EUROPEAN FILE

A European financial area: the liberalization of capital movements

COMMISSION
OF THE EUROPEAN
COMMUNITIES

June-July 1988
12/88

The liberalization of capital movements and of financial services is an indispensable element in the realization of the large European internal market. Such a market effectively implies the creation of a financial area without frontiers. Businesses and individuals in the Community should have access to efficient financial services; they should therefore be able to choose those services which appear to them to perform best, to be the most appropriate for their requirements, to be the most reliable and the least costly. In addition, they should be able to exercise their activities throughout the Community without having to fragment their financial dealings according to the country of operation and without the ruptures, restrictions, and direct or indirect barriers (such as those caused by exchange controls) which can be created by excessively disparate national regulations.

Why a European capital market?

When the Treaty of Rome was signed at the end of the 1950s, Europe was emerging from the period of post-war reconstruction, which was marked by weak interpenetration of financial markets and, often, external inconvertibility of currencies. Since that time, the development of financial dealings has made for international, even world, financial markets which were created by private initiative, frequently avoiding regulation and remarkable for their capacity to adapt swiftly. Among the reasons for such a development are:

- ☐ the multinationalization of trade flows and of firms themselves, which obliges financial establishments to strengthen their presence abroad;

- ☐ the desire of economic agents to provide against the risks of variations in exchange or interest rates and to manage available funds as well as possible, by using increasingly sophisticated financial instruments for reasonable anticipation of market developments and, sometimes, for speculation.

Instead of an integrated European capital market, a parallel 'Euromarket' has therefore developed, which profits from loopholes in an over-compartmentalized system and largely escapes national controls. This situation has rendered ineffectual a large number of the regulations that were adopted in different circumstances. It makes a particular paradox of the barriers to free movement of capital which still exist between the Community's different national markets. These barriers diminish the competitive capacity of European firms *vis-à-vis* their rivals on the other side of the Atlantic. In addition, among users of financial services, they particularly affect individuals and small and medium-sized enterprises, who have less resources to gain access to the international market.

There must be an end to this situation. Payments (reciprocal transactions in goods or services) have been liberalized for a long time; the process must be completed by the liberalization of capital movements (investments, loans, etc.) which involve the transfer of currencies from one Community country to another.

A proper Community capital market is not simply a 'gift to capitalists'. It is an objective in the public interest, a new chance for growth and employment in Europe. It will have a wide positive impact on the growth potential of the European Community:

- ☐ National financial systems will have to adapt to a more competitive environment; as a result, financial costs will be reduced and a process of modernization, specialization, and rationalization will develop, which will favour productivity and innovation. The European financial industry will thus be better able to face the growing international competition from the United States, Japan, etc.

- ☐ Disposable financial resources in the different Community member countries will be able to move more freely and more directly towards productive investments throughout the Community; this will encourage the optimal allocation of available resources.

- ☐ The trend towards the levelling and reduction of financial costs, brought on by increased competition, will reduce the distortions of competition and the financial charges which affect businesses. With the opening-up of financial markets, small and medium-sized enterprises which, unlike large enterprises, have little access to the international market, will be able to get credit and financing on more favourable conditions.

- ☐ Both savers and borrowers will benefit from a more diverse range of opportunities; it will be possible to eliminate niggling controls on cross-border movements of funds.

- ☐ National administrations will be encouraged to promote more convergent budgetary policies, due to the elimination of exchange controls and alternative possibilities for investment offered to the traditional purchasers of government bonds.

Achievements and projects

The Treaty of Rome, the 'constitution' of the European Community, provided from the beginning for the gradual liberalization of capital movements. Until recently, this was a far cry from reality: the only significant measures adopted dated from the 1960s. A Community directive classified capital movements under four categories, each subject to a different degree of liberalization. Because the Treaty of Rome provided safeguard clauses to allow exceptions to be made in the event of disturbances in the capital market or balance of payments difficulties, a series of Member States had to be authorized to maintain or reintroduce stricter exchange control measures than was intended. In the absence of new legislative progress, significant differences crept in between the Community Member States. Some States followed the world movement towards liberalization which developed in the 1960s; others went no further than the Community obligations, which remained very timid.

A new stage began in 1985 with the European Commission's White Paper on the completion of the internal market. As we know, the White Paper calls for the establishment of a large market without frontiers; this implies completely free movement of people, goods, services (particularly financial services), and captial between Community countries. In 1986, the Single European Act amending the Treaty of Rome was signed. It confirms these objectives and charges the Community with achieving them before the end of 1992. To this end, the Single Act improves the Community's decision-making mechanisms, by making more effective the participation of the European Parliament in the legislative process and by ensuring that the Council of Ministers can take a range of decisions by qualified majority rather than by unanimous agreement.

