. This recovery proved to be short-lived, and investment fell again in 2012, reflecting general concerns about global economic fragility, the ongoing deleveraging and weakening of the world economy.

Preliminary data for 25 EU Member States show that while direct investment into and out of the EU grew again in 2013, intra-EU cross-border investment continued its downward path, and plummeted to EUR 123 billion in 2013 (marking a 74 % decline from 2011).

It is well known that direct investment flows can be volatile and do not instantaneously track changes in business conditions. However, changes in average direct investment flows over several years confirm this trend. Average intra-EU cross-border direct investment was EUR 435 billion in the period 2004-08, falling to EUR 245 billion for the period 2009-13. This is a fall of EUR 191 billion, or 44 % (Figure 7).

Over the same period, average investment flows into the EU from outside increased by 49 %, and outflows from the EU to the rest of the world increased by 4 % (rather than decreasing as in the intra-EU context).

Figure 7: Average intra-EU direct investment and average extra-EU FDI inflows and outflows, 2004-08 and 2009-13



Source: Commission services' calculations based on Eurostat bop_fdi and bop_fdi_main.

Note: Intra-EU direct investment flows are based on inflows.

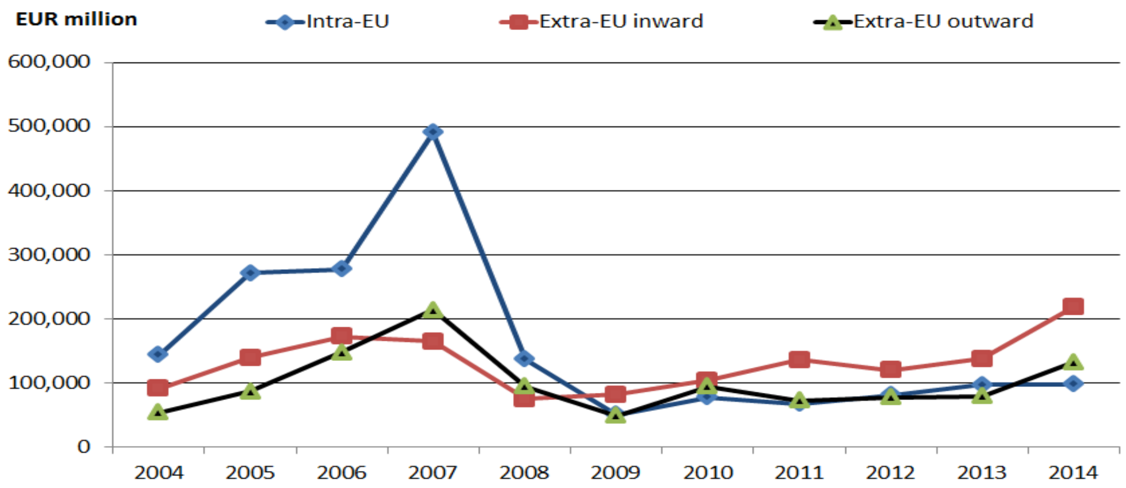
2.3.3. Mergers and acquisitions

After a steep decline triggered by the financial crisis, merger and acquisition (M&A)[14] activities recovered in the post-crisis period, especially in terms of numbers of deals (Figure 8 and Figure 9). However, the rate of post-crisis increase in the number of deals slowed down and had virtually stalled by 2013-14. In the same period, the number of cancelled deals increased, and the difference between the number of announced transactions and the number of closed transactions widened.

Before the crisis, the number and value of intra-EU transactions were much higher than those involving purchases by EU investors outside of the EU, or involving non-EU investors acquiring EU target companies. This situation has now completely reversed. On the one hand, in terms of number of deals, intra-EU M&A transactions are currently only 7% higher than their 2009 trough, and 64% lower than their peak in 2007. On the other hand, the number of purchases of EU companies by third-country investors is on a decisive upward trend, having increased by 71% since 2009 and currently being almost back to pre-crisis levels. The value of intra-EU transactions also declined 2011, while the number of extra-EU inward transactions has been increasing recently (Figure 9).

[14] M&A transactions imply the purchase or sale of existing equity, in contrast to 'greenfield' investments which are in completely new businesses.

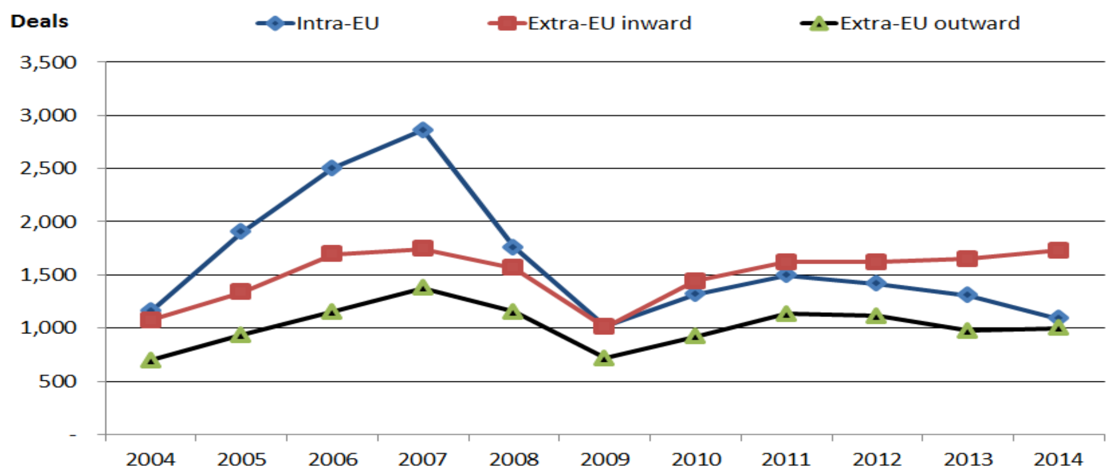
Figure 8: Merger and acquisition activity in the EU, value of transactions



Source: Commission services' calculations based on Standard and Poor's Capital IQ database.

Note: Data for the third and fourth quarter of 2014 is preliminary. The data cover only those deals that involved an acquisition of an equity stake of more than 10%.

Figure 9: Merger and acquisition activity in the EU, number of transactions



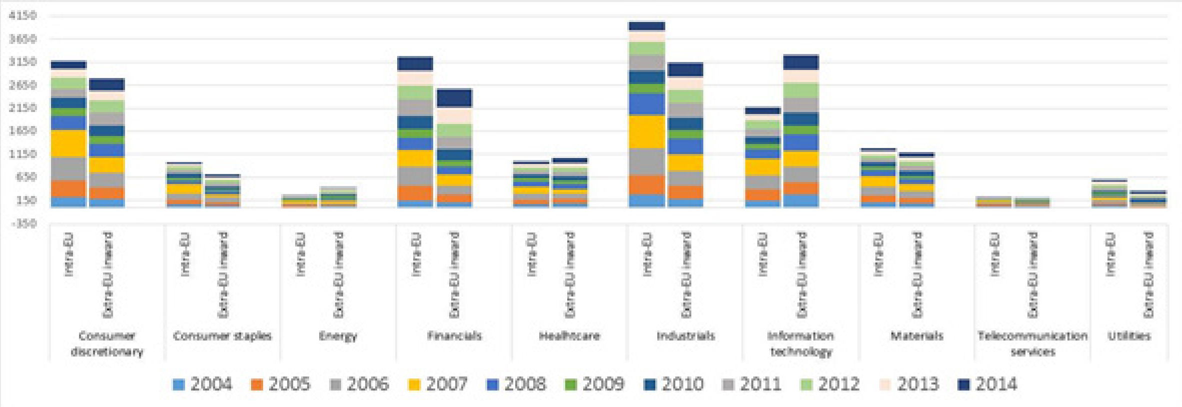
Source: Commission services' calculations based on Standard and Poor's Capital IQ database.

Note: Data for the third and fourth quarter of 2014 is preliminary. The data cover only those deals that involved an acquisition of an equity stake of more than 10%.

Figure 10 presents the number of intra-EU and extra-EU inward cross-border M&A transactions per sector in 2004-14. Cumulatively, for the entire period the number of deals was the highest in the industrial, information technologies and financial sectors. The number of cross-border transactions was markedly lower in the energy, utilities, healthcare and telecommunication services sectors. After 2007, the number of cross-border deals in the tradable sectors (industrial, information technology, materials and consumer discretionary) accelerated, which may be evidence of cross-border corporate restructuring supporting a shift from the non-tradable towards the tradable sectors.

The number of extra-EU inward transactions exceeded that of intra-EU cross-border deals only in the information technology sector (in which deals were mostly led by United States firms). The largest share of extra-EU inward transactions was originating by far in the United States (more than 50% of the deals in 2014), followed by Switzerland (around 15% of the deals).

Figure 10: Merger and acquisition cross-border transactions per sector, number of transactions, 2004- 2014



Source: Commission services' calculations based on Standard and Poor's Capital IQ database.

Note: Data for the third and fourth quarter of 2014 is preliminary. The data cover only those deals that involved an acquisition of an equity stake of more than 10 %.

Extra-EU inward transactions – Buyer outside the EU of company inside the EU. Intra-EU – cross-border buyer within the EU of a company in the EU.

2.4. Net international investment positions

Stocks of foreign assets and liabilities are important as they represent the legacy left behind by capital flows. For example, after a prolonged period of current account deficits, a country is left with a large stock of net external debt liabilities which may pose a deleveraging or rollover challenge. Over the (likely long) period required to deleverage, countries' accumulated positions may decline in value. The net international investment position (NIIP) reflects the accumulated stock of capital flows and changes in the value of the earlier stock as the price of different assets and liabilities changes (see Figure A.3 in Annex).[15]

The EU's NIIP was mostly negative from the pre-crisis period until early 2014, although with some significant differences within the EU[16]:

[15] The international investment position is a measure of the assets that a country owns abroad and the assets that foreigners own in the country in question. In the figures, the negative bars indicate an increase in the claim of non-residents on a country in question, while the positive bars indicate an increase in the claims of the country in question on non-residents.

[16] These findings are based on data compiled according to the 5th edition of the IMF Balance of Payments Manual (BPM5).

- **In the euro area,** the negative position was mainly driven by the high stock of equity and debt held by non-residents. However, according to some estimates, accounting for unrecorded assets would turn the euro area into a net creditor and not a net debtor to the rest of the world as indicated by official statistics.[17] There were also significant differences within the euro area. The NIIP was positive and growing for a group of Member States (Austria, Belgium, Finland, Germany, Luxembourg and the Netherlands). For other euro area Member States (Ireland, Greece, Spain, France, Italy, Cyprus and Portugal), the NIIP became increasingly negative as a percentage of GDP.

- The NIIP of **Denmark, Sweden and the United Kingdom** was also negative during the period under consideration, and turned positive only in 2013 (at 1.5 per cent of GDP in the fourth quarter of 2013). Portfolio investment also represented an important driver of the negative NIIP of the non-EA-3. However, in the case of these Member States, other investment (mainly cross-border bank loans) also played a major role.

- In the **CEE EU Member States**, FDI liabilities are dominant and account for about the same as the sum of net portfolio and other investment liabilities. With Brazil and India, the CEE Member States are the only economies for which the net positions of all investment instruments are negative, suggesting that these regions relied significantly on capital from abroad and therefore are prime examples of ‘downhill’ capital flows.[18]

In a global perspective, Latin America and eight states in the former Commonwealth of Independent States (excluding Russia) also have negative overall NIIPs, but they have positive net portfolio and/or other investment positions. Japan and Switzerland exhibit strong positive NIIPs. Switzerland accumulated sizeable positive reserve assets, stemming from interventions in the foreign exchange rate market by the Swiss National Bank.

The accumulation of a large stock of external assets and liabilities for the euro area and the CEE Member States was the result of a prolonged period of financial account imbalances, and points to the need for structural reforms addressing these divergences and thus reducing the external vulnerabilities of those EU Member States.

Although the scale of the stocks of assets and liabilities in the international balance sheets has not changed significantly in recent years, an adjustment in their composition had been ongoing in the EU and major advanced economies. More specifically, the share of bank-intermediated flows[19] in the stock of external liabilities has been declining and

17 Around 8 % of the global financial wealth of households is held in tax havens; three quarters of this goes unrecorded. *Source:* Zucman, Gabriel (2013), ‘The Missing Wealth of Nations: Are Europe and the US Net Debtors or Net Creditors?’, the Quarterly Journal of Economics, Oxford University Press, vol. 123(3), pages 1321-1364.

18 Capital is said to flow ‘downhill’ from capital-rich countries to capital-poor countries with higher returns on capital.

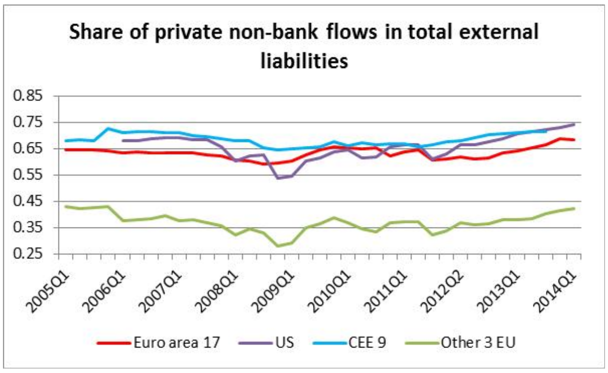
19 Approximated in Panel B of Figure 11 by ‘other investment’.

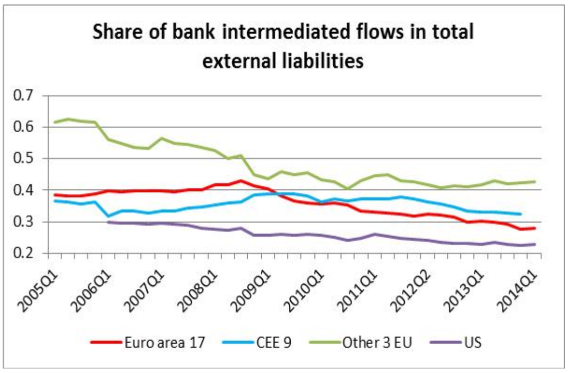
this adjustment has been only partly compensated by a gradual increase in the non-bank-intermediated private flows[20] both as a share of external liabilities (Figure 11).

Figure 11: Adjustment in the composition of the liability side of international balance sheets

A. The share of private non-bank intermediated liabilities has been increasing…

B … partly compensating for the declining .share of cross-border bank intermediated liabilities





Source: Bruegel's and Commission services calculations based on IMF, BoP, BEA data.

Notes: ***Euro area*** *– the 17 euro area Member State (as of 2013);* ***Other 3 EU*** *– Sweden, Denmark, United Kingdom;* ***CEE8*** *- Bulgaria, Czech Republic, Croatia, Latvia, Lithuania, Hungary, Poland and Romania.*

Bank-intermediated flows consist of "other investment"; private non-bank flows consist of the sum of FDI and portfolio liabilities, including equity investment, fund shares and debt securities.

2.5. Implicit demand for foreign capital in the EU

In order to explore the role of domestic and foreign savings in financing domestic investment, Figure 12 compares the implicit demand for foreign capital in the EU, the euro area and CEE8 with that in Japan and the US.[21] The implicit demand for foreign capital position can be derived by subtracting gross national saving from total investment and expressing this investment funding gap as a ratio to total investment.

In 2013 gross national saving exceeded investment by almost 20 percentage points as a ratio to total investment in the euro area, compared to around 7 percentage points in the EU as a whole. The lower figures for the EU reflect the different patterns for demand for foreign capital in the converging economies of the CEE that traditionally have investment needs exceeding their national savings and thus are necessitating foreign borrowing. The demand for foreign capital in the non-euro CEE8 countries is expected to

[20] Approximated in Figure 11 by the sum of FDI liabilities and portfolio liabilities, including equity investment, fund shares and debt securities.

[21] The implicit demand functions as implied by the data can be useful when it may be difficult or not possible to identify the factors that influence the developments, to specify the functional form of the relationship between them or to establish the causality. Sometimes, it may be useful simply to examine the outcome of an economic relationship as implied by the data even without specifying the contributing factors.

start rising again after 2015 and to accelerate towards the end of the forecast period, although it is not projected to reach the pre-crisis levels. CEE8 are expected to become again net importers of foreign capital around 2017, after turning into exporters of domestic savings during the crisis period and more specifically after 2012.

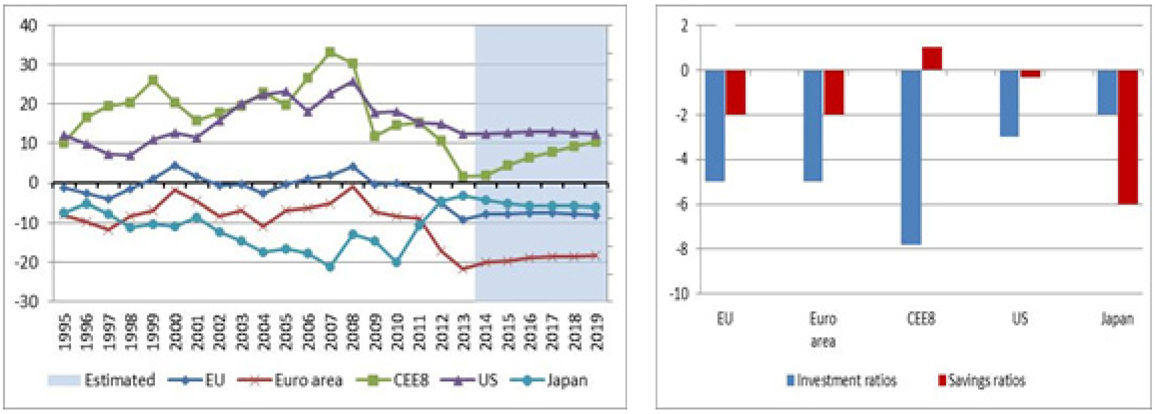
The implicit demand for foreign capital declined after the crisis in the United States as well as in the EU and the euro area. However, the United States remained a net importer of capital, while the EU and the euro area turned into net exporters of capital and domestic savings.

Based on the IMF World Economic Outlook, these patterns are unlikely to change until 2019. Therefore, the EU and the euro area seem to have ample savings that may finance the forecasted investment needs without external borrowing provided that there are no major barriers or disincentives to intra-EU investment and to the efficient allocation of resources across the Single Market.

Figure 12: Implicit demand for foreign capital

A. As a share of total investment

B. Composition of the adjustment in the implicit demand for foreign capital in 2007-2013, pps of GDP



Source: Commission services' calculations based on IMF WEO October 2014.

Panel B of Figure 10 highlights the composition of the adjustment of the demand for foreign capital after the outbreak of the economic crisis in 2007-2013. The post-crisis reduction in the implicit demand for foreign capital, in the EU and in the euro area seems to have been mostly driven by investment as the decline in the investment to GDP ratios in 2013 compared to 2007 has been higher than that of the savings to GDP ratios.[22]

Similarly, the decline in the implicit demand for foreign capital in the United States was as well mostly due to a decline in the investment ratio, albeit the magnitude of its reduction compared to the pre-crisis levels was smaller than in the EU and the euro area and the implicit demand for foreign capital in the US did not turn negative. The savings

22 This analysis cannot disentangle the impact of supply and demand factors on the decline in the investment ratio or the drivers behind it. It only reports on current developments and expected trends based on an unchanged policy scenario used in the IMF WEO forecast.

ratio in the US almost returned to the (relatively low) pre-crisis levels of 2007 and the United States remained a net importer of foreign capital as investment still significantly exceeded domestic savings as a ratio to GDP. In Japan, the demand for foreign capital started to increase in 2010 (though it remained negative), implying a lower export of domestic savings. This mostly reflected a significant decline in the national savings ratio exceeding that of the investment ratios. In CEE8 both the significantly lower investment to GDP ratio and the slight increase in the savings to GDP ratio contributed to the sizeable post-crisis decline in the implicit demand for foreign capital.

