

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

PROGRAMME FOR THE LIBERALIZATION OF CAPITAL MOVEMENTS
IN THE COMMUNITY

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Introduction

The communication on Financial Integration which the Commission presented to the Council in April 1983(1) gave new impetus to Community discussions on the liberalization of capital movements. Today there are two essential reasons for placing this question among the Community's top priorities.

First, the Luxembourg Act makes new demands on the process of financial integration which has already begun. The Act clearly affirms the need for the large internal market to assume its full financial dimension, since the objective of free movement by 1992 also applies to capital and financial services.

Already, a considerable effort is in progress to remove the technical, administrative and legal obstacles to trade: the effort covers the harmonization of standards, the opening up of public procurement contracts, the ending of excessive controls at frontiers and the approximation of indirect taxation. It would be difficult to imagine that it should not extend to exchanges of capital.

The result will be the closer coordination of economic and monetary policies, which is important for the Community's integration. This will have to be accompanied by appropriate measures to bring levels of development as close together as possible and to reduce the structural differences between the Member States. Article 130(b) of the Single Act provides that the implementation of common policies and of the internal market shall take into account the objectives of cohesion. The proposals set out in this communication while ultimately beneficial for all, may create difficulties for some Member States. In such cases, it may be necessary to take additional measures, outside the scope of this communication, in order to help those Member States to participate fully in the creation of a genuine common market in financial services with full freedom of capital movement.

(1) COM(83) 207 final.

- Second, there is a close link between the development of the EMS and the free movement of capital: this link was established by the Commission in its communication to the Council of November 1984 on developing the European Monetary System(2). The EMS experience has played a decisive role in the evolving attitude of the Member States. The opinion which has prevailed is that the stability of exchange rate relationships must reflect and be nurtured by a genuine convergence of monetary policies and economic performances.

The purpose of this Communication is:

- to trace the logic behind the Commission's proposed approach and the major phases in that approach, so as to arrive at as liberal as possible a Community system of capital movements;
- to set out the resultant implications for the effective integration of the financial markets and for the coordination of the monetary and financial policies of the Member States.

I. The proposed approach for the liberalization of capital movements

A. The logic behind the liberalization of capital movements

1. Analysis and experience show that there are three degrees in the progressive liberalization of capital movements which, in simple terms, correspond to three categories of operations:

(2) COM(84) 678 final.

- capital operations - such as commercial credits, direct investments or various personal capital movements - which are directly linked to the effective exercise of the other fundamental freedoms of the common market (the freedom of trade in goods and services, the free movement of persons, the freedom of establishment);
- operations in financial market securities (bonds, shares and other securities of a participating nature), the liberalization of which determines the existence of a single European financial market; liberalization in this area has to cover the operations carried out by investors as well as those carried out by issuers;
- operations involving financial credits and operations relating to money market instruments, the liberalization of which is necessary for the establishment of a unified financial system in the Community.

2. As each threshold is crossed, growing constraints are imposed on the Member States in the conduct of their monetary policy.

The first group of operations requires merely that the inevitable consequences, in terms of balance of payments, be drawn from a system of freedom of establishment and the free movement of goods, services and persons. The liberalization of operations in securities also opens the possibility of choosing between the financial markets of the Member States and therefore places them in direct competition. The extension of liberalization to monetary transactions imposes not only a greater constraint in terms of the balance of payments, it also affects the organization and functioning of national banking and financial systems and the methods of controlling the external indebtedness of financial institutions and the external circulation of the national currency;

3. In the face of these constraints, the Member States are not in identical positions. Three factors determine their room for manoeuvre in settling potential conflicts between the internal and external objectives of their monetary policy:

- their level of development and the structural characteristics of their balance of payments, which determine the speed and ease with which the requisite adjustments can be made;
- the international status of their currency (its importance as a vehicle of trade and a reserve instrument) and of their exchange regulations (whether or not they participate in the EMS exchange rate mechanism);
- the level of development of their domestic financial system (size, liquidity, diversification of techniques, methods of regulation).

B. The main phases in the liberalization of capital movements

In this context, two phases could be involved in the process of continuing to liberalize capital movements.

1. In the first phase, the objective would be to achieve the unconditional and effective liberalization throughout the Community of the capital operations most directly necessary for the proper functioning of the common market and for the linkage of national markets in financial securities.

Two types of measure are required for the attainment of this objective:

(a) the ending of exceptional arrangements

- certain of these exceptional arrangements derive from the application of the safeguard clause provided for in Article 108(3) of the EEC Treaty and is within the Commission's field of competence. The Decisions relating to France, Ireland and Italy were revised, and made stricter, in December 1984. A target date was fixed for the expiry of the Decisions (the end of 1986 for France, the end of 1987 for Ireland and Italy). Similarly in November 1985 Greece was authorized to maintain certain restrictions on capital movements normally liberalized under Community law, but only for a period of three years.

Also, the revised Decisions referred to the need for restrictions to be gradually relaxed before the expiry date, in line with the results achieved in the recovery of the balance of payments. This partial progress is to be consolidated at regular intervals by the modification of the original authorizations.