The establishment of an integrated financial area involves progress on several points:

- ☐ The strengthening of the European Monetary System.
- ☐ The harmonization of national supervisory structures to facilitate complete freedom for financial services.
- ☐ Measures to combat tax evasion.
- ☐ The implementation of the full liberalization of capital movements.

The view of the European Commission is that an integrated financial market cannot be achieved by the simultaneous implementation of all the necessary measures: it is the liberalization of capital movements which will create a dynamic process leading to integration.

The liberalization of capital movements should be carried out in two phases, the first of which has already been realized.

- ☐ In the first phase, efforts were made to achieve the liberalization of the capital operations most necessary for the proper functioning of the common market and for linking financial markets. To this end, exceptional arrangements approved for different Member States were gradually terminated and important amendments were made to the 1960 directive.

  Thus in 1986, a new European directive reduced from four to three the number of categories of capital movements. At the same time, the directive extended 'List A' which covers operations in the first category, the liberalization of which is unconditional. This list now includes, besides direct investments or investments in real estate made since 1960, all credits related to commercial transactions, the purchase of shares and bonds (even those not traded on a stock exchange), the admission of a company's securities to the capital market of another Community Member State, etc.

  In all such cases of unconditional liberalization, a Member State may still subject the operations to authorization procedures. Authorization must, however, be given automatically. In addition, these movements should benefit from an exchange rate as close as possible to the official currency rate. In countries such as Belgium where there is a dual foreign exchange market, one of which is not supported by official intervention, a separate rate may be applied to these capital movements only if it does not produce significant or lasting differences from the rate applied to current transactions.

There is also a List B, which sets out operations on which a Member State may maintain or re-introduce exchange restrictions for economic policy reasons. Finally, List C imposes no requirement on Member States other than that they inform the European Commission on provisions in force and endeavour to avoid any measure which would make such provisions more restrictive.

☐ The second phase of the liberalization of capital movements was the subject of three proposals submitted by the European Commission at the end of 1987: a proposal for a directive on the complete liberalization of capital movements; a proposal to amend the directive of 1972 on regulating international capital flows; a proposal for a regulation amending and combining Community instruments of medium-term assistance for the balance of payments.

The first proposal requires that an important step be taken in that it would provide total freedom of capital movements between people living in Community member countries and the establishment at European level of a truly integrated financial market. This proposal:

- is aimed at all capital operations and particularly at short-term operations, which are still subject to numerous restrictions even though their volume on the international markets is at least equal to that of medium and long-term assets;

- involves the elimination of every restriction, whether as regards the freedom to carry out a transaction or the applicable rate of exchange.

At the end of this second phase, the residents of each Community Member State will have free access to the financial systems of other Member States in order to conduct any operation involving investment, borrowing, lending, etc.

Such a complete liberalization of capital movements will not prohibit Member States from introducing declaration procedures for statistical purposes, nor from taking essential measures to foil breaches of laws and regulations, particularly as regards taxation. None the less, such measures may not have the effect of creating barriers to capital movements.

Under the proposals of the European Commission, limits could, however, be imposed on the free movement of capital in certain cases:

- *For prudential reasons.* Financial institutions administer funds entrusted to them by the public and it is important to ensure protection for savers. National monetary authorities should therefore be able to continue to fix certain rules with regard to indebtedness or investment, so as to require financial institutions to take full account of exchange risks and the various guarantees offered by the different types of investment. However, such measures may not legitimize discrimination on grounds of nationality and the limitation imposed on freedom of movement should be strictly in proportion to the objective.

- *For reasons of monetary policy.* National monetary authorities would retain the possibility of regulating the external position of credit establishments and of fixing specific reserve coefficients for their assets and external liabilities; such measures would be subject to Community supervision. In addition, with the agreement of the European Commission, Member States would be able to invoke a new safeguard clause when huge flows of short-term capital present a risk of seriously disrupting their monetary and exchange rate policy operations. The effect of the safeguard clause would in each case be limited to several months and would apply only to short-term operations which are not yet liberalized.

- *As a transitional measure, to take account of specific national circumstances.* For a variety of reasons, several Member States are still below the average level of financial and monetary integration already achieved by the Community. Extra time would be allowed before full liberalization is required of Spain, Ireland, Portugal and Greece, on the understanding that all countries would be on board by the end of 1992. From that date, Member States for whom freedom of capital movements continued to pose problems would have to rely on other instruments. We shall return to this point later.

As regards third countries, the second proposal from the European Commission provides for an amendment to the 1972 directive on the regulation of international capital flows. Under the terms of this proposal, Member States would endeavour to achieve the same degree of liberalization of capital movements for operations with countries outside the Community. However, they would equip themselves with the means for coordinated action which would allow them to discourage inopportune flows of short-term capital, particularly in cases where the European Monetary System would be subjected to violent external shocks.