3. MONITORING AND ENFORCEMENT OF THE FREE MOVEMENT OF CAPITAL PRINCIPLES

3.1. Legal framework

The free movement of capital is one of the four fundamental freedoms at the heart of the Single Market, and is broad in scope. While the Treaty on the Functioning of the European Union (TFEU) does not explicitly define capital movements, the case law of the Court of Justice of the European Union (CJEU) has consistently upheld a broad notion[23] including: foreign direct investment (FDI), real estate investments or purchases, securities investments (for instance in shares, bonds, bills and unit trusts), granting of loans and credits, and other operations with financial institutions, including personal capital operations such as dowries, legacies, and endowments. This list is open and non-exhaustive. Therefore, the free movement of capital rules, together with other provisions of EU law, apply to all cross-border flows of financial resources including FDI, portfolio investment, and other investments such as cross-border bank loans.

The objective of the freedom of capital movement is to ensure openness to other Member States and third countries. To this end, the EU Treaty prohibits all restrictions on capital movements and payments (Article 63 TFEU). However, this openness is not unconditional, as the Treaty allows restrictions on capital movements under specific conditions.

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 as well as measures taken on grounds of public policy or public security[24] (Article 65(1)((b)); and measures taken for other overriding reasons in the general interest[25] as recognised by the Court of Justice. The exceptions provided in the Treaty must not constitute a means of arbitrary discrimination or a disguised restriction

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

24 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, the derogations must not be misapplied so as, in fact, to serve purely economic ends (*Rutili*, cited above).

25 Examples of overriding reasons in the general interest include: the need to safeguard energy supply (Case C-174/04 Commission v Italy); protection of consumers (Case C-442/02 *Caixa-Bank France v Ministère de l'Economie*, para. 21); 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*).

on the free movement of capital and payments. All measures must be suitable and proportionate.

There is no secondary EU legislation harmonising the general rules on the free movement of capital.[26] Therefore, the free movement of capital policy is mainly enforced by monitoring developments in Member States and applying these principles across the economy. This requires continuous efforts to stay abreast of political and economic developments in the EU and globally.

3.2. The general framework for investment

Concerning national measures of a cross-cutting nature, in 2014 Italy, France and Portugal amended or adopted new legislation to review investment in strategic sectors, such as defence, energy, transport and communication.

Italy completed the implementation of its Law on the State's special powers in companies carrying out strategic activities or owning strategic assets by adopting four implementing decrees[27] which specify the strategic activities in relation to which the Italian state may exercise special powers and which set out the procedure to be followed for the exercise of these powers. The Italian legislation requires notice of company decisions and transactions resulting in a change of ownership or control or affecting the availability of assets. This applies to companies carrying out certain activities in the defence and national security sectors, or owning strategic assets in the energy, transport and communication sectors. It empowers the state to impose conditions or oppose such decisions and transactions in the event of serious threats to certain public security interests. It provides for detailed rules on the relevant thresholds triggering the obligations, on the specific criteria for the exercise of special powers, and on the application to investors inside the EU and European Economic Area (EEA) and extra-EU/EEA investors in the different sectors. Mandatory deadlines apply.

France extended the existing mechanism of prior authorisation for investment in activities that pose risks to public safety, public order or defence interests to cover certain strategic activities in the areas of energy, water, transport, communications and public health.[28] The mechanism applies to investments leading to the acquisition of control or one third of voting rights. It applies to both intra-EU and extra-EU investors, the latter being subject to more stringent rules. The authorisation can be made subject to certain conditions or refused, in case of risks to public order, public security and/or national defence. The procedure provides for mandatory deadlines.

Portugal has adopted a new law[29] introducing a mechanism to review acquisitions which confer control over major infrastructure or strategic assets in the area of energy, transport and communication. It applies to extra-EU/EEA investors only and enables the

[26] However, at EU level there is extensive sectoral legislation on financial services, and secondary legislation on specific aspects of capital movements and payments in financial markets.

[27] Decrees No 35 of 19.02.2014, No 82 of 25.3.2014, No 86 of 25.3.2014 and No 108 of 6.6.2014, implementing Decree-Law No 21/2012 converted into Law No 56/2012.

[28] Decree No 479 of 14.05.2014 amending the 'Code monétaire et financier'.

[29] Decree-Law No 138 of 15.09.2014.

government to oppose an acquisition only in case of a genuine or sufficiently serious threat to national defence and security or the security of supply in services critical to the national interest, e.g. in case of links with terrorist organisations. Mandatory deadlines apply.

In total, 11 Member States have mechanisms in place to review investments to safeguard public security or public policy interests, and/or exercise special powers over companies operating in strategic sectors.[30] Most of these mechanisms apply to both intra-EU/EEA and extra-EU/EEA investors, although some of them distinguish between these categories and treat them differently. A limited number of mechanisms focus on extra-EU/EEA investors only, though some of them may apply to intra-EU/EEA investors to deal with cases of possible circumvention by extra-EU investors.

Measures taken to these aims must fully comply with the free movement of capital rules and with other EU Treaty provisions in order to avoid that they negatively affect the attractiveness of the Single Market as an investment destination.

As to other measures related to the general investment framework, bilateral investment treaties between Member States (intra-EU BITs) have maintained a fragmented framework for the treatment of investment within the Single Market. The Commission considers that such agreements are incompatible with EU law and that they should be terminated as soon as possible. In this respect, it is a welcome development that Italy recently terminated all its BITs with other EU Member States.

The problem of intra-EU BITs has been aggravated by the fact that the number of international arbitration proceedings based on intra-EU BITs has been increasing in recent years[31]. In addition, concerns have emerged with regard to the possibility that certain interpretations by arbitral tribunals may conflict with EU law. The procedures in place allow the Commission to intervene in such cases on matters of EU law, through submissions as amicus curiae, including in regard to the jurisdiction of the arbitral tribunals. In practice, however, the impact of such submissions was limited, given also their non-binding nature.

3.3. Investments in real estate and agricultural land

Cross-border investments in real estate (including both secondary residences and agricultural land) are a special type of capital movement, given their potential socioeconomic impacts. Although it is difficult to get accurate data on investments in land, some information is available through the media, international and non-governmental organisations, as well as academic (and in part field-based) research. This information shows that, for example, since 2004 foreign investors have acquired rights to

[30] Three Member States (Denmark, Spain and Slovenia) limit their regime to measures necessary to protect national security which are connected with the production of or trade in arms, munitions and war material, which are allowed under Article 346(1)(b) TFEU. Eight Member States have some kind of entry control or screening mechanisms that goes beyond the defence sector (Austria, Germany, Finland, France, Lithuania, Italy, Portugal and the United Kingdom).

[31] According to UNCTAD, in 2013 24 arbitration cases (42 per cent of all cases) were brought against EU Member States. In all except one, the claimants are also EU nationals; they started the proceedings on the basis of either intra-EU bilateral investment treaties (BITs) or the Energy Charter Treaty (ECT), sometimes relying on both at the same time. The year's developments brought the overall number of intra-EU investment arbitrations to 88, i.e. approximately 15 per cent of all cases.

use or control in around 68 000 ha in Bulgaria, 8 000 ha in Lithuania and 84 000 ha in Romania, in terms of either rights to use or control.[32] These estimated acquisitions represent 1.3 % of total arable land in Bulgaria, 2.3 % of total arable land in Lithuania, and 0.4 % of total arable land in Romania.

Investments in real estate are covered by free movement of capital principles and therefore subject to continuous monitoring by the Commission.

Some Member States obtained a specific derogation from the rules on free movement of capital in relation to acquisitions of real estate in their treaties of accession to the EU, and thus have been allowed to maintain their own special regimes. All the temporary derogations related to acquisition of secondary residences have now expired.[33] Denmark, the Åland Islands (Finland) and Malta have permanent derogations.

The transitional period for acquisitions of agricultural real estate recently expired in six Member States: in Bulgaria and Romania on 31 December 2013, and in Hungary, Latvia, Lithuania and Slovakia on 30 April 2014. A transitional period is still in force in Poland until 1 May 2016[34] and in Croatia until 1 July 2020, with the possibility for the latter to request a three-year extension.

Before, or in some cases after the expiry of the temporary derogations for acquisitions of agricultural real estate, the six Member States concerned adopted new legislation governing the acquisition of agricultural and forestry land. Commission staff have thoroughly analysed these laws. The new land laws generally pursue policy objectives (including agricultural, land and social policies) which are capable of justifying restrictions to basic Treaty freedoms, primarily to the free movement of capital. Nevertheless, a number of the restrictions raise concerns of compliance with EU law, in particular with regard to the principle of proportionality. The Commission is ready to ensure that these concerns are resolved, if necessary by launching infringement procedures.

On 16 October 2014, through a letter of formal notice the Commission requested Hungary to submit its observations on its legislation terminating certain contractual rights of investors to use agricultural land. In the Commission’s view, Hungarian legislation has restricted the rights of cross-border investors in a way that may violate EU law on free movement of capital and freedom of establishment.

3.4. Direct taxation and free movement of capital

Although direct taxation falls within the main responsibility of the Member States, they must exercise that responsibility in compliance with EU law, including the free

[32] Commission services’ calculations based on Land Matrix (www.landmatrix.com). This Land Matrix records transactions that entail a transfer of rights to use, control or own land through sale, lease or concession; that cover 200ha or larger; and that have been concluded since the year 2000.

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

[34] Hungary, Latvia, Lithuania and Slovakia were granted a three-year extension of their transitional period in accordance with the Accession Treaty, while Poland originally had a 12-year period for transition. The Czech Republic and Estonia did not request the extension of the transitional period, which therefore terminated on 1 May 2011.

movement of capital. To this effect, as mentioned above, the free movement of capital rules allow capital movements to be restricted for the purposes of preventing infringements of national law and regulations in the field of taxation. However, such measures must not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.

As in other fields, informal and formal problem-solving procedures play an important role in the enforcement of free movement of capital rules. However, other policy initiatives also contribute to more integrated capital markets within the EU. For example, the Capital Markets Union will play a crucial role in this area.

The Action Plan to strengthen the fight against tax fraud and tax evasion,[35] which continued to be at the heart of the Commission's initiatives on direct taxation for 2014, also plays an important role. Following the Recommendations on Aggressive Tax Planning (ATP)[36] and Tax Havens,[37] the Platform for Tax Good Governance was established to assist with the best practical application and implementation of the Commission Recommendations and to assist the Commission in identifying further priorities in these areas.

The willingness to strengthen the current rules on exchange of information between tax authorities was confirmed by the EU Council in March 2014 through its adoption of the 2008 Commission proposal to revise the EU Savings Directive (EUSD). The Commission and the Council were also actively involved in the preparation by the Organisation for Economic Cooperation and Development (OECD) of the Global Standard for Automatic Exchange of Financial Account Information in Tax Matters, which was adopted by the OECD Council on 15 July 2014. On 9 December, the EU Council adopted the June 2013 Commission proposal to revise the Directive on Administrative Cooperation in order to implement this Standard within the EU from January 2016. Negotiations with five third countries on amending their existing agreements with the EU in line with international developments are now based on full implementation of the OECD Standard.

In connection with aggressive tax planning by multinationals, in June 2014 the Commission opened three in-depth investigations to examine whether decisions by tax authorities in Ireland, The Netherlands and Luxembourg on the corporate income tax to be paid by Apple, Starbucks and Fiat Finance and Trade, respectively, comply with EU rules on state aid. On 7 October 2014 and 3 February 2015 respectively, the Commission opened further investigations regarding Amazon in Luxembourg and into the Belgian scheme of "excess profit" tax rulings. In December 2014, the Commission announced that it would enlarge the enquiry into the tax ruling practice under EU state aid rules to cover all Member States.

3.5. Infringement proceedings

Formal infringement proceedings are important to enforce the integrity of the Single Market for capital, but they are used as a last resort, and therefore only in a minority of

[35] *Action Plan to strengthen the fight against tax fraud and tax evasion* COM(2012) 722 final, 6.12.2012.

[36] Commission recommendation C(2012) 8806 final, 6.12.2012.

[37] Commission recommendation C(2012) 8805 final, 6.12.2012.

detected cases. Many barriers to capital movements are solved through dialogue with Member States, either through informal problem solving procedures, or through bilateral or multilateral contacts.

During the reporting period, the Commission closed two infringement cases based on CJEU rulings. The Volkswagen case was closed following the CJEU's dismissal of an action brought by the Commission seeking financial penalties for non-compliance with an earlier judgment.[38] The second case was closed following Poland's satisfactory compliance with a CJEU judgment.[39] In the same period, the Commission opened two new infringement cases, one related to usufruct rights, and the other to special rights in an energy company.[40]

In the area of direct taxation related to the free movement of capital, the Commission initiated eight infringement procedures in 2013 and ten new infringement proceedings in 2014 on the basis of Article 63 TFUE and Article 40 of the EEA Agreement.

In 2014, the Commission brought action to the CJEU against two Member States regarding the taxation of certain interests paid to foreign companies and the exemption from duty payable on donations and legacies to certain public or charitable bodies.

Since June 2013, the CJEU has ruled in five tax cases concerning the restrictions on the free movement of capital based on the infringement proceedings against the Member States. The CJEU considered that the application of a tax exemption reserved only to interest payments for savings deposits in resident banks, as well as a tax reduction for savings pension contributions paid to resident institutions and funds, is contrary to EU law. The CJEU also stated that Article 63 TFUE and Article 40 of the EEA Agreement prohibit a different tax treatment between domestic and cross-border situations in the field of inheritance and concerning the attribution of gains to participators in companies.

4. INTEGRATED AND STABLE CAPITAL FLOWS

4.1. Capital controls in Cyprus

Capital controls are one of the most serious forms of exceptions to the free movement of capital principle, but they are sometimes needed to prevent disorderly outflows from causing a financial and economic meltdown. In its 2012 institutional view on the liberalisation and management of capital flows, the IMF also recognised that capital flow management measures (including capital controls) can be useful to manage the macroeconomic and financial stability risks associated with inflow surges or disruptive outflows. The administrative restrictions in force in Cyprus are a recent example of necessary restrictions on the free movement of capital within the EU.

[38] Judgment of 22 October 2013 in case C-95/12, *Commission v Germany* (VW).

[39] Judgment of 21 December 2011 in case C-271/09, *Commission v Poland* (pension funds).

[40] 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).

In March 2013, a serious banking crisis in Cyprus created an imminent risk that mass capital flight from Cyprus would lead to the collapse of the banking system. This exceptional situation led national authorities to adopt emergency measures in the form of administrative capital controls, which limited both the outflow of deposits from the country and the flow of capital between banks in Cyprus.

The aim was to ensure that deleveraging would take place in an orderly way and at a predictable pace, while safeguarding the weaker banks from collapse and causing the least possible damage to the real economy. In particular, there was a high risk that the 'bail-in' of uninsured depositors in the two largest banks in Cyprus (Bank of Cyprus and Laiki Bank) could lead to a massive flight of deposits. The Commission took the view that the imposition of capital controls, which is one of the most serious forms of exceptions to the free movement of capital principle, was justified and complied with the conditions set in EU law.

Assessing the justification for and proportionality of the measures has ever since been a continuous process, mainly contingent on changes in bank liquidity and deposits. The main objective is to ensure that the measures do not last longer than necessary and are gradually relaxed while restoring financial stability. The Monitoring Board set up for this purpose has continued to work on the basis of the roadmap (adopted by the Cypriot authorities in August 2013) setting out a milestone-based strategy to remove domestic restrictions and capital controls gradually.

To date, Cyprus has adopted 33 general decrees on the capital controls and 26 decrees specific to foreign banks (including both other EU Member States' and third countries' banks). The 30th decree represented an important landmark by removing all domestic administrative restrictions.

4.2. Capital controls in Iceland

Iceland is another example of an EEA country which has been imposing capital and foreign exchange controls since 2008. These restrictions were introduced as a reaction to a severe banking crisis and acute pressure on the country's balance of payments.

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

Commission staff has been working with the Icelandic authorities and with the European Free Trade Area (EFTA) Surveillance Authority to explore the best way forward in order to remove restrictions to the free movement of capital in the EEA, while safeguarding the financial and economic stability of Iceland.

According to a September 2014 progress report by the Icelandic Minister of Finance and Economic Affairs to Parliament, conditions have become more favourable for taking the next steps towards the removal of capital controls.

4.3. Cross-border banking services

The free movement of capital principle also underpins EU banking legislation, which must be applied in compliance with the rules on freedom of capital and freedom of establishment. This means that limits which national authorities are allowed to impose on banks' activities in order to address financial stability concerns under EU banking legislation[41] must be justifiable on grounds of overriding public interest, must be non-discriminatory and proportionate, and must meet strict requirements for consultation and cooperation with national banking supervisors in other Member States.

Commission staff has been monitoring the prudential measures taken by national bank supervisors with regard to the banking subsidiaries of cross-border EU banking groups, because such measures could have the effect of 'ring-fencing' assets, thus restricting cross-border transfers of bank capital and leading to financial fragmentation in the Single Market. Ring-fencing may prevent Member States from reaping the full benefits of the Single Market, distort optimal capital allocation, make the transmission of a single monetary policy more difficult and trigger adverse spillover effects across borders, all of which could delay economic recovery.

Commission staff have therefore carried out a survey on supervisory practices restricting cross-border transfers of capital of banks and analysed the replies received from national supervisors. The survey confirmed that some banking supervisors introduced measures with 'ring-fencing' effects between 2008 and 2013, mostly in response to the economic and financial crisis, in order to keep bank assets within national borders or to pre-emptively strengthen the liquidity position of local banks. The main areas concerned were institution-specific quantitative requirements under the supervisory review and evaluation process, the large exposures regime and domestic liquidity frameworks.

The measures reported include both individual measures addressed to a particular institution, such as those limiting intragroup exposure, and general measures affecting the whole banking system, such as laws allowing supervisors to prohibit intragroup flows of liquidity or capital or the distribution of profits to the parent company. The survey showed that in certain cases supervisors decided to take action unilaterally, without consulting the other supervisors concerned, even in areas where EU banking legislation so requires. In particular, supervisors seem to consider that 'soft law' tools, such as recommendations or requests to enter into voluntary commitment, do not trigger cooperation obligations. In addition, some of the measures reported raised questions about their appropriateness and proportionality in relation to the prudential concerns they were designed to address. Ring-fencing along national borders has thus increased market fragmentation, which exacerbated the adverse feedback loops between weak banks, sovereigns and the economy in distressed euro area countries and has entrenched significant differences in the financial and economic conditions of countries within the euro area.

Commission staff have informed all national supervisors of the outcome of the survey and invited them to take appropriate action to prevent the risk of unduly restrictive supervisory practices. In particular, national supervisors have been invited to ensure timely exchange of information and consultation of other supervisors concerned on all measures with ring-fencing effects that may affect other countries' banking markets, including soft law measures such as recommendations or request to enter into voluntary commitments. The Commission has also encouraged national supervisors to cooperate closely with fellow supervisors and with the European Banking Authority (EBA) — which was set up in 2011 precisely as a remedy for uncoordinated supervision in Europe

[41] Regulation (EU) No 575/2013 and Directive 2013/36/EU.

— with a view to preventing disproportionate ring-fencing measures which would be contrary to EU law, in particular because they would unduly restrict the free movement of capital, and to settle disagreements at an early stage, in particular by using the EBA's mediation tools. In addition, the Commission stressed the importance of cooperation and the need to avoid unjustified obstacles to the free movement of funds between credit institutions in its 5 July 2014 report on the functioning of single liquidity subgroups.[42]

The ring-fencing measures identified in the survey were taken in a context where competence for banking supervision was mostly at national level. The development of the Banking Union, based on a 'single rulebook', and consistent and convergent implementation of the Bank Recovery and Resolution Directive will significantly change the supervisory framework. This is expected to address most of the concerns that guided national supervisors' action in the past, thus reducing the risk of ring-fencing within the Single Market. However, that risk may not disappear completely, especially in areas where national supervisors will continue to have discretionary powers, such as in the use of macro-prudential tools.

