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COVER NOTE

From:	Thomas Wieser, President of Economic and Financial Committee (EFC)
date of receipt:	12 December 2013
To:	Rimantas Šadžius, President of the ECOFIN Council
Subject:	2013 Annual EFC Report to the Commission and the Council on the Movement of Capital and the Freedom of Payments

Dear Mr. President,

Under Article 134 (2) of the EC Treaty on the Functioning of the European Union (TFEU), the Economic and Financial Committee (EFC) is called upon

"to examine, at least once a year, the situation regarding the movement of capital and the freedom of payments, as they result from the application of this Treaty and of measures adopted by the Council; the examination shall cover all measures relating to capital movements and payments; the Committee shall report to the Commission and to the Council on the outcome of this examination."

I hereby provide you with the annual EFC Report for 2013. As in the past, the Report reflects key developments in global capital markets and reviews the state of affairs with respect to the movement of capital, the Commission's enforcement actions and new policy initiatives, the commitments undertaken by candidate countries and action taken in the fight against terrorist financing and money laundering.

On key developments in global markets, the present report highlights a decline in worldwide financial resources in 2012. After an initial return to recovery in 2011, the trend was reversed for the EU in 2012 and the inward, outward and intra-EU flows decreased.

The Report also underlines a further decrease in formal infringement procedures also thanks to the EU Pilot procedure and other informal efforts to find amicable solutions. Since the last report, three formal infringement cases have benne closed and two have been opened, bringing the number of open cases to 11.

The EFC has taken note of the continued efforts of the Commission to assist Member States in terminating the remaining intra-EU BITS, which in the Commission's opinion are incompatible with the EU law. Moreover, the Commission set up an informal Experts' Group of representatives of all interested Member States and conducted bilateral meetings with Member States and industry in order to find a way how to re-enforce investment protection in the EU. Member States insisted on the necessity to set up, within the EU, a pragmatic mechanism for an out-of-court settlement of disputes between investors and States. In addition, consultations with stakeholders recognized the need for an efficient dispute solving mechanism to resolve cross-border disputes as well as a mechanism for an out-of-court settlement of disputes between investors and States.

On cross-border banking services, the EFC recalls the importance of Banking Union in these matters and of the European Banking Authority's mediation mechanism as the appropriate and suitable tools to mitigate disputes between home and host supervisory authorities.

(Complimentary close.)

(s.) **Thomas WIESER**

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ECONOMIC AND FINANCIAL COMMITTEE

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

INTRODUCTION

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

2. Based on the Commission's examination, the EFC in its 15th Report assesses key developments in global and EU[1] capital markets since 2012, including the impact of the on-going crisis on capital movements. It covers the assessment of enforcement actions and policy initiatives undertaken to enhance capital movements and underlines the role of international dialogues in promoting cooperation.

DEVELOPMENTS IN CAPITAL FLOWS IN 2012-2013

3. In global terms, **total financial resources** declined in 2012 by about EUR 934 billion relative to 2011, with a significant drop in FDI and other investments. The decline in capital

[1] On July 1st 2013, Croatia became a member of the EU. As the report covers mainly the year 2012, and only the first months of 2013 when data is available, Croatia is not included in the EU aggregate.

inflows to the EU and other major economies in 2012 was driven by investors searching for higher yields in emerging markets, which exhibited higher GDP growth relative to the EU.

4. In 2012, the EU27 accounted for 22% of total **gross capital inflows** against 16% for the US and 24% for major emerging economies. The general downward trend in the EU's share of total gross capital inflows since 2005-06 continued in 2012, whereas the share of gross capital inflows to the major emerging economies increased.

5. Although 2010 and 2011 showed signs of recovery, global **FDI** inflows decreased further by 11.8% in 2011-2012, with the decline of inflows into the EU accounting for 86% of the overall decrease. While the share of worldwide FDI inflows to the major emerging economies has increased, reaching 24.1% in 2012, the inflow to the EU has continuously decreased falling to 19.1%.

6. The increase in **mergers & acquisitions** (M&A) that was witnessed in 2011 in the EU proved to be short lived, and was sharply reversed in 2012. Although domestic M&A still increased, the number and value of cross-border deals decreased, signalling companies' preference to consolidate their assets in core geographical areas. Furthermore, the overall decline in M&A in the EU is also reflected in inward M&A from outside the EU, which also decreased.

7. **Portfolio investment**[2] increased in both inflows and outflows during the observed period. The two largest recipients of investments at the global level were the US followed by Luxembourg. The UK had the largest outflow. In the EU context, the UK, Germany and Greece had large negative balances, while Luxembourg, Belgium and France witnessed a large inflow of portfolio investments.