Finally, the third proposal from the Commission aims to establish, in the framework of the European Monetary System, a single instrument to provide short-term financial assistance for the balance of payments of Member States. Such an instrument would combine the two current support mechanisms and broaden their scope. The Community would thus be in a better position to help Member States which had particular problems in fully participating in the liberalization of capital movements.

Progress which demands further progress

The liberalization of capital movements is not in itself sufficient to establish a true financial area at European level. It calls for complementary supporting arrangements in the areas of prudential harmonization, fiscal alignment and monetary cooperation. However, in the eyes of the Commission a global solution for these problems is not a precondition. The Commission has opted for a strategy which aims to create a dynamic process of integration and therefore accepts the risks of temporary disequilibrium which the strategy may provoke. In short, rather than relying on progress in other areas, the liberalization of capital movements should itself bring about such progress.

☐ *Towards improved protection for savers.* Increased competition between financial institutions must not lead to weaker protection for the users of financial services. This is why European harmonization of prudential rules and supervisory standards is necessary. In facilitating freedom for the provision of financial services throughout the whole of the Community, it should guarantee the solvency and stability of credit institutions and information and protection for savers. The approach proposed is a follows:

- Minimal, limited harmonization of the essential elements of prudential rules and standards: definition and minimal amount of own funds, solvency coefficients, supervision and control of major risks, conditions of access to financial activity, guarantee for depositors.

- Mutual recognition by Member States of the rules and techniques of control implemented by each of them, since they conform to jointly defined minimal principles.

- Control, by the country of origin of a financial institution, over all its activities, where such activities are carried out inside the Community, whether by cross-border provision of services or by the intermediary of a branch established in another member country.

☐ *Towards an approximation of taxation.* Measures should be taken to ensure that matters of taxation do not cause distortions liable to affect the functioning of the capital market.

- Tax provisions to encourage the purchase of domestic securities exist in many Community countries. The European Commission is proposing to open discussions on them and a gradual elimination of the discriminations and distortions which they create.

- Investment decisions are influenced too often by significant differences in company taxation. Some approximation of taxation is therefore necessary so that the liberalization of capital movements bears all the fruits expected of it for the optimal allocation of resources. The Commission intends to give a new impetus to this process of approximation, along the lines of the proposals which it submitted in 1975 on company taxation.

- Finally, the European Commission is considering two types of measures to reduce increased risks of tax evasion resulting from investors having greater ease in collecting income outside their country of residence. These are: a generalized withholding tax applied to all Community residents; an obligation on banks to disclose information about interest received by Community residents. In any case, greater cooperation between the tax authorities in Member States is indispensable.

□ *Towards a strengthening of monetary cooperation and the EMS.* The European Monetary System has won the first round by ensuring the joint achievement of a certain internal and external stability between Community countries participating in its exchange mechanism.[1] Such an achievement is valuable and must be preserved. However, it is not possible to hide the fact that the dismantling of controls on capital, besides having many advantages, also runs the risk of allowing markets to magnify the impact which external disturbances (particularly those created by the development of the dollar) or temporary differences between Member States' economic policies may have on exchange rates. The liberalization of capital movements therefore calls for increased coordination of economic policies and a strengthening of European monetary cooperation.

In 1987, the Governors of Central Banks in the Community decided to undertake several actions aimed at stregthening the European Monetary System (EMS). Essentially, the intention is to supervise more closely market developments, use all available intervention instruments more actively and more flexibly, and strengthen European cooperation on the financing of interventions made on the exchange rate market.

Further progress is necessary in this area:

- More determined coordination of economic and monetary policies, including the definition of exchange rate policies with regard to countries outside the Community.

- Full participation, on equal terms, of all Community Member States in the EMS exchange rate mechanism.

- The creation, in the not too distant future, of a European Central Bank to ensure a more solid foundation for the EMS and the ECU.

Fears are sometimes expressed that the liberalization of capital movements might be of greater benefit to the more developed Member States. It is therefore appropriate to recall that a European financial area is only a part, although an essential one, of the Community in the 1990s. In addition to the proposals already mentioned on certain transitory measures and the creation of a single instrument of medium-term financial assistance for balance of payments, the European Commission has other proposals, articulated in a wider context. These are aimed at strengthening the economic and social cohesion of the Community, particularly by reinforcing support

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[1] See *European File* No 15/86: 'The European Monetary System'.

for the development of the poorer regions. Taken as a whole, these provisions should vigorously help all Member States to benefit fully from the advantages of the liberalization of capital movements ■

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Office for Official Publications
of the European Communities
L - 2985 Luxembourg

ISSN 0379-3133

Catalogue number: CC-AD-88-012-EN-C

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