The Commission will continue to monitor closely both the state of integration of the European banking market and compliance with the free movement of capital principle, and will assess the need for further action to prevent fragmentation of the Single Market in cooperation with the EBA.

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

Lending in foreign currencies to unhedged households and companies reached excessive levels prior to the outbreak of the crisis in several Central and Eastern European Member States. It is acknowledged that such lending activities may produce significant systemic risks for the Member States concerned and may create conditions for negative cross-border spillover effects.[43] In order to address those risks, Member States introduced a combination of different policy measures on the basis of prudential, consumer protection and monetary policy considerations. The Commission has closely monitored these developments, including measures taken in relation to outstanding loans and how they respect the free movement of capital principle.

In addition, a new Directive on credit agreements for consumers relating to residential immovable property[44] was adopted in February 2014. This Directive aims at fostering responsible lending practices and protecting consumers better across Europe, as well as establishing a single European mortgage credit market in the long run. The Directive also strives to increase the protection of consumers as far as foreign currency mortgage loans are concerned. The legislation has to be transposed by the Member States by 21 March 2016 and is only applicable to credit arrangements concluded after that date. Following the entry into force of the Directive, the Commission will continue to monitor

[42] Report from the Commission to the European Parliament and the Council, Legal Obstacles to the Free Movement of Funds between Institutions within a Single Liquidity Sub-Group, COM(2014) 327.

[43] As noted in the European Systemic Risk Board's Recommendation of 21 September 2011 on lending in foreign currencies (ESRB/2011/1).

[44] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010.

compliance with the free movement of capital principle in areas that are not covered by harmonised rules at EU level.

4.5. Reinforced rules to fight against money laundering within the Single Market

The Commission has continued its efforts with respect to the fight against money laundering and terrorist financing. The risks to the reputation of the EU's financial sector are considerable without a sufficiently robust protective framework. In particular, the misuse of the financial system to launder criminal funds or to channel "clean" money for the purpose of supporting terrorist activities can have significant negative economic impacts, disrupting international capital flows and leading to reduced investment and lower economic growth.

While the integrated European financial area allows the free movement of capital and the freedom to supply financial services, the prevention of and the fight against money laundering and terrorist financing are recognised as being overriding reasons in the public interest which justify derogations from the fundamental freedoms.

Two proposals to reinforce the EU's existing rules on anti-money laundering and fund transfers have been recently agreed upon the European Parliament and the Council, following the political agreement that was reached in December 2014.[45] They update and improve the existing EU Third Anti Money Laundering Directive and the Funds Transfers Regulation. Both proposals fully take into account the latest Recommendations of the Financial Action Task Force (FATF), the international anti-money laundering standard setter, and go further in a number of fields to promote the highest standards for anti-money laundering and counter terrorism financing. Both proposals aim to provide for a more targeted and focussed risk-based approach.

In particular, the Directive clarifies and reinforces the rules on customer due diligence and introduces new provisions to deal with politically exposed persons. It goes beyond the FATF requirements by introducing a requirement for Member States to put in place central registers of beneficial ownership for companies and trusts, and bringing within its scope all persons dealing in goods for cash payment of 10,000 EUR or more, as there have been indications from certain stakeholders that the current 15,000 EUR threshold leaves open a vulnerability that criminals have been able to exploit. The Directive also ensures a more comprehensive coverage of the gambling sector (in the light of concerns that money laundering risks extend beyond casinos) and includes an explicit reference to tax crimes. The proposals foresee a reinforcement of the sanctioning powers of the competent authorities by introducing a set of minimum principle-based rules to strengthen administrative sanctions and a requirement for them to coordinate actions when dealing with cross-border cases.

Furthermore, in support of the ongoing efforts for the development of information exchange between financial intelligence units, significant progress has been made over the course of 2013 to develop the Commission-funded real time information exchange system (FIU.net). A pilot project to facilitate the sharing of suspicious transaction reports is currently underway.

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45 Proposal for a directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (COM(2013) 45 final) and proposal for a regulation on information accompanying transfers of funds (COM(2013) 44 final).

4.6. New EU regulatory framework to fight against market abuse

In order to further increase investor confidence and market integrity, a new EU framework was introduced which establishes tougher rules to better prevent, detect and punish market abuse.

Market abuse occurs when investors have been unreasonably disadvantaged by others who have used inside information to trade in financial instruments to their advantage (insider dealing) or have distorted the price-setting mechanism of financial instruments or disseminated false or misleading information (market manipulation). The previous regulatory framework provided by the Market Abuse Directive 2003/6/EC, has been outpaced by the growth of new trading platforms, OTC trading and new technology such as high frequency trading (HFT).

The new Regulation EU 596/2014 on market abuse (Market Abuse Regulation) keeps pace with market developments and strengthens the fight against market abuse across commodity and related derivative markets. It covers abuse on the electronic trading platforms that have proliferated in recent years as well as manipulation of benchmarks. It reinforces the investigative and sanctioning powers of regulators, in particular by strengthening and harmonising the minimum investigatory powers of regulators as well as by providing for mechanisms for the reporting of actual or potential breaches of the provisions of this Regulation to regulators (whistleblowing) and by introducing tougher and more harmonised sanctions.

The new Market Abuse Directive 2014/57/EU (Directive on criminal sanctions for market abuse) further reinforces the deterrent effect of national sanctioning regimes by introducing minimum rules on criminal offences and on criminal sanctions, which will better ensure the effectiveness of the EU policy on market integrity.

4.7. Reinforced rules on the protection of notes and coins against counterfeiting

Counterfeiting of the euro and other currencies remains a concern throughout the European Union. Protection against counterfeiting is of fundamental importance to ensure trust and confidence in the authenticity of notes and coins for citizens, companies and financial institutions. Counterfeits harm citizens and businesses that are not reimbursed for counterfeits even if received in good faith. It also decreases the acceptability of notes and coins and thus the flow of cash capital.

The new Directive on the protection of the euro and other currencies against counterfeiting[46] increases the protection through criminal law measures. An adequate and efficient level of protection will be achieved across the European Union. The new Directive completes the other instruments specifically designed to protect the euro, such as the legal framework on authentication of euro notes and coins and the EU programme for awareness raising and training Pericles 2020, and the Geneva Convention for the suppression of counterfeiting currency.

[46] Directive 2014/62/EU of the European Parliament and of the Council of 15 May 2014 on the protection of the euro and other currencies against counterfeiting by criminal law, and replacing Council Framework Decision 2000/383 /JHA, OJ L151 of 21 May 2014, p.1

The new Directive provides added value compared to the current framework as follows: it raises the level of penalties; it obliges Member States to ensure that effective investigative tools are available to facilitate cross-border investigations; it increases the possibility of detecting counterfeit notes and coins in circulation by a timely technical analysis and detection during judicial proceedings; and it will allow collecting data on the number of counterfeiting offences, of the persons prosecuted and those convicted on a European level. These measures will contribute to deterring crimes across the Union and improve cooperation between judicial authorities and thus to help catch criminals.

5. NEW RULES ON PAYMENT SERVICES FOR A BETTER INTEGRATED EU RETAIL PAYMENT MARKET

The free movement of capital principle also encompasses the liberalisation of payments. In the area of payments, significant progress has been achieved through harmonisation at EU level.

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

The integration of the SEPA is progressing. According to European Central Bank (ECB) statistics on SEPA migration, in January 2014 SEPA credit transfers represented 83.13 % of all credit transfers in euro in the euro area and SEPA direct debits 60.23 % of all direct debits.

However, the pace of migration raised concerns as to whether payment service users, in particular ‘big billers’ and small and medium-sized enterprises (SMEs), would be ready to operate fully in a SEPA environment as of 1 February 2014, which was the deadline for euro area migration to SEPA credit transfers (SCT) and SEPA direct debits (SDD). While communication at national level was increased to make sure that payment service providers and users could migrate smoothly and on time, in early 2014 the Commission also proposed to amend the SEPA Regulation, introducing a six-month transition period — to 1 August 2014 — to ensure minimal disruption for consumers and businesses as migration rates were not satisfying. During this period, banks and payment institutions were still able to process payments that differed from the SEPA standard. Migration to SEPA was completed in August 2014 and the latest figures of migration at that time indicated a level of migration close to 100% for both SCT and SDD

Some euro area Member States opted to make use of the options under the SEPA Regulation allowing for exceptions until February 2016. Non-euro Member States have to migrate to SCT and SDD for euro payments by October 2016. These are the first ‘next steps’ to complete SEPA for credit transfers and direct debits.

5.2. New legislative package for an EU-wide market for electronic payments

The 24 July 2013 package consists of a proposal for a revised Payment Services Directive (PSD2) and for a Regulation on interchange fees for card-based payment transactions. Legislative negotiations have advanced. The package aims to help expand the EU-wide market for electronic payments. It will enable consumers, retailers and other market players to enjoy the full benefits of the Single Market. The proposed changes to interchange fees will remove an important barrier between national payment markets and finally put an end to the unjustifiably high level of these fees.

Today the Single Market for cards, internet and mobile payments remains fragmented and faces major challenges that hinder further development and the EU’s growth potential.[47] Furthermore, while card payments are becoming more and more widespread, the still prevailing 'interchange fees'[48] business model promotes high inter-bank fees and affects the cost to retailers and ultimately the price paid by consumers. It also prevents the emergence of new players.

The revised Payment Services Directive would facilitate the use of low-cost internet payment services (such as online credit transfers) and render them more secure, by including payment initiation services within its scope. These are services that operate between the merchant and the purchaser's bank, allowing cheap and efficient electronic payment without the use of a credit card. In addition, consumers would be better protected against fraud, possible abuses and payment incidents (e.g. in the event of disputed or incorrectly executed payment transactions). Consumers would have to face only very limited losses — up to a maximum of EUR 50 (as opposed to the current EUR 150) — in cases of unauthorised card payments. The proposal would also expand the rights of consumers sending transfers and remittances outside Europe or paying in non-EU currencies. The revised Directive would also promote the emergence of new players and the development of innovative mobile and internet payments in Europe for the sake of EU competitiveness worldwide.

The European Parliament adopted the text in April 2014 and the Council reached a general approach in December. The trilogue negotiations on PSD2 were due to start in February 2015.

The proposed regulation on interchange fees, combined with the revised Directive, would introduce maximum levels of interchange fees for transactions based on consumer debit and credit cards, and ban surcharges on these types of cards.[49] Capping the interchange fees would reduce costs for retailers and consumers and surcharging would no longer be permitted for those cards subject to capping.

The proposed Regulation has been agreed in a trilogue held on 17 December 2014. The proposed caps are set at 0.2 % of the value of the transaction for debit cards and 0.3 % for credit cards and will enter into force 6 month after publication. These levels have already been accepted by competition authorities for a number of transactions with cards branded MasterCard, Visa and Cartes Bancaires. The text includes many measures to foster competition on the cards market, such as a ban on obligations imposed on retailers to accept all cards of the same brand ("honour all cards rules") and a rule that payment licences should cover the whole EU territory.

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[47] Such as the divergent cost of payments for consumers and merchants, differences in technical infrastructure and payment providers' inability to agree on introducing common technical standards.

[48] Fees paid by banks to each other for each card payment.

[49] Surcharges are the extra charge imposed by some merchants for payment by card, notably for purchases of airline tickets.

6. MAIN DEVELOPMENTS IN THE INTERNATIONAL SPHERE

6.1. Investment protection agreements with non-EU countries

6.1.1. Free trade agreements and stand-alone investment agreements

The EU's common international investment policy aims not only to protect EU investors' rights in non-EU countries, but also to grant investors from outside the EU a set of substantive and procedural rights when investing in the Single Market. Therefore, it has a direct bearing on the investments between the EU and non-EU countries.

The EU started to devise a common international investment policy after the Treaty of Lisbon gave the EU exclusive competence in this field under the common commercial policy (Article 207 TFEU).

The Commission seeks to include a chapter on investment protection in free trade agreements or stand-alone investment agreements (e.g. China), encompassing a number of standards on issues such as non-discrimination, free transfers, fair and equitable treatment, and expropriation. The agreements usually also allow an investor to bring a claim before an arbitral tribunal against a state if the state is alleged to have acted inconsistently with the investment protection agreement. This is known as investor-state dispute settlement (ISDS). The state in question may have to pay financial compensation if the arbitral tribunal rules against it. To this end, a Regulation on financial responsibility linked to investor-state dispute settlement tribunals[50] was adopted on 23 July 2014. The Regulation allocates financial responsibility arising from investor-state dispute settlement between the EU and the Member States on the basis of who is responsible for the treatment that is claimed to breach the agreement. It also sets out rules for deciding who would defend a particular case.

Negotiations on investment protection in a free trade agreement were concluded with Canada in September 2014 and with Singapore on October 2014. A seventh round of negotiations on a free trade agreement between the EU and Japan was held in December 2014. A seventh round of EU and US talks on a transatlantic trade and investment partnership (TTIP) was held in October 2014, but did not discuss investment protection or ISDS.

In response to the growing public debate and increased concerns about ISDS within the TTIP, the Commission launched a public consultation on the issue. The aim was to better define the EU's approach to investor protection and ISDS in the proposed TTIP negotiation by allowing all stakeholders an opportunity to comment. The consultation ran from March 2014 to July 2014 and generated very substantial interest. The Commission received a total of 149 399 online contributions. The final report on the consultation was published on 13 January 2015[51] and identified a number of areas that appeared to be particularly important to respondents such as the protection of the right to regulate, the establishment and functioning of arbitral tribunals, the relationship between domestic judicial systems and ISDS and the review of ISDS decisions for legal correctness through

[50] Regulation No 912/2014 establishing a framework for managing financial responsibility linked to investor-to-state dispute settlement tribunals established by international agreements to which the European Union is party.

[51] http://trade.ec.europa.eu/doclib/press/index.cfm?id=1234

an appellate mechanism. In the course of 2015, the Commission will further explore these areas.

Negotiations on a stand-alone investment agreement with China covering both market access and investment protection started in October 2013 and the third round took place in June 2014. The ninth round of negotiations with Vietnam took place in September 2014. Investment protection is also part of free trade area (FTA) negotiations with Malaysia, Thailand and India, but these are currently on hold. Negotiations on a deep and comprehensive free trade area (DCFTA) between the EU and Morocco were launched on 1 March 2013 and the most recent round took place in April 2014. The Commission has received authorisation from the Council to start a similar process with Egypt, Jordan and Tunisia, but these negotiations have not yet started.

6.1.2. Member States' bilateral investment treaties with non-EU countries

The European comprehensive investment policy will be introduced progressively through investment protection negotiations which gradually replace the Member States' relevant bilateral investment agreements with the non-EU countries in question. For those non-EU countries for which no immediate EU-wide investment negotiations are scheduled, a Regulation[52] on transitional arrangements establishes a mechanism for empowering Member States — under certain conditions — to negotiate BITs. It therefore provides legal certainty for existing and future bilateral investment agreements which Member States aim to negotiate or amend.

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

The Regulation required Member States to notify the Commission of BITs that were signed before the Lisbon Treaty by 8 February 2013. This resulted in the notification of 1 400 pre-Lisbon BITs.[53]

6.2. International organisations and fora

6.2.1. Free movement of capital in the OECD

The OECD has continued to coordinate policies helping governments to resist protectionist pressures while developing effective policies to respond to genuine concerns raised by international capital flows and investment. The Commission has actively contributed to this work and in particular, has supported the enforcement of the

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52 Regulation (EU) No 1219/2012 of the European Parliament and of the Council of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries.

53 List of the bilateral investment agreements referred to in Article 4(1) of Regulation (EU) No 1219/2012 of the European Parliament and of the Council establishing transitional arrangements for bilateral investment agreements between Member States and third countries, OJ C 131, 8.5.2013.

OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations through a dedicated Advisory Task Force.

Measures to deal with risks generated by capital flows are receiving increasingly greater attention in the aftermath of the global financial crisis. Measures taken to mitigate risks, including financial system stability issues associated with volatility in capital flows, should strike the right balance between the objectives of safeguarding financial stability through greater flexibility to regulate, on the one hand, and of maintaining the openness and integration of the global financial system, on the other.

The OECD has also engaged in the revision of the 2005 Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) in the light of OECD countries' experience with implementing them. The Guidelines offer a standard benchmark to help governments evaluate and improve the governance of SOEs. They provide concrete advice on how to ensure the efficiency and professionalism of SOEs, improve the transparency and accountability of the state as an owner, and maintain a level playing field when state-owned and private companies compete in the commercial marketplace. The revised Guidelines are expected to be adopted in the first half of 2015.

6.2.2. The Financial Action Task Force

On anti-money laundering and preventing terrorist financing, the Commission actively participates in the work of the Financial Action Task Force (FATF): the FATF has begun its fourth round of peer reviews and discussed the first two reports on Norway and Spain at its last plenary meeting. In October 2014, the FATF issued an updated public statement listing those jurisdictions with high money laundering/terrorist financing risks and expressed concern with the financing generated by and provided to the terrorist group the Islamic State of Iraq and the Levant (ISIL).

6.2.3. International Forum of Sovereign Wealth Funds

According to the United Nations Conference on Trade and Development (UNCTAD), between 15 and 25 per cent of listed companies in the EU have sovereign wealth fund (SWF) shareholders. With regard to FDI, at the end of 2013, about 43 per cent of the cumulative SWF investment was in the EU. However, FDI by SWFs, at USD 40 billion worldwide in 2013, remains a very small fraction of their portfolios.

The Commission participated as an observer in the sixth annual meeting of the International Forum of Sovereign Wealth Funds (IFSWF) which was held in Doha, Qatar, on 19-20 November 2014. The event was hosted by the Qatar Investment Authority and brought together about 200 participants, including sovereign wealth funds from 27 countries, international organisations, representatives of countries in which SWFs invest, academia and the private sector.

The focus of the meeting was the domestic and international role of SWFs. The IFSWF members adopted a three-year strategic plan focused on promoting the use of the Santiago Principles to support the free flow of long-term, global capital.

6.3. Economic and financial restrictive measures

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. In particular, Article 75 TFEU provides for the possibility of economic and financial administrative measures against individuals, groups or non-state entities to prevent and combat terrorism. Pursuant to Article 215 TFEU, economic and financial restrictive measures may be taken against non-EU countries, or individuals, groups or non-state entities, based on decisions adopted within the framework of the common foreign and security policy.

During the reporting period, a number of existing sanctions regimes were modified or extended. The most notable example is the new restrictive measures concerning Russia, introduced in August 2014 in the context of the Ukrainian crisis, expanded on 12 September 2014 and amended in December 2014. These measures include prohibitions targeting Russian interests in the financial, oil and defence sectors.

The financial services restrictive measures 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. They prohibit EU persons from dealing in any way with transferable securities or money market instruments issued by the targeted entities with a maturity exceeding 30 days and from providing new loans or credits to them with a maturity exceeding 30 days, except where these are to finance non-prohibited trade between the EU and Russia. These measures aim to cut strategic state-owned Russian companies off from EU and international financing sources, thus imposing an indirect financial cost to the state and limiting their ability to grow in the future.

In addition, the Regulation prohibits EU persons from exporting sensitive technologies or providing relating services to Russian entities for the development of oil projects in the Arctic, prohibits exports of dual-use goods to military end-users, and imposes an arms embargo.

Another restrictive measures regime was adopted in response to the illegal annexation of Crimea and Sevastopol. Among other prohibitions, initial sectoral investment restrictions adopted in June 2014 were followed by a more complete foreign investment ban in December 2014.

The restrictive measures have an initial application period of one year but may be reviewed, extended or rolled back at any time depending on developments on the ground.

7. CONCLUSION

The main trends identified in this Commission staff working document – enduring volatility of world capital flows, uneven recovery of global financial resources flows with a shift away from the EU towards emerging markets, decrease in EU cross-border bank flows only partly compensated by direct investment and portfolio investment – all call for an effective free movement of capital, underpinning a well-functioning Single Market.