8. Despite initial positive signs in 2011, gross "**other investment**"[3] decreased significantly in 2012. Large positive inflows were witnessed in Greece and Spain due to external financial assistance. Negative gross inflows in some Member States were mainly due to foreign banks decreasing their exposure towards these countries. This phenomenon was counterbalanced by domestic investors reducing their external exposures. Some EU Member States observed

[2] Investment in equity and debt instruments, including sovereign debt.
[3] The "other investment" is a heterogeneous category that includes, among others, loans and deposits, trade credits and changes in external assets and liabilities of the government sector. After excluding these official financing flows (which, however, can be quite sizeable), flows from and to the banking sector represent the larger share of "other investments".

negative net **bank lending flows**, particularly in Spain and Italy, whereas France and the UK had significant surpluses.

MAIN DEVELOPMENTS WITHIN THE SINGLE MARKET

9. 2013 saw the temporary introduction of restrictions on the movement of capital and payments between Member States and between Member States and Third Countries.

10. For the first time since the introduction of the euro, **capital controls** were being applied in the EU, as Cyprus undertook this emergency measure to guard its financial stability and ensure deleveraging in an orderly way. The Commission assessed that the imposition of capital controls in application of article 65(1) of the TFEU, was justified, as the critical situation in Cyprus constituted a matter of overriding public interest and public policy/public security. Currently, the Commission monitors the situation to ensure capital controls are gradually relaxed while reinstating financial stability in Cyprus.

11. Moreover, some concerns had been raised already in the previous report that some national bank supervisors in home and host countries were sheltering domestic banking systems from market pressures, by taking unilateral prudential measures (including "ring-fencing" assets and hindering cross-border transfers of capital of banks), which could lead to a further fragmentation of the Single Market for capital. While recognising the legitimate objective of addressing financial stability concerns, the Commission continues to monitor **cross-border banking services** and has collected information on current supervisory practices from all national banking supervisors in order to gain insights into possible unilateral prudential measures addressed to national banking subsidiaries of cross-border EU banking groups such as restrictions on intra-group transfers and lending, limits on activities of branches or on the expatriation of profits. The cooperation from all Member States' supervisors is appreciated. The Commission is currently analysing the results in order to determine possible further steps as appropriate.

12. The November 15th ECOFIN statement underlined that in order to facilitate cross-border banking recovery, ring-fencing of capital and liquidity should be prevented. In this context the **EFC welcomes** the Commission monitoring of national banking supervisory practices and underscores the importance of preventing unduly discriminatory or disproportionate supervisory action and the resulting enhanced fragmentation. The EFC also recalls the importance of banking union to these matters and of the EBA's mediation mechanisms as the

appropriate and suitable tools to mitigate disputes between home and host supervisory authorities.

13. The Commission also continues to monitor developments concerning the **free movement of capital** between Member States. The number of formal infringement cases has decreased also thanks to the EU Pilot procedure and other informal efforts to find amicable solutions. [4] Since the last report, three formal infringement cases have been closed and two have been opened, bringing the number of open cases to 11. The closure of the three cases resulted from satisfactory compliance with the Court of Justice of the European Union (CJEU) judgments. In addition, the CJEU dismissed the action brought by the Commission seeking to have financial penalties imposed on Germany in relation to the Volkswagen Law. The Commission is currently considering the implications of this judgement.

14. In the observed period, the Commission issued two Letters of Formal Notice on issues relating to foreign exchange loans in Hungary and resort homes in Austria. In addition, one Reasoned Opinion was sent to Bulgaria regarding mortgages imposed after privatisation. Following relevant rulings by the CJEU, the Commission is monitoring the process of amending the non-compliant provisions in three cases concerning Third Country Bilateral Investment Treaties as well as in the case on Polish pension funds.

15. In order to ensure their conformity with free movement of capital principles, the Commission is monitoring **special rights** and **screening mechanisms** to review incoming investments. In addition, the Commission follows the preparations by the Member States concerned for phasing out temporary restrictions on **investments in agricultural real-estate**, and stand ready to assist these Member States in this task so as to avoid potential infringement procedures later on.

16. **The EFC** welcomes the Commission's work on monitoring developments in the Single Market to detect potential restrictions on free movement of capital as early as possible and thus prevent fragmentation in the Single Market for capital.