To this aim, in 2013-2014 the emphasis was put on monitoring and enforcing free movement of capital rules, at EU level and in the Member states, with specific focus on cross-border banking services, direct taxation and real estate and agricultural land.

Necessary exceptions to the free movement of capital principle, such as temporary capital controls in Cyprus following the serious banking crisis of March 2013 were closely assessed and monitored with a view to safeguarding important policy objectives such as financial stability while making sure that restrictions are gradually removed in the benefit of cross-border investment.

Finally, several pieces of legislation were adopted to improve the regulatory framework supporting free movement of capital – in particular through the promotion of responsible lending practices and reinforced rules to fight against money laundering, market abuse and the counterfeiting of notes and coins – and the freedom of payments – with the progress made in the Single Euro Payments Area (SEPA) and the legislative package for an EU-wide market for electronic payments.

While FDI from non-EU countries into the EU have increased marginally in 2013, the new regulatory framework, combined to efficient enforcement of free movement of capital rules and ongoing investment protection negotiations with non-EU countries, aim at making Europe more attractive to foreign investors.

Sustainable and resilient cross-border direct investment will be a crucial source of long-term financing for the European economy, and even more so since many companies today have financial constraints and experience difficulties in accessing financing via conventional channels. In this context, improving the investment environment in the Single Market will be crucial, as highlighted in the Investment Plan for Europe.

ANNEX I

Determinants of bilateral financial linkages and the role of the euro and the EU Single Market[54]

This section explores whether there was a role for the euro and the euro-system facilities in explaining cross-border financial flows, asset holdings and their composition over and above the main traditionally analysed determinants of cross-border capital flows, such as trade linkages, growth prospects, geographical and cultural factors like common language and traditions.

It is well documented that financial integration in the EU and in the euro area has proceeded mostly from (bank-intermediated) debt flows. One of the reasons may be that foreign exchange risk (and its reduction) is a less important consideration for FDI and portfolio equity flows inside the euro area. However, this may have implications for the scope of risk sharing during economic downturns as debt instruments with fixed repayment schedules are less linked to the current economic performance (Lane, 2013).[55] At the same time, it has become evident that not only the euro but also the availability of euro-system facilities such as the TARGET2 system were very important in sustaining cross-border capital flows during the crisis[56] or in shaping their composition.

While the impact of the euro on financial integration using aggregate data has been documented, bilateral databases have not yet been used so far to address this question. Therefore, in this study the empirical model is tested based on the Hobza and Zeugner[57] update to 2012 of the Waysand, Ross and de Guzman[58] database on bilateral cross-border capital flows and asset holdings.

The results suggest that the euro and the euro system facilities have had a positive impact on bilateral asset holdings and flows even after taking into account factors like trade openness, distance and the general government debt-to-GDP ratio of the partner countries, as well as the size of the public and private bond markets, the global economic cycle[59] and country specific factors[60] or EU membership (see Table 1). These results (which are based on data up to 2012) apply on average across Member States.

The coefficients of the euro area and the EU dummy variables are positive and statistically significant — except for real debt holdings in the EU, after taking into

[54] This section is based on Chapter 6 of Bruegel's study '*Analysis of developments in EU capital flows in the global context*', 2014.

[55] Lane, 'Capital Flows in the euro Area', Economic Papers 497, April 2013.

[56] EC, Quarterly Report on the euro Area, Issue I 2012, 'Capital Flows into Vulnerable Countries: Official and Private Funding trends'.

[57] Hobza, A. and Zeugner, St., 'The 'Imbalanced Balance' and its Unravelling: Current Accounts and Bilateral Financial Flows in the euro Area', European Economy, Economic Papers, July 2014.

[58] Waysand, C., K. Ross, J. de Guzman, 'European Financial Linkages: A New Look at Imbalances', 2010, IMF Working Paper 10295.

[59] Approximated by time dummy variables.

[60] Approximated by country-specific dummy variables.

account the effect of the euro and the euro system facilities. This means that bilateral holdings tend to be bigger when two countries are both members of the euro area, suggesting that belonging to the monetary union does have a significant effect on bilateral asset holdings even after controlling for some of the main determinants of capital flows and EU membership.

However, the magnitude of this effect varies between asset types. The effect is largest for debt holdings, confirming the 'debt bias' in euro area cross-border flows, and a bit smaller but still strongly significant for portfolio equity holdings and FDI. This supports the stylised fact presented in this Commission Staff Working Document that the single currency appears to be conducive to debt and banking flows (which here are both considered into the dependent variable 'debt').

Table 1 Regression results for stocks of asset holdings, 2002-2012

	Real debt	Real Portfolio debt	Real Other Investment	Real Ptf. Equity	Real FDI
Euro area dummy (1 if only one of the two in EA in year t)	**1.348*** **	**1.408*** **	**1.252*** **	**0.638*** **	**1.016*** **
	0.130	0.154	0.136	0.191	0.210
Euro area dummy (1 if both in EA in year t)	**2.378*** **	**2.660*** **	**2.229*** **	**1.762*** **	**1.358*** **
	0.195	0.213	0.225	0.27	0.29
EU dummy (1 if only one of the two in EU)	**0.913*** **	**1.015*** **	**0.980*** **	**0.711** **	**0.644* **
	0.202	0.235	0.22	0.269	0.274
EU dummy (1 if both in EU)	**0.14**	**-0.011**	**-0.172**	**1.719*** **	**2.275*** **
	0.258	0.285	0.295	0.352	0.365
Log(General Govt. Debt to GDP, partner)	**-0.074**	**-0.159** **	**-0.076**	**0.144* **	**0.368*** **
	0.047	0.048	0.061	0.068	0.073
Log(Government Bond Yield, partner)	**0.292* **	**0.740*** **	**0.197**	**0.797*** **	**0.549*** **
	0.12	0.138	-0.135	0.129	0.15
Public bond mkt. capitalisation to GDP, partner	**0.041**	**-0.097**	**0.336*** **	**0.866*** **	**0.607*** **
	0.07	0.074	0.088	0.08	0.099
Private bond mkt. Capitalisation to GDP, partner	**0.582*** **	**0.596*** **	**0.608*** **	**0.453*** **	**0.242*** **
	0.036	0.041	0.043	0.047	0.055
Public bond mkt. Capitalisation to GDP, reporter	**0.038**	**0.189**	**-0.144**	**0.448**	**0.472**
	0.188	0.202	0.224	0.269	0.254
Private bond mkt. Capitalisation to GDP, reporter	**-0.112**	**-0.028**	**-0.169**	**0.043**	**0.146**
	0.071	0.071	0.109	0.097	0.104
R-squared	0.759	0.772	0.695	0.693	0.623
N	1931	1883	1850	1836	1750

Control variables for log(trade),, log(population) of the partner and reporting countries, absolute distance as well as a dummy variable for contiguity and a constant.
Country dummies and time dummies

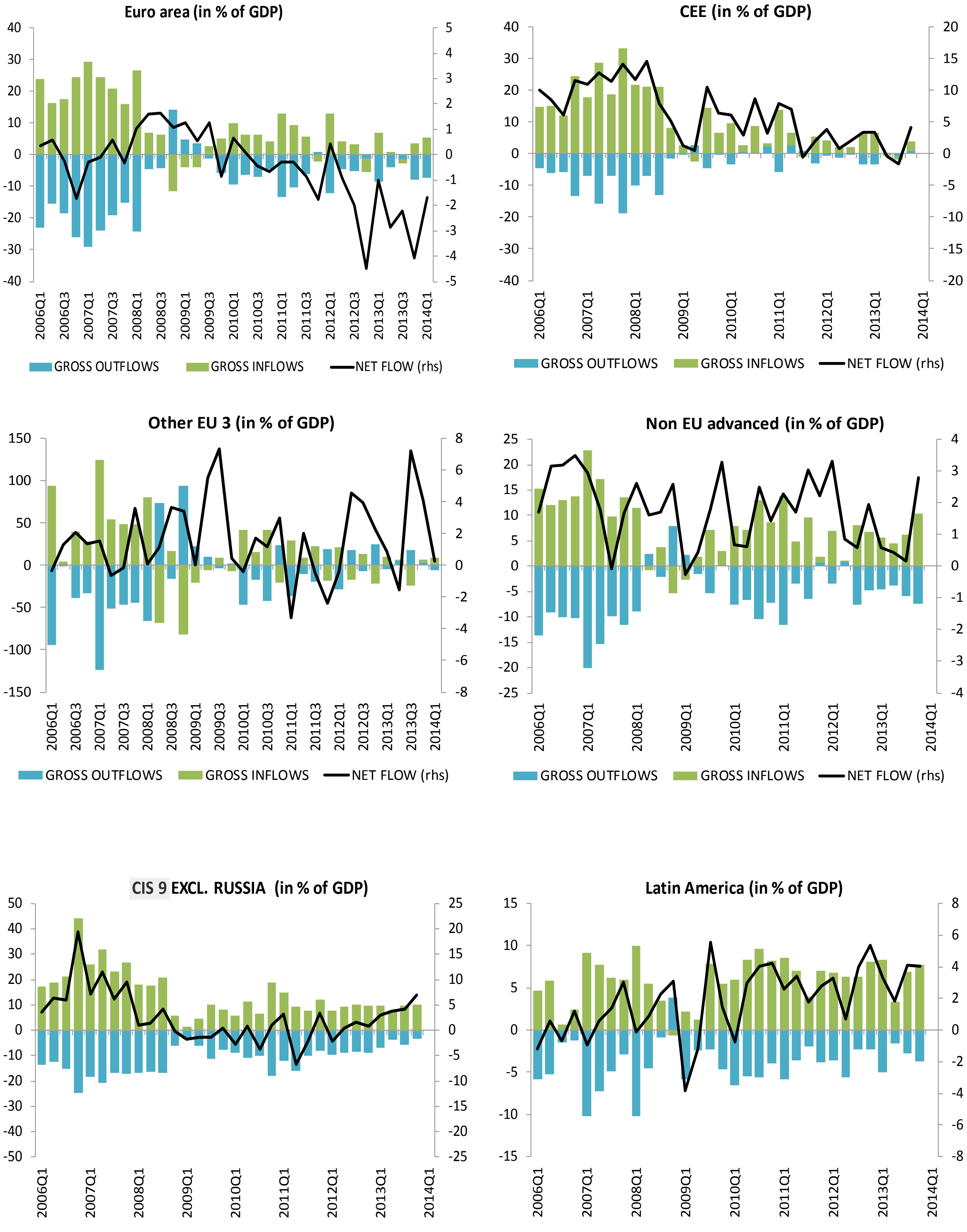
The lower magnitude of the coefficients of the euro area dummy variable for portfolio equity and FDI, together with the sign and significance of the EU membership dummies, suggest that the geography of bilateral FDI holdings may be quite different from that of other assets and that the euro and the euro system facilities may have played a less pronounced role in the case of FDI than that of membership in the EU and the Single Market.

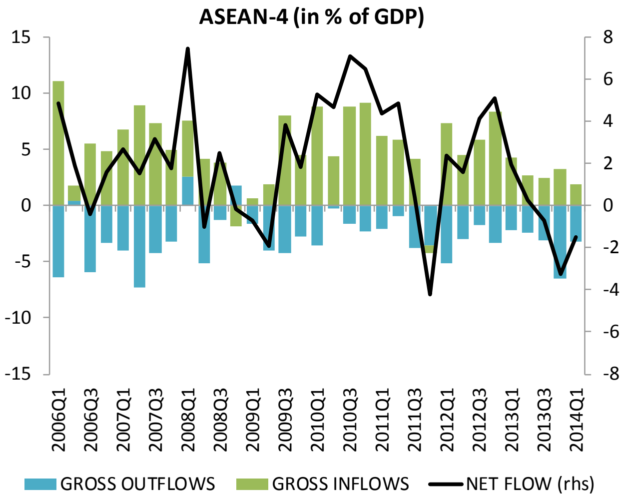
Regarding membership in the EU and the Single Market the sign and significance of the dummy variable for membership in the EU also vary between different asset classes with debt and FDI being on two opposite extremes and portfolio equity in an intermediate position. Membership of two countries in the EU tends to be negatively or not statistically significantly associated with bilateral asset holdings of debt, after controlling for all other country-specific factors as well as for membership in the euro area, while this coefficient is positive and significant for portfolio equity and FDI. This suggests that the EU and the Single Market provided an additional boost, over and above the role of the euro and the other determinants of capital flows, mostly for equity-type relations and less so for debt-type relations for intra-EU partners. The results suggest as well that membership in the monetary union (and not merely the EU) is what really boosted bilateral debt holdings.

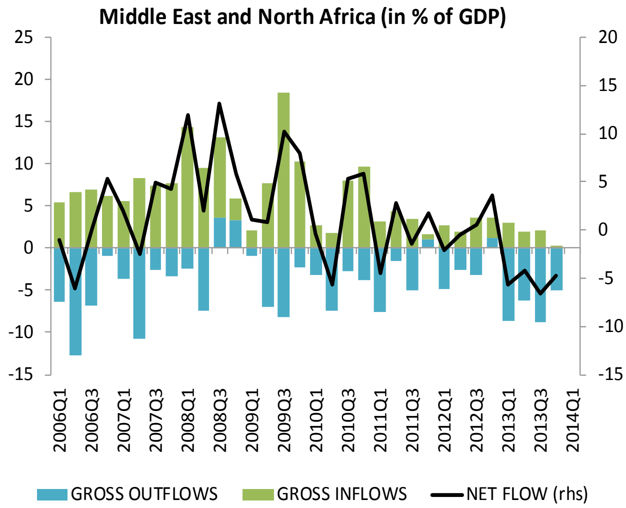
EU membership of both countries in a pair of bilateral partners appears to be positive and significant for FDI, a result which is robust across different specifications. This suggests that FDI holdings are bigger in pairs of EU countries, underlining that what mattered for cross-border FDI holdings was not so much the euro but rather the EU membership. Furthermore, the sum of the ‘both in EU’ dummy (2.275) and either of the two euro area dummies (1.016 or 1.358) is positive, confirming that EU membership had a positive impact on FDI developments throughout the EU. Regarding portfolio equity and FDI between EU and third countries, the coefficients of the EU dummy variable for pairs of countries in which at least one was a third country not in the EU are smaller in magnitude and less statistically significant, underlying once again the role of the Single Market.

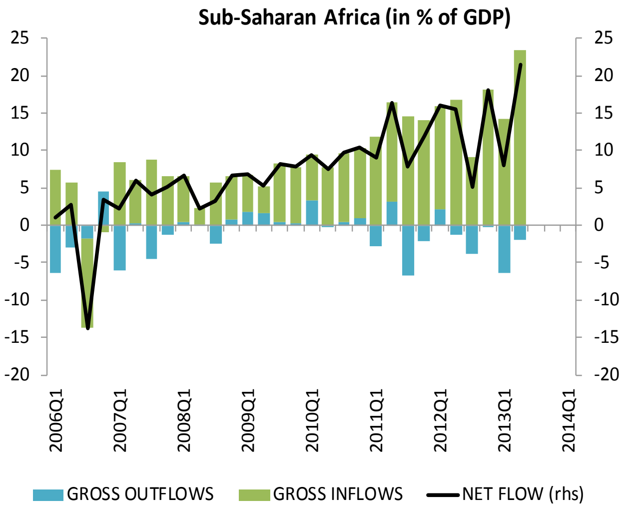
ANNEX II

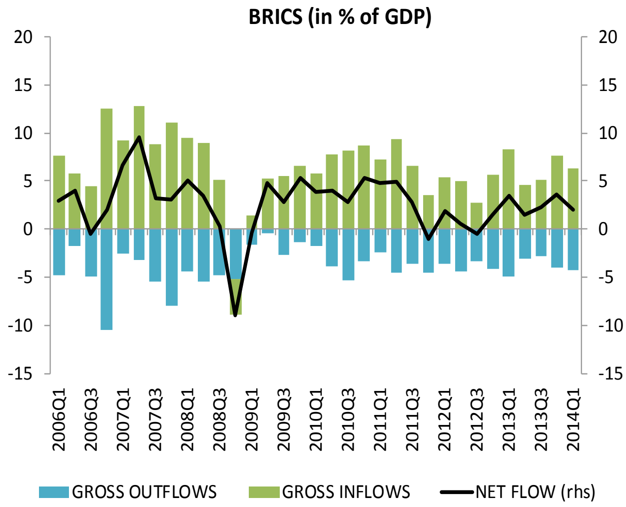
Figure A.1: The evolution of gross and net capital flows in the world (as a percentage of GDP)







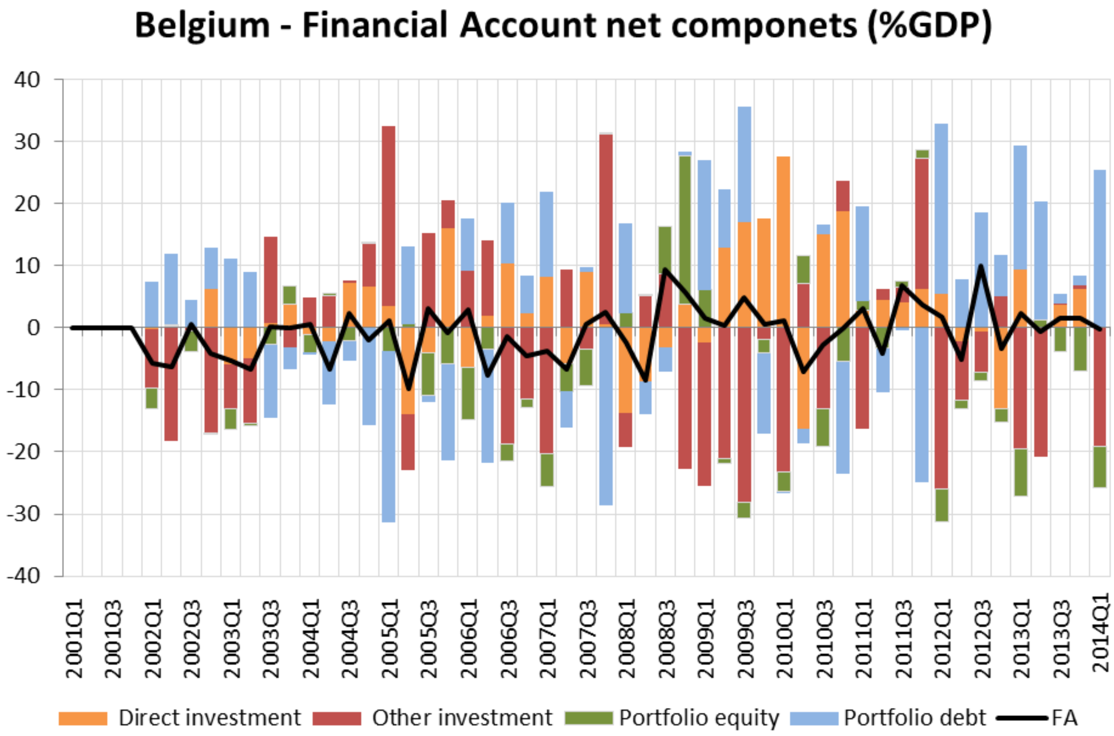


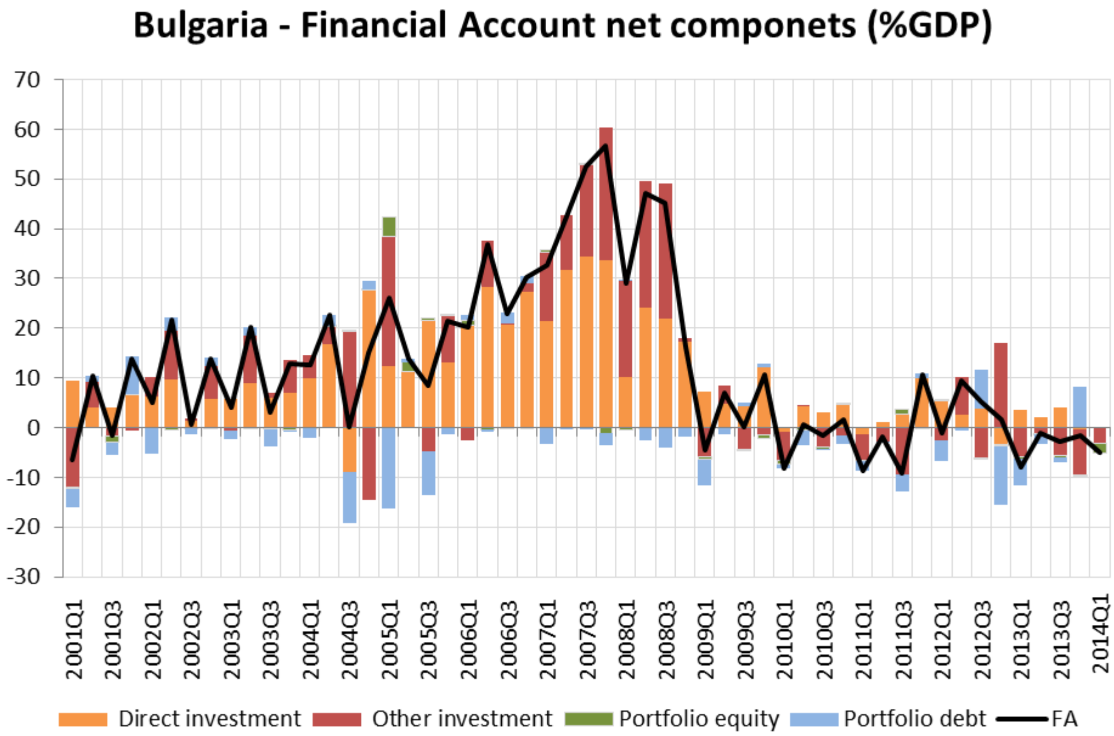


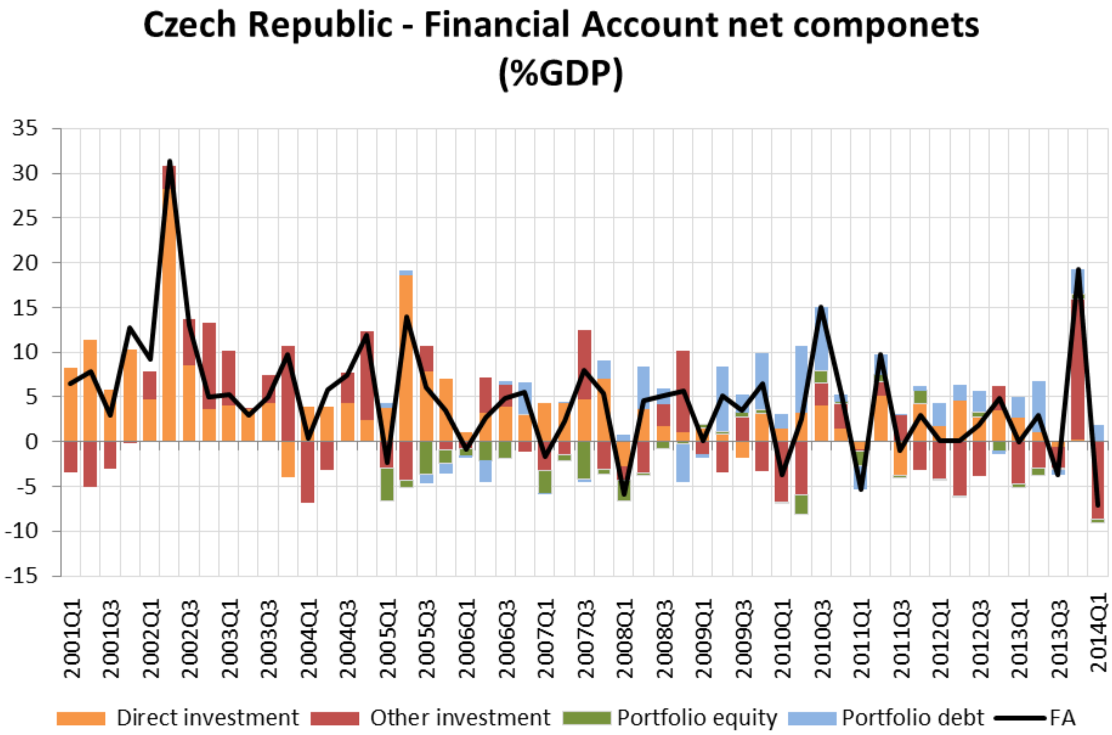
Source: IMF IFS (quarterly capital flows), except for China: Chinese State Administration of Foreign Exchange; WEO (annual GDP).

Note: The country groups are as follows: Euro area = EA 17; other EU 3 = United Kingdom, Sweden, Denmark; CEE8 = 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 8 (excl. Russia) = Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Ukraine; Latin America = Argentina, Bolivia, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Panama, Venezuela, Mexico, Peru, Uruguay, Middle East and North Africa = Jordan, Lebanon, Morocco, Saudi Arabia, Yemen; Sub-Saharan Africa = Cabo Verde, Ethiopia, Lesotho, Mozambique, Seychelles (note that data for Sub-Saharan Africa ends in 2013Q2 due to data limitations); ASEAN-4 = Indonesia, Philippines, Thailand, Vietnam; Gross inflows/outflows is calculated as the sum of the liabilities/assets of the following instruments: direct investment, Portfolio investment and Other investment. Net flow is the net financial account.

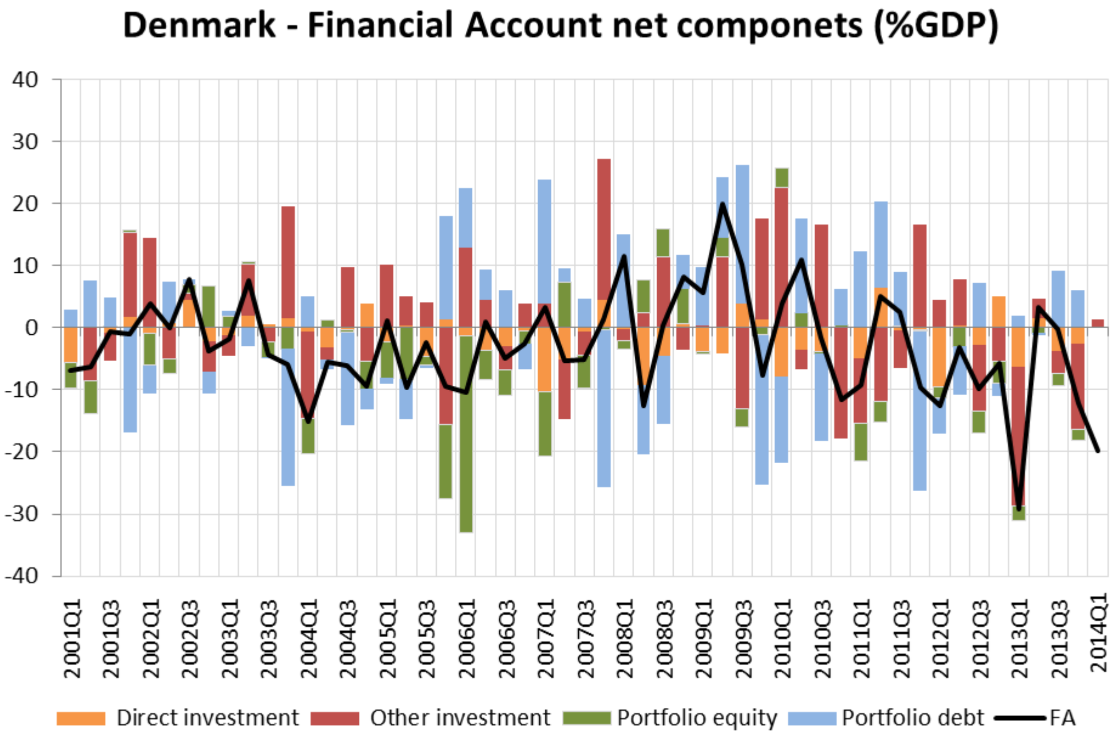
Figure A.2: Financial accounts of individual EU Member States



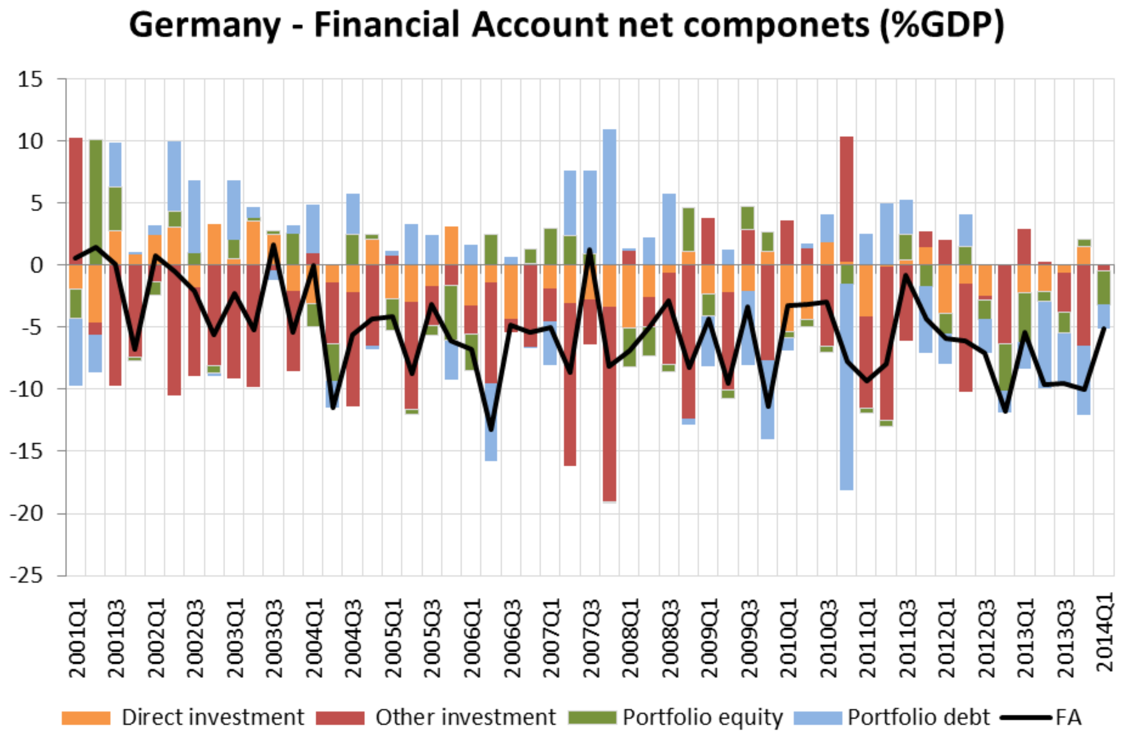


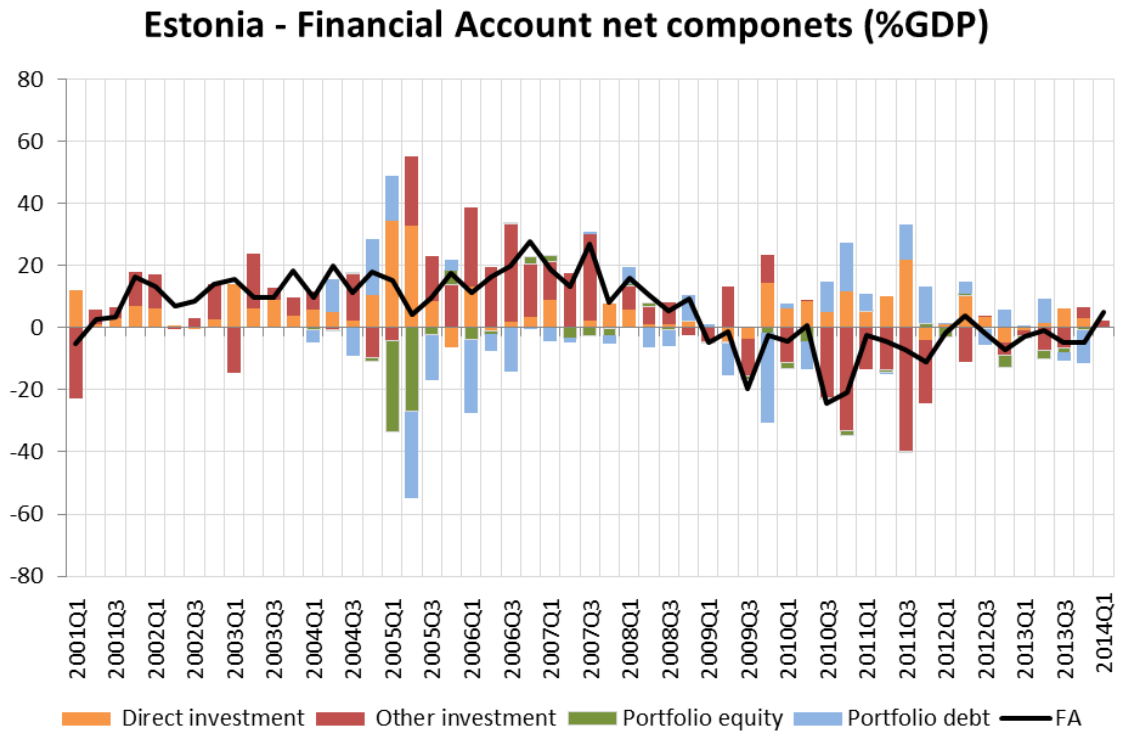


Czech Republic - Financial Account net componets (%GDP)
35
30
25
20
15
10
5
0
-5
-10
-15
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

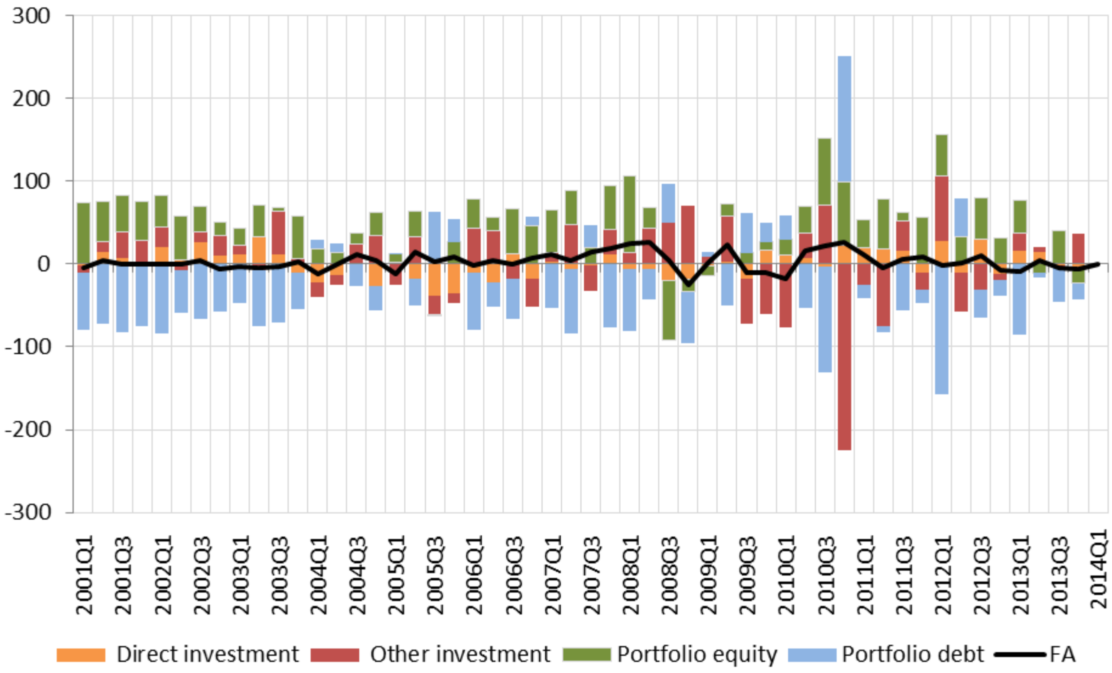


Denmark - Financial Account net componets (%GDP)
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

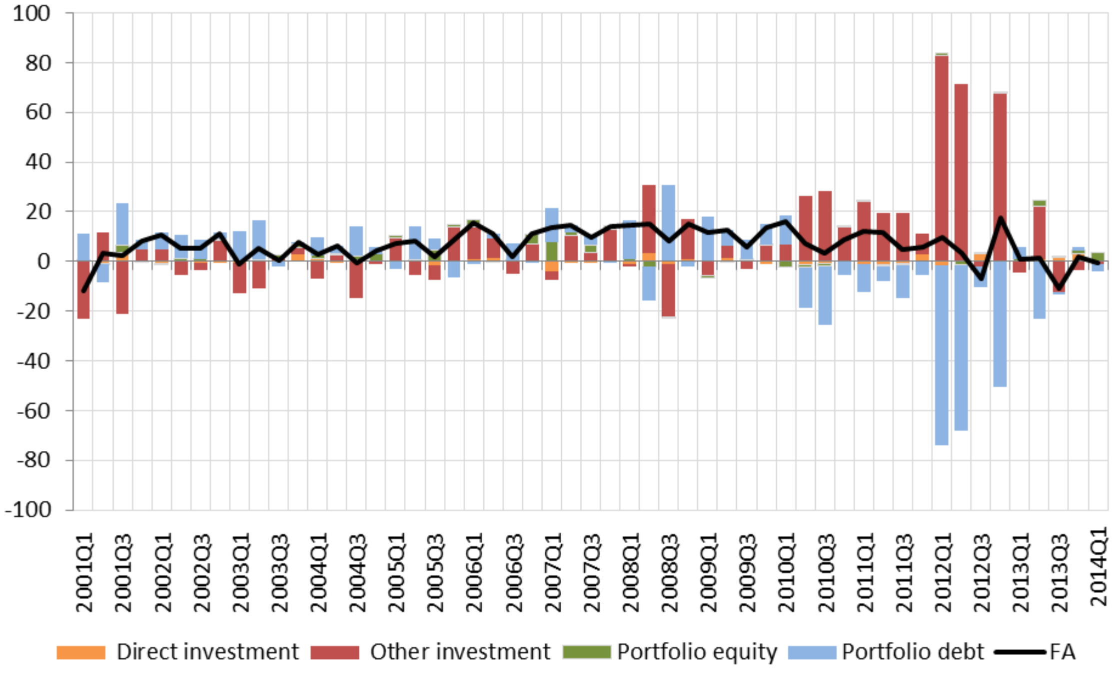

Germany - Financial Account net componets (%GDP)
15
10
5
0
-5
-10
-15
-20
-25
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