17. There has been a significant policy shift in direct taxation during the 2012-2013 period. Previously, the Commission's focus has been on encouraging capital flows and investment, and removing inconsistencies, which distort the functioning of the Single Market. For the past year, the Commission's work has been aimed at protecting Member States' national tax bases

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[4] Please see Annex 1 of the Commission contribution to the 2013 EFC report for an overview of developments in the period 1993-2013.

against aggressive cross-border tax planning, which in some cases may lead to restrictions to the free movement of capital. Key measures of Commission's Action Plan to strengthen the **fight against tax fraud** and **tax evasion**, which have an impact on capital movements, include Recommendations on Aggressive Tax Planning (ATP) and Tax Havens, the Proposal for amending the EU Savings Directive (EUSD) together with a draft mandate to open negotiations with five third countries in order to modify their existing agreements with the EU, and the planned revision of the anti-abuse provisions in the Parent-Subsidiary, Mergers and Interest and Royalties Directives.

18. The Commission and Member States have made some progress on **Bilateral Investment Treaties between Member States (intra-EU BITs**). As already highlighted in previous reports, the Commission's opinion is that intra-EU BITs are incompatible with EU law and have recommended Member States to terminate them bilaterally. Nevertheless, to provide for a high level of protection to investments, some Member States insist on the necessity to set, within EU, an alternative mechanism of dispute settlement prior they terminate their BIT that contain provisions as to international arbitration. A few Member States have already started termination procedures and some of them have been successfully concluded. The number of investor-to-State arbitrations initiated against Member States on the basis of intra-EU BITs is nevertheless growing. In order to agree on a coordinated approach to the termination of intra-EU BITs and, at the same time, to consider how investment protection within the Single Market should be further improved, the Commission set up an informal Experts' Group of representatives of all interested Member States and conducted bilateral meetings with Member States and industry. Consultations with stakeholders recognized the need for an efficient dispute solving mechanism to resolve cross-border disputes and a mechanism for an out-of-court settlement of disputes between investors and States. As a result of discussions with stakeholders, a mechanism for an out-of-court settlement of disputes between investors and States, an **Investment Dispute Mediation,** has been identified as a proportionate, light touch solution. In cooperation with the Commission, the mechanism involves creating a **Network of Investment Contact Points** in all Member States. The network will monitor and analyse developments related to cross-border investments in Member States, exchange best practices and identify structural issues, which may hamper the free movement of capital and investment protection.

19. **The EFC welcomes** the work of the Commission in assisting Member States with the implementation of investment dispute mediation, and expects the Commission to submit appropriate initiatives to this effect as soon as possible.

20. The Commission has continued its **fight against money laundering and terrorist financing**. To this end the Commission adopted two proposals in early 2013, that reinforce the EU's rules on anti-money laundering and fund transfers, updating the EU 3rd Anti Money Laundering Directive and the Funds Transfers Regulation. In addition, significant progress has been made on the on-going efforts to develop information exchange between financial intelligence units.

21. Work on a European wide **market for payments** has continued. The Single Market for cards, internet and mobile payments nevertheless remains fragmented and inter-bank fees and costs for retailers persist to be disproportionally high. All this adds to slowing down the EU growth potential. In order to facilitate growth, the Commission has issued a new legislative package in 2013 which, among other objectives, aims to develop further an EU-wide market for electronic payments by capping fees of interchange fees for transactions.

MAIN DEVELOPMENTS WITHIN THE INTERNATIONAL SPHERE

22. In the context of **investment protection in bilateral agreements**, the Commission is working on a common international investment policy with a specific focus on investment protection. Negotiations on investment protection in the Free Trade Agreement (FTA), which were launched in 2012 with Canada, have been successfully concluded with a political agreement in October 2013, however, technical negotiations continue. In addition, the EU-Singapore FTA negotiations have been opened and talks on investment protection are still on-going, in order to complete a global and ambitious agreement. Negotiations with India are ongoing. Negotiations with Japan and the United States were launched in 2013. The Council recently adopted decisions authorising negotiations with China and ASEAN on investment protection to be opened.

23. In 2013 official **accession negotiations** were opened with Serbia with which the Stabilisation and Association Agreement entered into force on 1 September 2013. Other significant developments include the finalisation of an assessment on Montenegro's alignment with the *acquis*, and the suspension of accession negotiations with Iceland. Concerning

potential candidate countries, the Council adopted a decision on the opening of negotiations on the Stabilisation and Association Agreement with Kosovo.

24. On the **international fora**, the Commission participated as an observer in the meeting of the International Forum of Sovereign Wealth Funds, where the participants stressed that the completion of the Banking Union is crucial to the EU's recovery. In addition, IFSWF members called for resisting protectionist temptations and maintaining an open climate for capital flows.

25. There are over 30 **sanctions regimes** in place. Since the last report no sanction regime was terminated and several sanction regimes were extended. The most extensive sanctions regime in place is against Iran, which prohibits any kind of financial transactions between Iran and the EU. Following another nuclear test executed by the Democratic People's Republic of Korea, last February, both the EU and the UN have strengthened the existing sanctions.