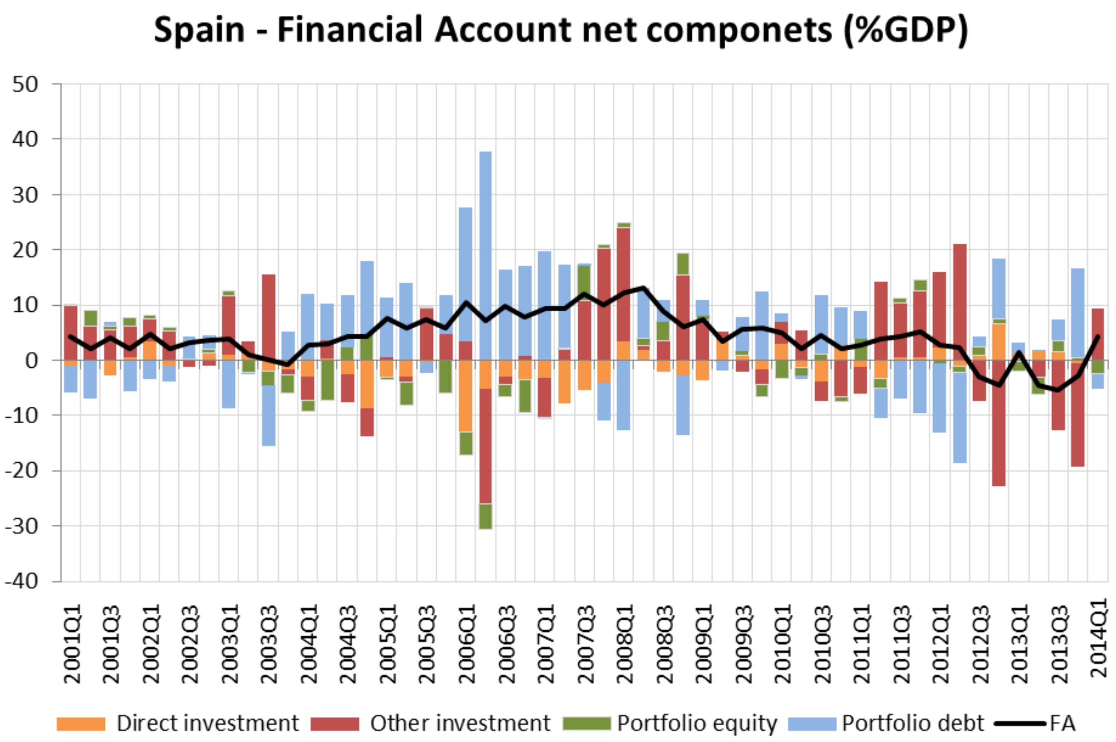

Estonia - Financial Account net componets (%GDP)
80
60
40
20
0
-20
-40
-60
-80
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

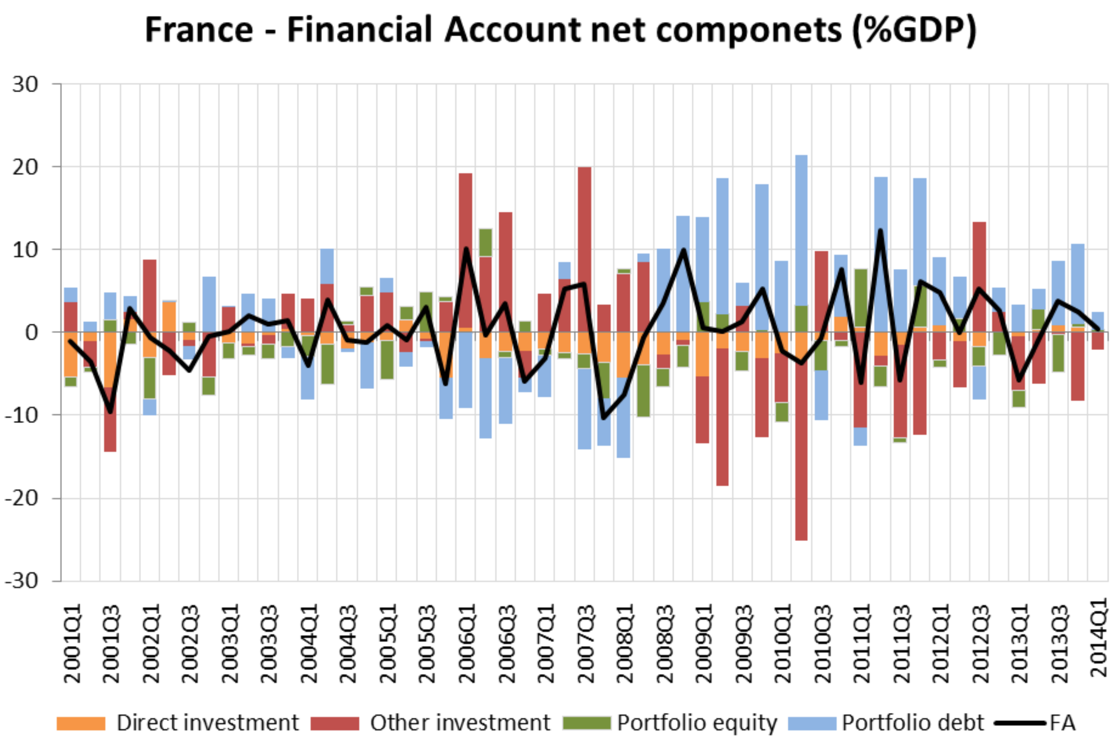
Ireland - Financial Account net componets (%GDP)



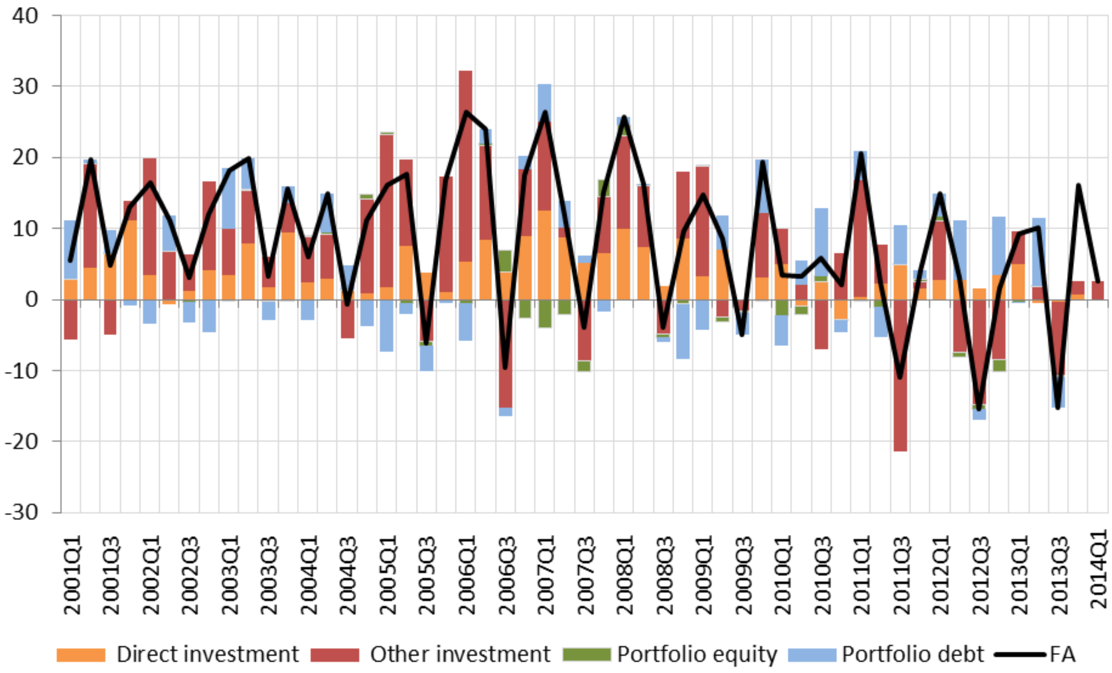
Greece - Financial Account net componets (%GDP)



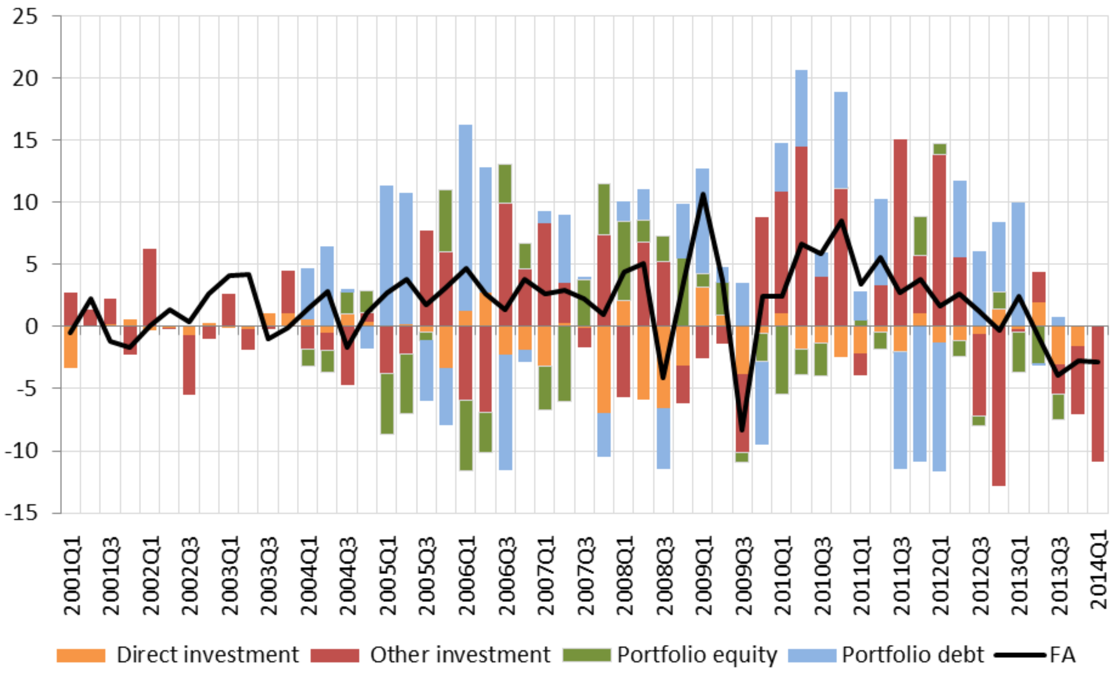

Spain - Financial Account net componets (%GDP)
50
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

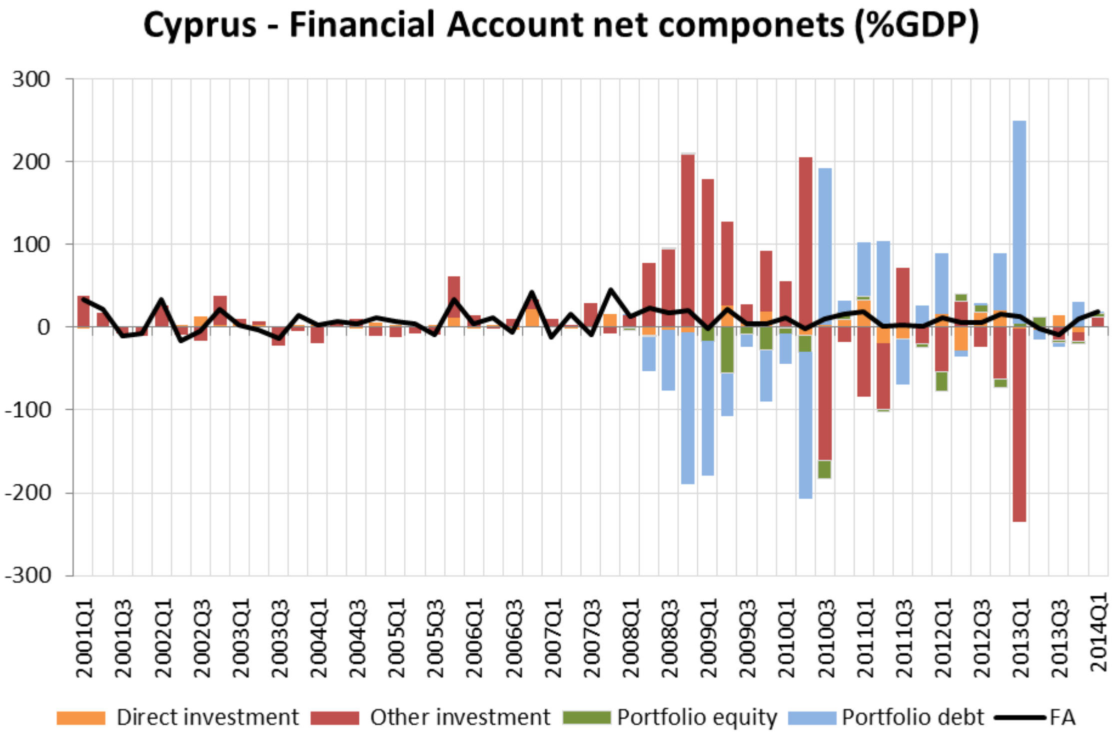

France - Financial Account net componets (%GDP)
30
20
10
0
-10
-20
-30
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

Croatia - Financial Account net componets (%GDP)



Italy - Financial Account net componets (%GDP)




Cyprus - Financial Account net componets (%GDP)
300
200
100
0
-100
-200
-300
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
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2011Q1
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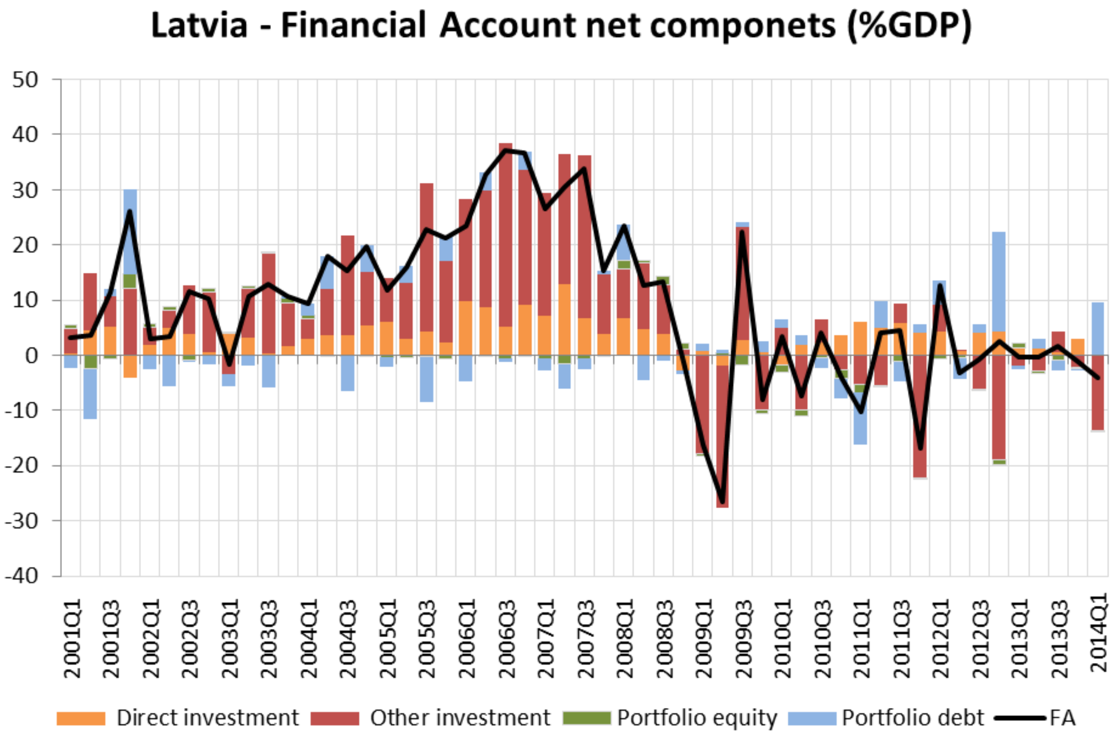
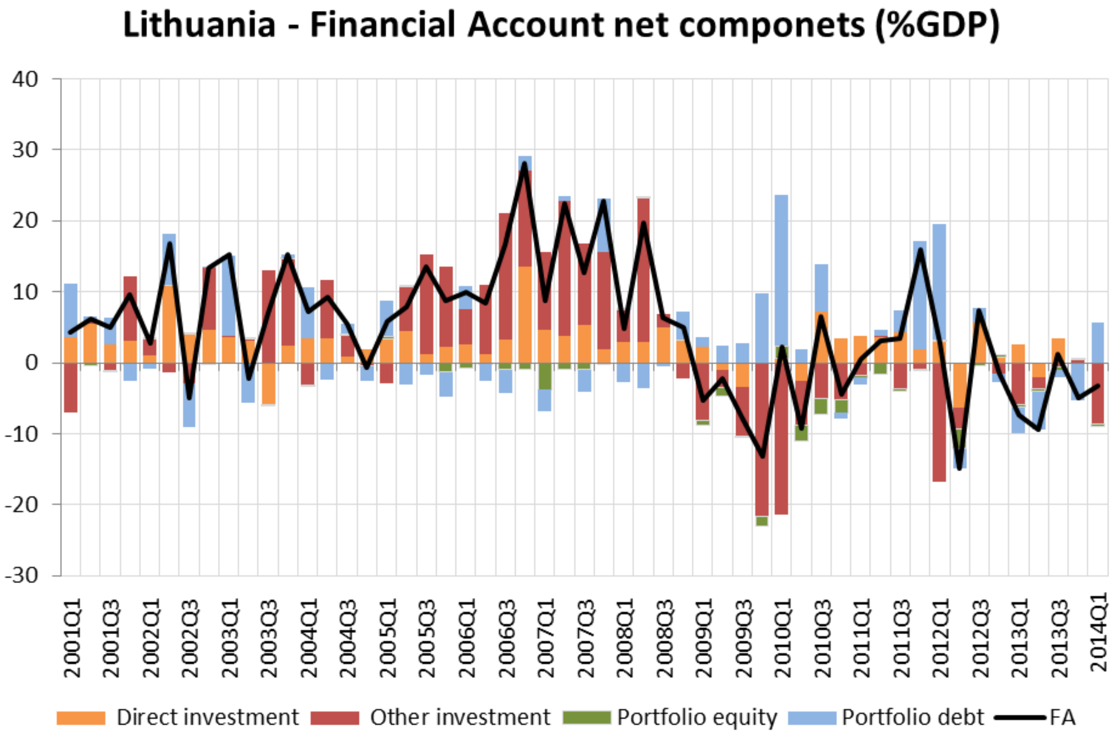
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Latvia - Financial Account net componets (%GDP)
50
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Lithuania - Financial Account net componets (%GDP)
40
30
20
10
0
-10
-20
-30
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
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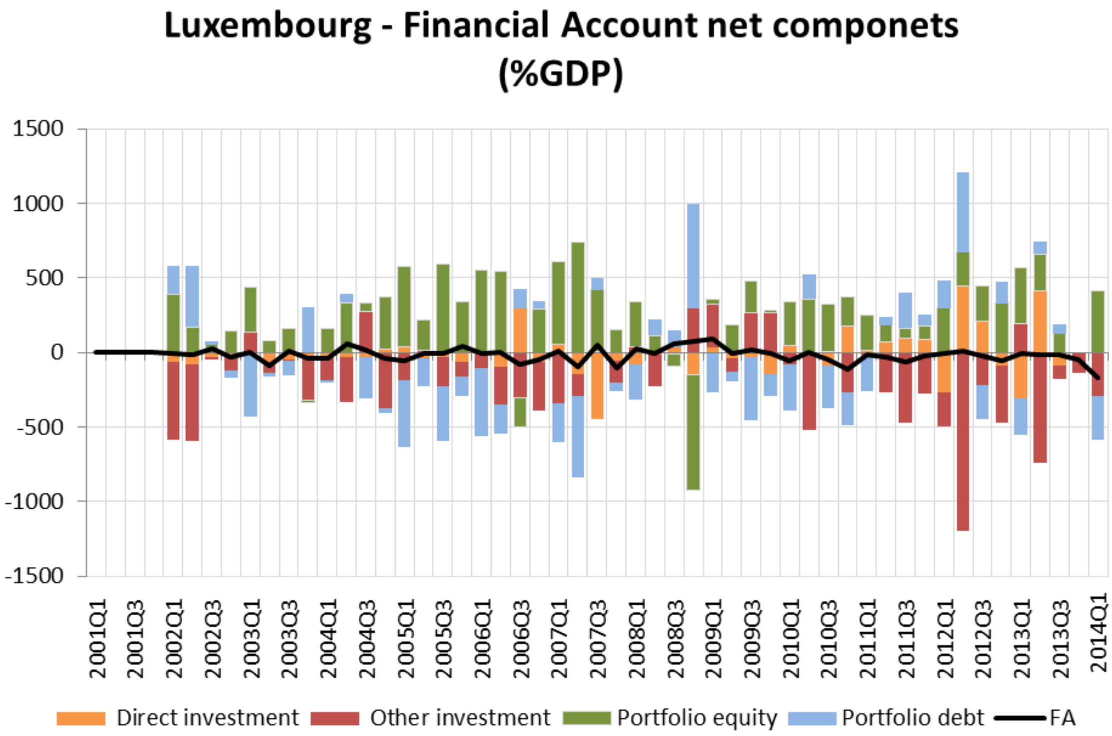
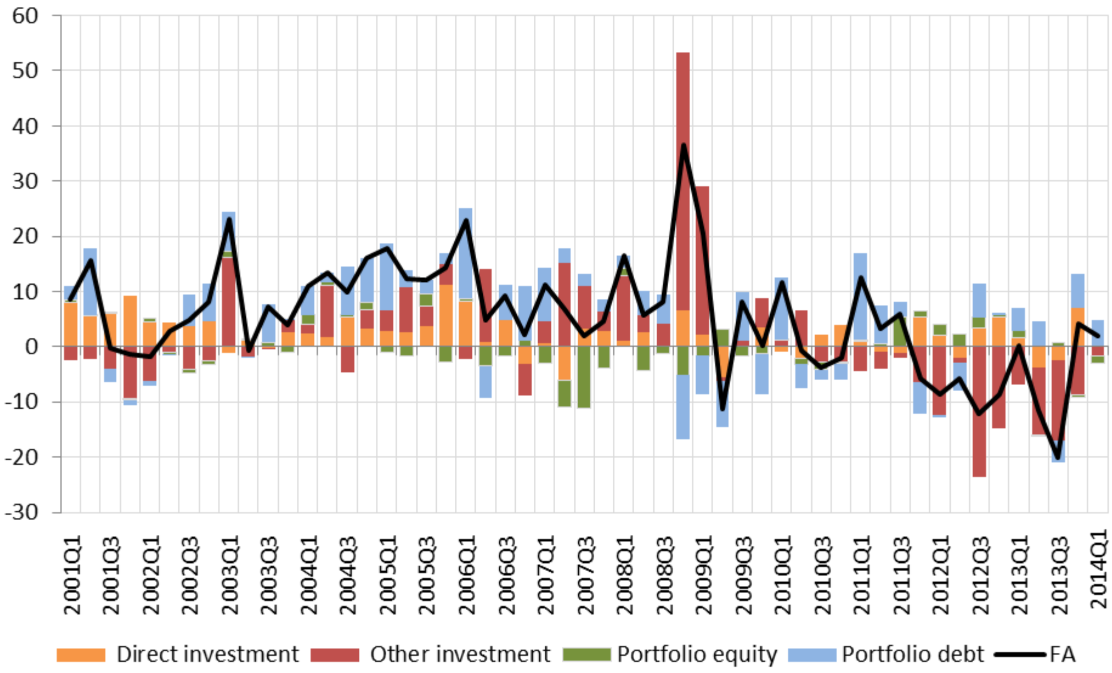
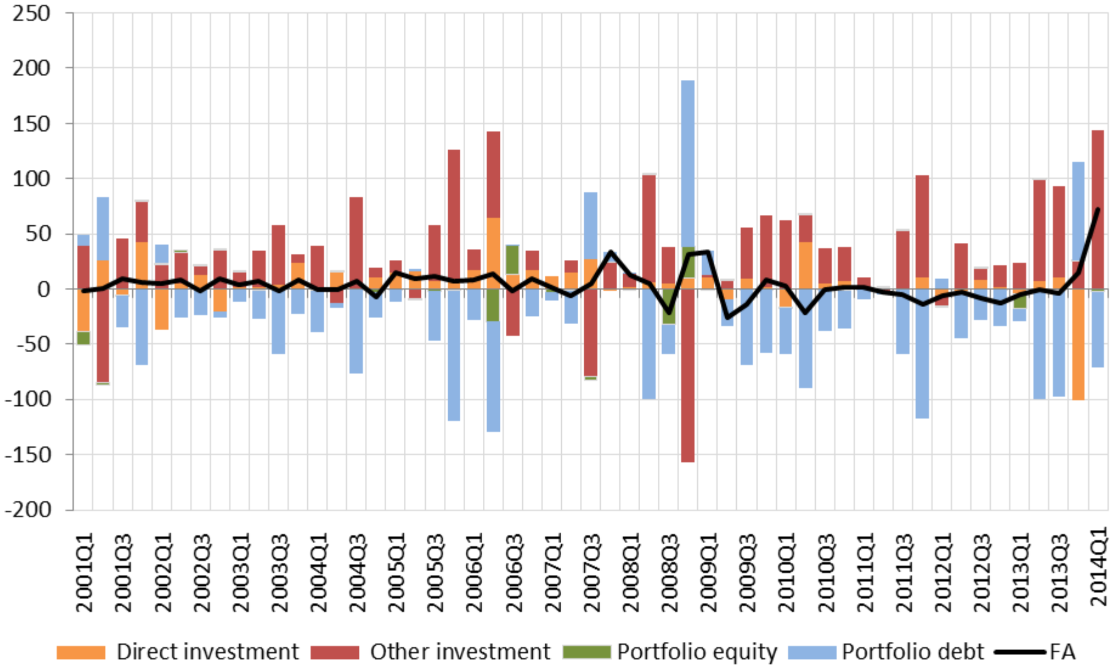
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

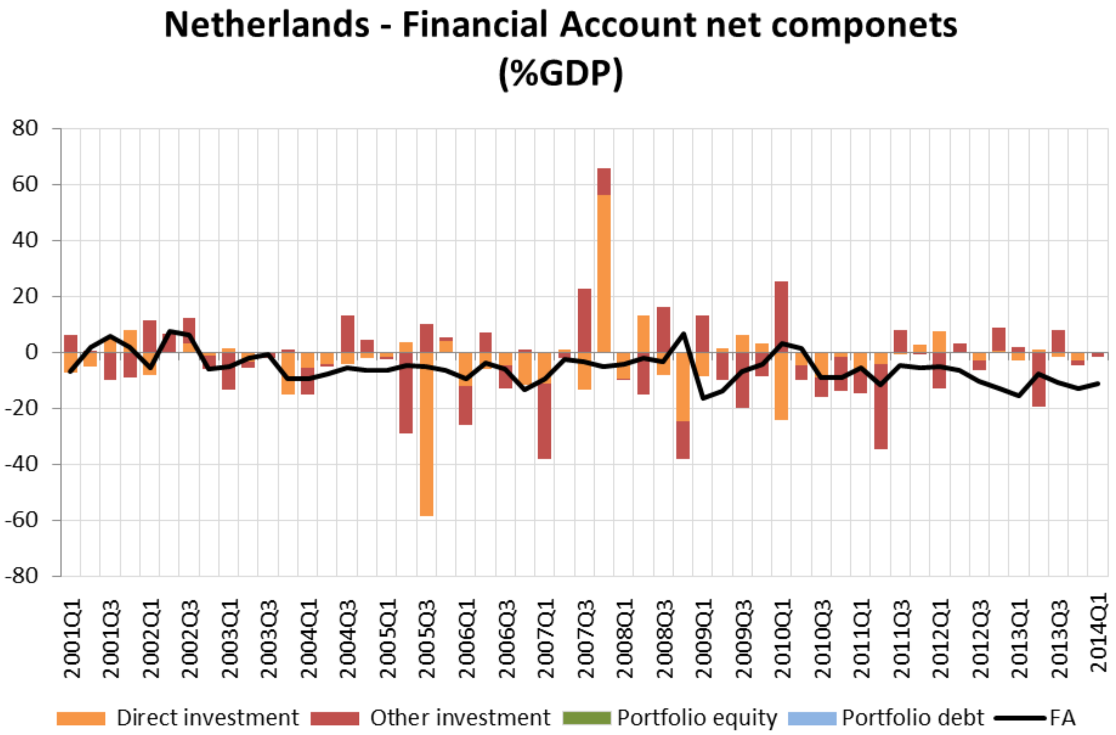

Luxembourg - Financial Account net componets (%GDP)
1500
1000
500
0
-500
-1000
-1500
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

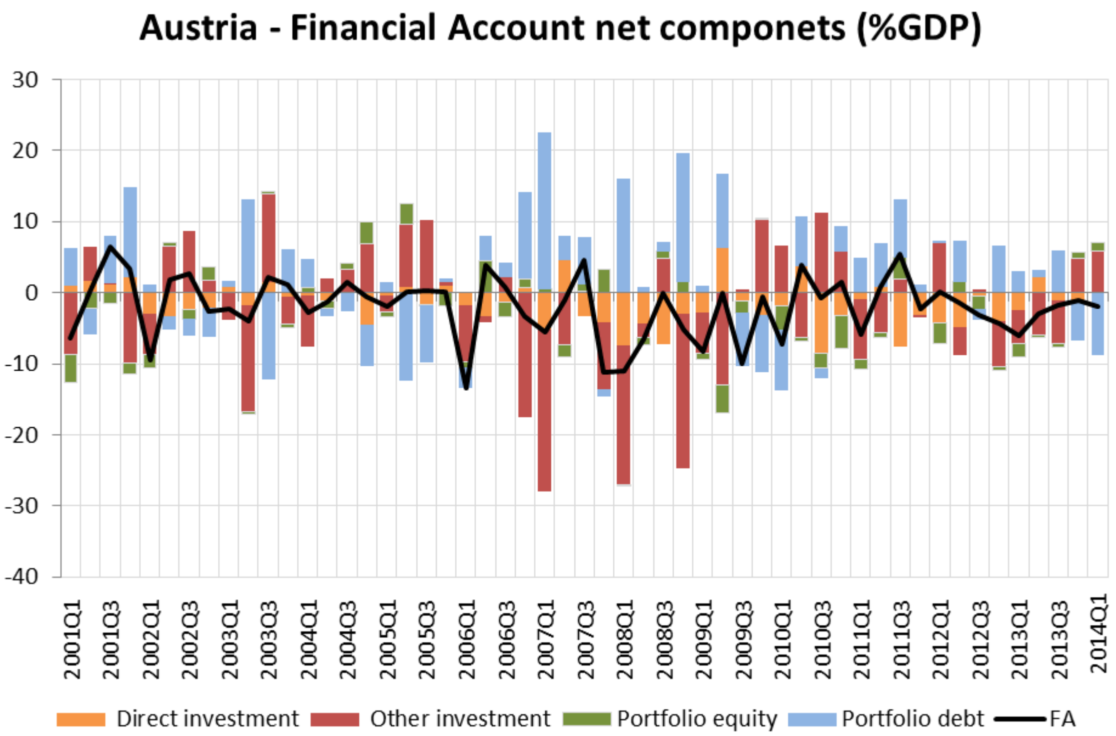
Hungary - Financial Account net componets (%GDP)

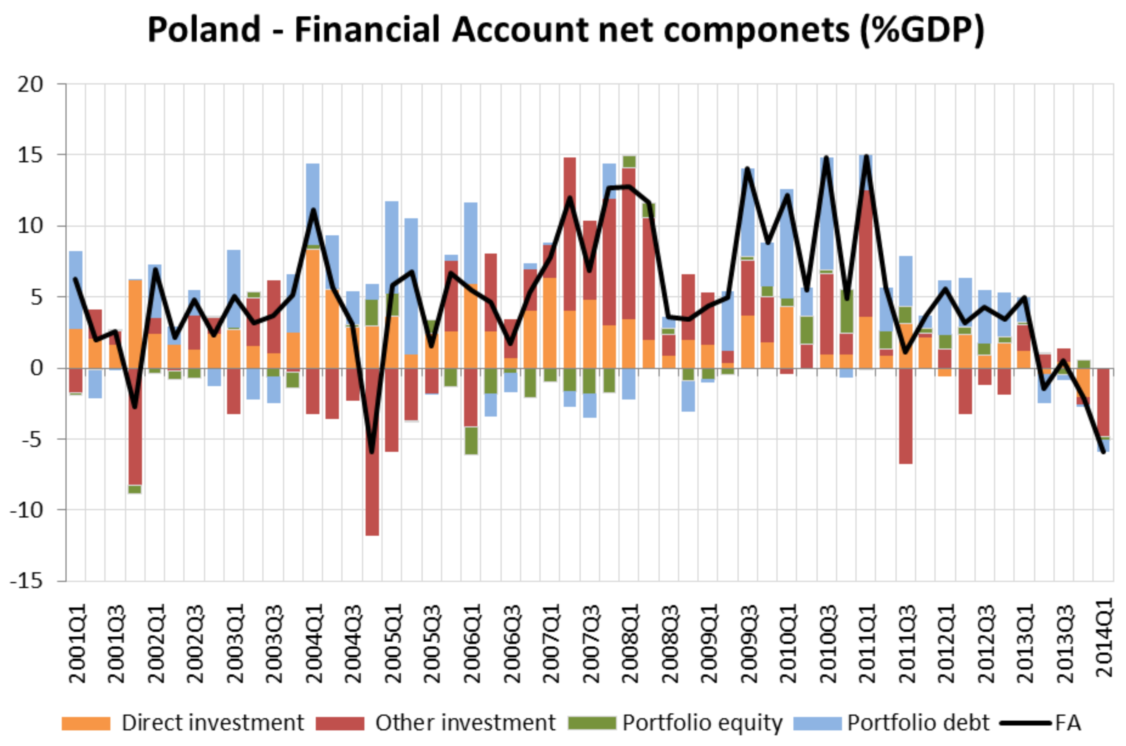


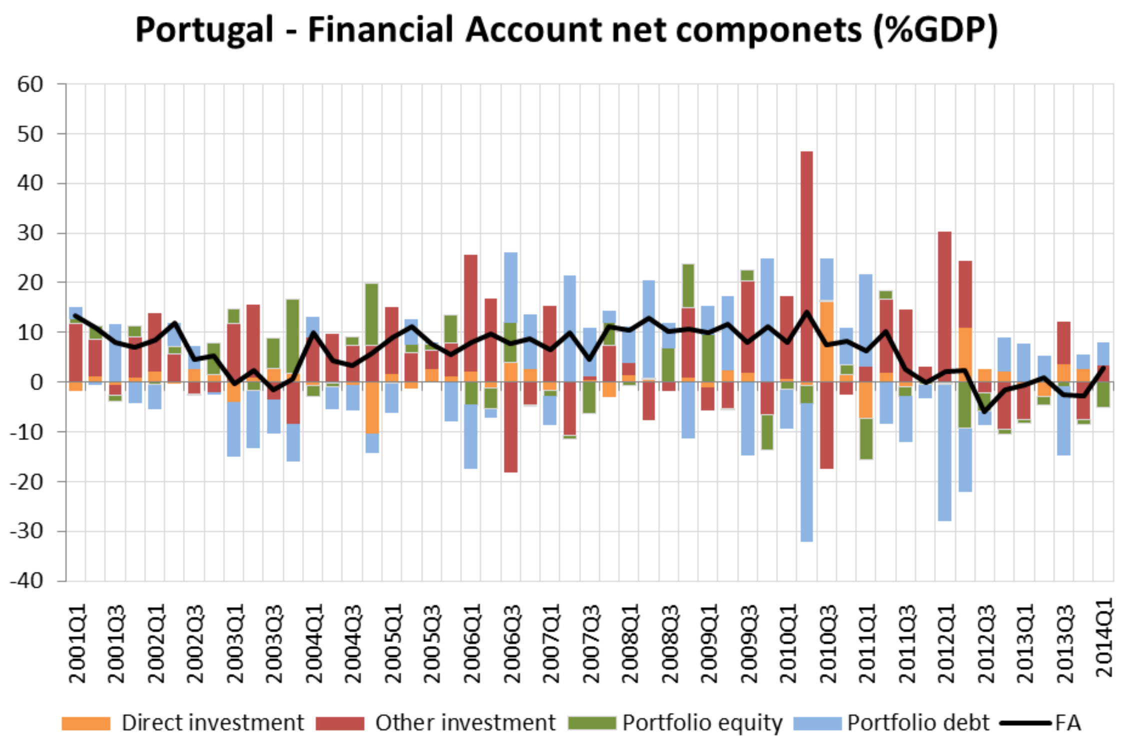
Malta - Financial Account net componets (%GDP)

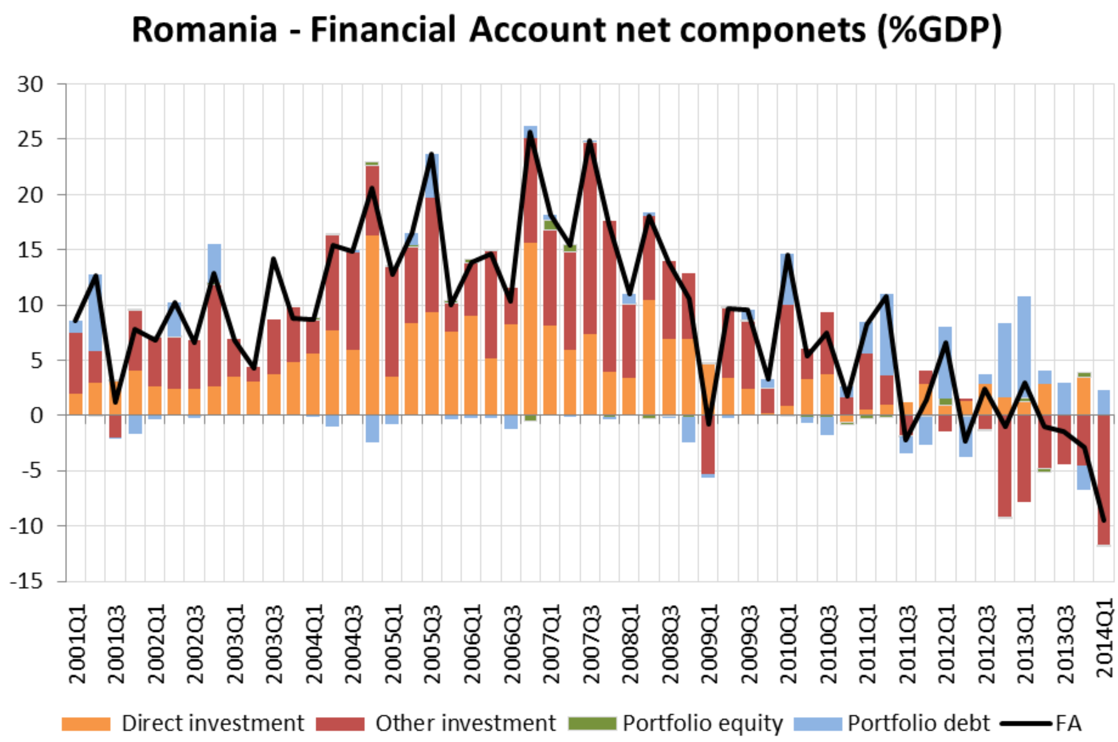


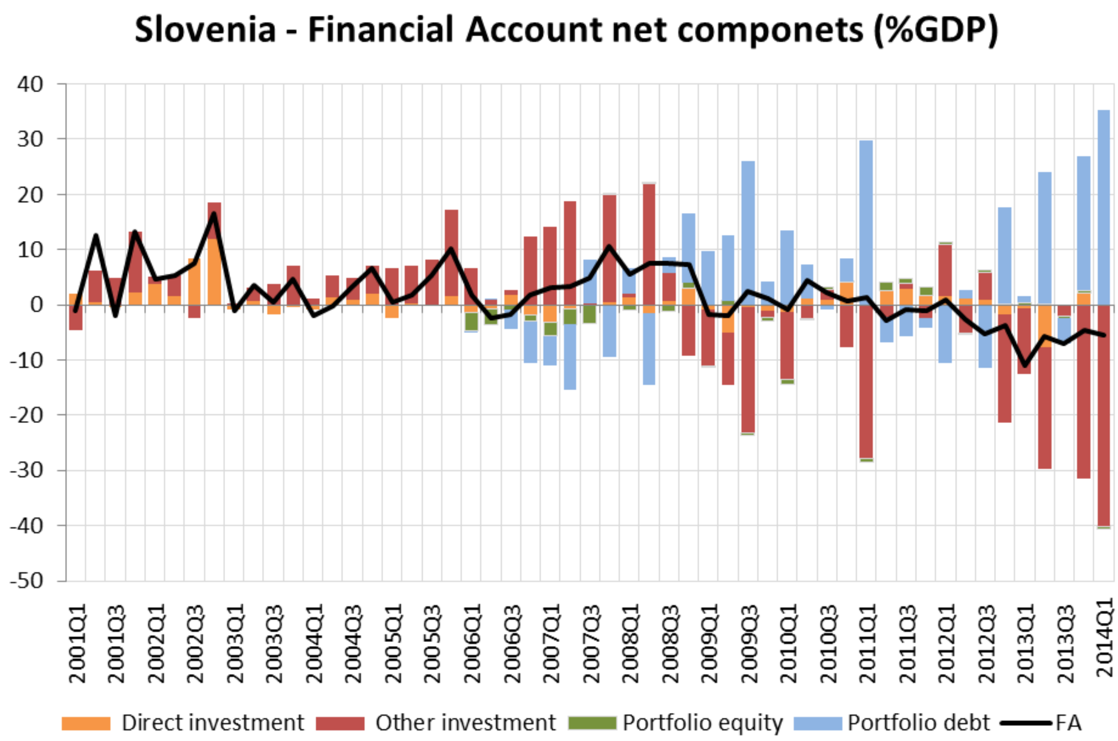

Netherlands - Financial Account net componets (%GDP)
80
60
40
20
0
-20
-40
-60
-80
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

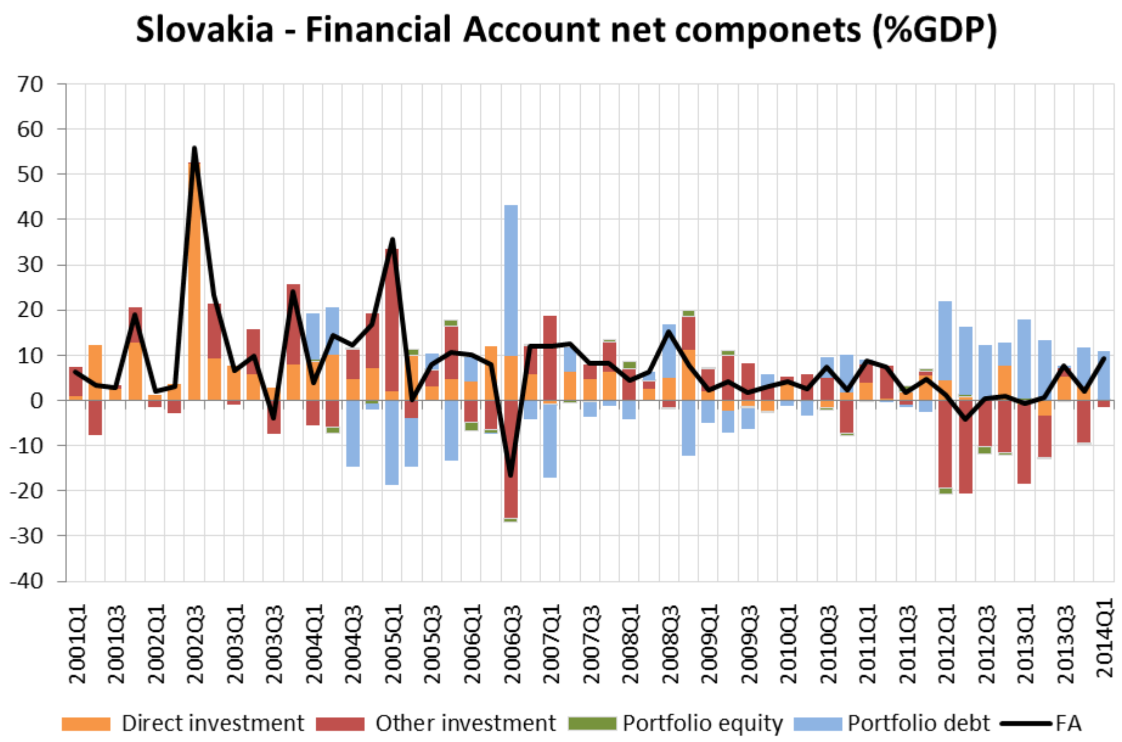

Austria - Financial Account net componets (%GDP)
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

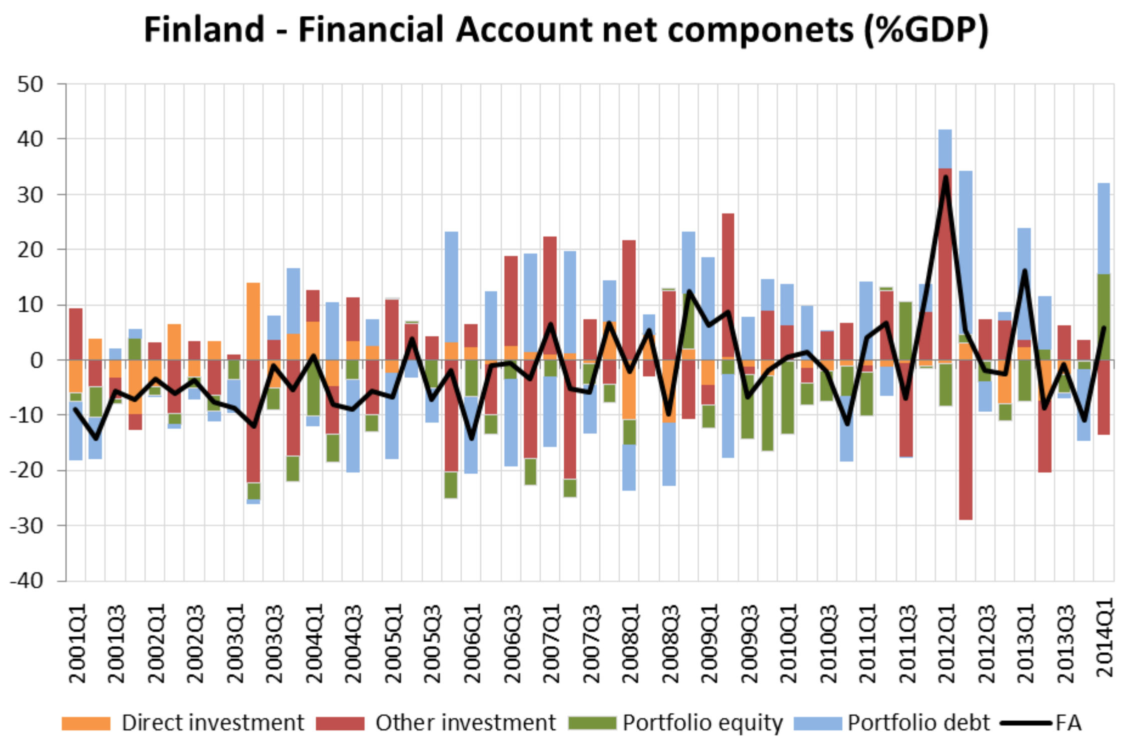

Poland - Financial Account net componets (%GDP)
20
15
10
5
0
-5
-10
-15
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Portugal - Financial Account net componets (%GDP)
60
50
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

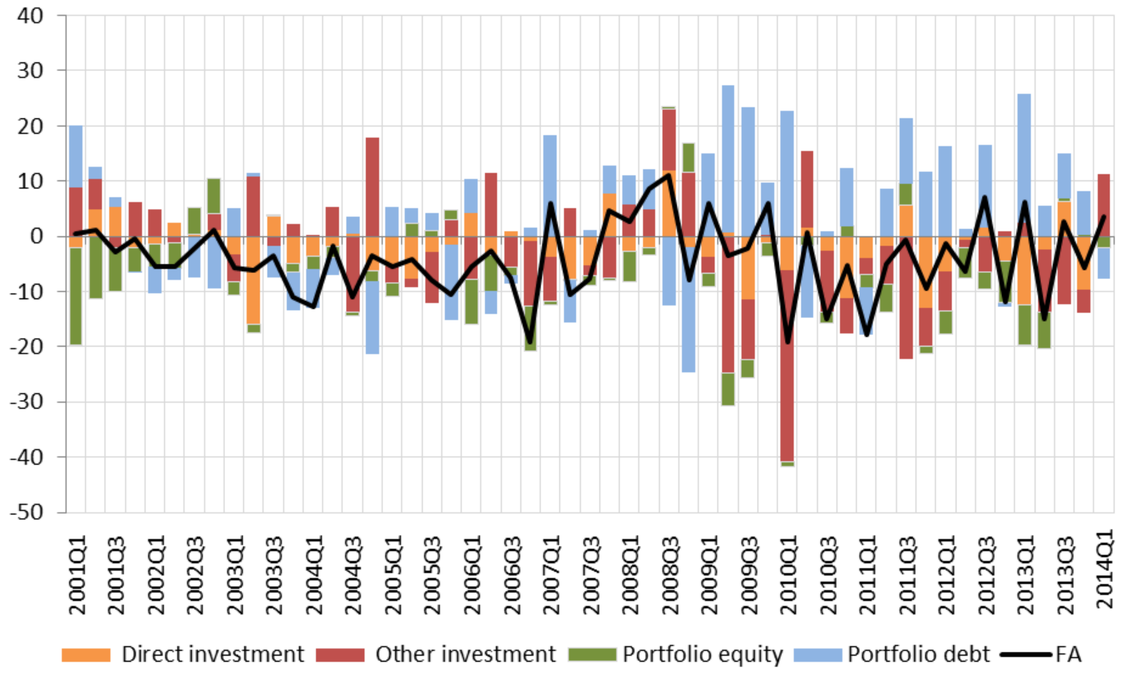

Romania - Financial Account net componets (%GDP)
30
25
20
15
10
5
0
-5
-10
-15
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Slovenia - Financial Account net componets (%GDP)
40
30
20
10
0
-10
-20
-30
-40
-50
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Slovakia - Financial Account net componets (%GDP)
70
60
50
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA


Finland - Financial Account net componets (%GDP)
50
40
30
20
10
0
-10
-20
-30
-40
2001Q1
2001Q3
2002Q1
2002Q3
2003Q1
2003Q3
2004Q1
2004Q3
2005Q1
2005Q3
2006Q1
2006Q3
2007Q1
2007Q3
2008Q1
2008Q3
2009Q1
2009Q3
2010Q1
2010Q3
2011Q1
2011Q3
2012Q1
2012Q3
2013Q1
2013Q3
2014Q1
Direct investment
Other investment
Portfolio equity
Portfolio debt
FA

Sweden - Financial Account net componets (%GDP)



United Kingdom - Financial Account net componets (%GDP)

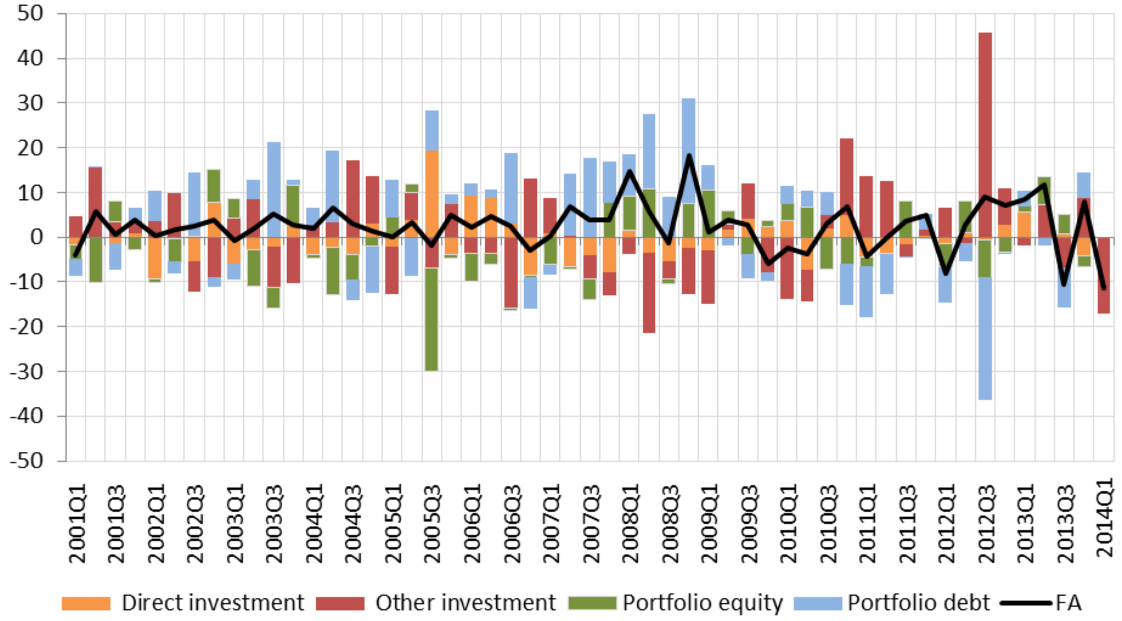
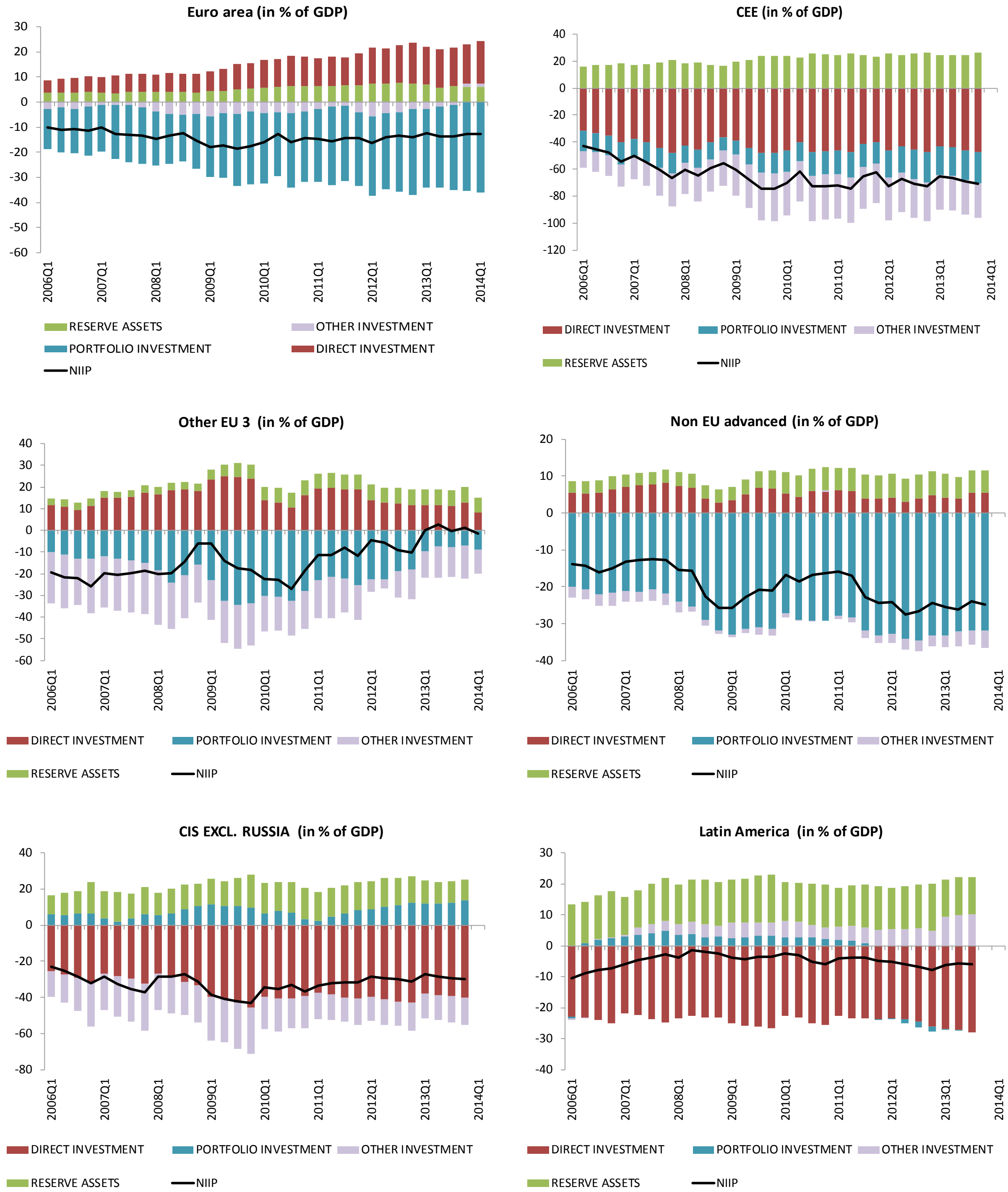
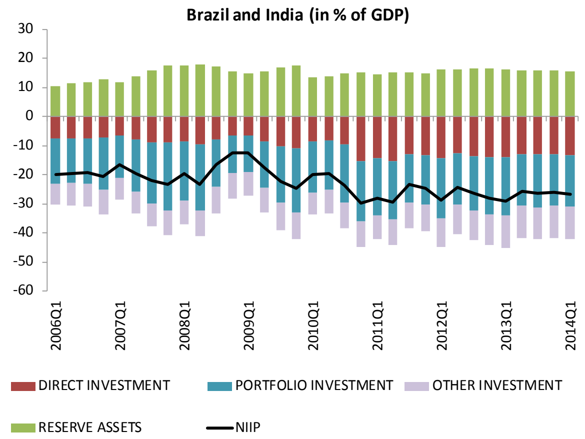
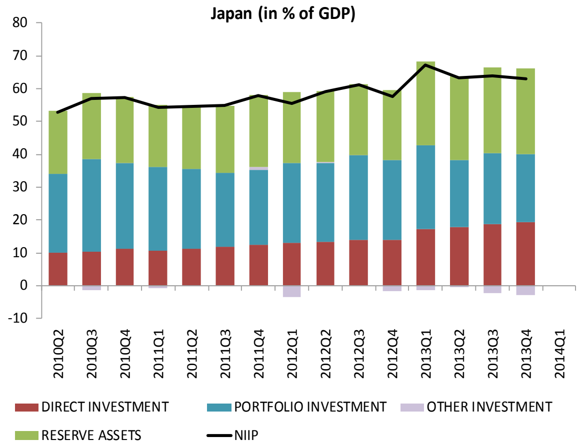
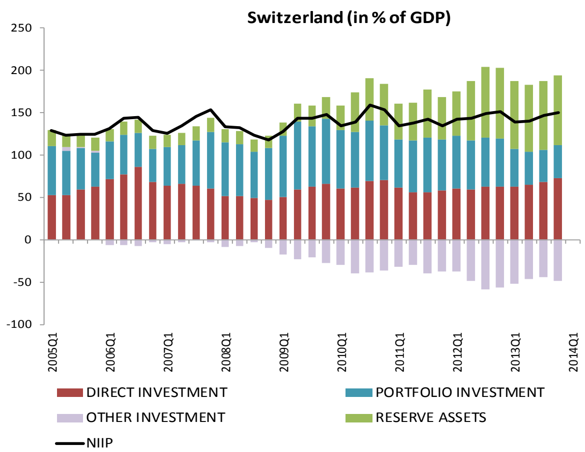


Figure A.3: Net International Investment Positions (as a percentage of GDP)









Source: IMF IFS (quarterly IIP) and WEO (annual GDP). Note: country groups are defined in the note to Figure A.1, but due to data limitations, the following changes occur: non-EU advanced: Hong Kong is included only since 2010; CEE8: Bulgaria is included only since 2007; Latin America: without Argentina, Bolivia, Ecuador, Mexico, Uruguay; CIS 8 (EXCL. RUSSIA): without Azerbaijan, Kyrgyz Republic, Tajikistan and Ukraine; No data availability for ASEAN-4, Middle East and North Africa and Sub-Saharan Africa.