- Other exceptional arrangements were introduced on a temporary basis by the Treaty of Accession of Spain (until the end of 1990) and Portugal (until the end of 1992). Here too, and chiefly in order to avoid the difficulty of bringing all the authorized restrictions to an end at once, on the expiry date, the Commission will ensure that every opportunity for partial liberalization is taken.

(b) An extension of Community obligations as regards liberalization

As a result of the discussions held on this question in the Monetary Committee, two main guidelines have been identified.

First, the legislative progress in view, which will not assume its full significance unless it is applied by all the Member States, must not make it more difficult to dismantle the existing exceptional arrangements. It is logical for these exceptional arrangements to apply, initially, to the new liberalization obligations, insofar as they relate to the same type of operations or present an equivalent risk to the balance of payments. (For example, could a Member State be compelled to liberalize transactions in securities not dealt in on a stock exchange if restrictions on operations in listed securities were still authorized?).

Secondly, the extension of Community obligations must mean that all the capital operations involved in the free movements of goods, services and persons or which are the very basis of a financial market can be reclassified within the rules of unconditional liberalization. On the basis of these criteria, the Commission is preparing a proposal for a Directive, which it intends to present shortly to the Council, and which would make the following additions to the Community's liberalization rules of 1960-62:

- (1) The obligation of unconditional liberalization applying to the operations in Lists A and B of the present Directives(1) would be extended to:

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- (1) Lists A and B cover direct investments, personal capital movements, short and medium-term credits related to commercial transactions or to provision of services in which a resident is participating, transfers in performance of insurance contracts, and the acquisition of securities dealt in on a stock exchange. Liberalization of these operations is unconditional and may be suspended only by the implementation of the safeguard clauses provided for in Articles 73, 108 and 109 of the Treaty.

The capital movements contained in List C (in particular the issue of securities, the acquisition of securities not dealt in on a stock exchange and financial credits) are subject only to conditional liberalization, in that a Member State may maintain or reintroduce restrictions on these operations provided that they were operative on the date of entry into force of the Directive or on the date of accession, when such free movement of capital might form an obstacle to the achievement of the economic policy objectives of that Member State.

For the other operations - chiefly short-term capital movements (securities dealt in on the money market, the opening and placing of funds on current or deposit accounts, etc.) - the Member States can choose whether or not to impose restrictions.

- long-term commercial credits;
 - the acquisition of financial market securities, whether or not they are dealt in on a stock exchange;
 - the admission of securities to the capital market (introduction on a stock exchange, issue or placing). On this point, the Commission had first envisaged that, in the initial stage, the liberalization obligation would be restricted to the admission of certain categories of securities only: shares, units of undertakings for collective investment subject to Community coordination rules, and bonds issued by Community institutions. But it felt that liberalization which immediately covered the admission of all bonds (except the public securities referred to in Article 68(3) of the Treaty) would be closer to the objective of achieving the close linkage of national financial markets, and would avoid giving preferential treatment to certain categories of issuers, as recommended by the Monetary Committee.
- ii) It would also be proposed that, for all liberalized capital movements (Lists A and B), uniform conditions would be laid down for the functioning of any dual exchange market which might exist, by aligning these conditions on the most binding provisions of Article 1 (List A operations) of the present Directive. As a result, Lists A and B of this Directive could be merged.

2. In a second phase, the realization of a large internal market, in full possession of its financial dimension, means that a decisive step must be taken towards the total freedom of capital movements.

- (a) In the White Paper, "Completing the internal market", the Commission stressed the need to achieve the liberalization of financial services in the Community by 1992 at the latest. The attainment of this objective, and more generally the logic of a European financial system without internal frontiers, inevitably leads to the ending of all restrictions on capital movements. The free movement of capital will therefore have to extend to operations which, under Community law, would still remain excluded, i.e. financial loans in both domestic and foreign currencies, money market operations, deposits and balances on current account. Such liberalization is necessary if the financial intermediaries are to compete fully on the European market and derive full advantage from the freedom to provide services which they will be offered. Complete exchange liberalization will make it possible to do away with control procedures for the purposes of verification which have to be maintained, even on liberalized operations, so long as restrictions continue to exist.
- (b) The question which arises is whether all the Member States are capable of moving towards this objective at the same speed of the complete freedom of capital movements. This question is especially relevant since, as indicated above, a link has been established between the liberalization of capital movements and the development of the EMS in which not all the Member States fully participate. Moreover, the Luxembourg Act provides for the possibility of special arrangements for the most vulnerable Member States in the realization of a large internal market.

In any event, any differentiation to be made between the Member States in the liberalization process should not be introduced below a uniform level of Community obligations as previously defined (point B.1 above). Also through its instruments for supporting balances of payments, the Community must be able to offer Member States which are faced with special constraints the means of overcoming these difficulties so as to enable them to take part in the full process of the liberalization of capital.

(c) Consequently, the approach required for completing the process of liberalization without doubt differs from the one followed up to this stage and based on the progressive transfer of certain categories of operations to a system of unconditional liberation (save where recourse is had to the safeguard clauses of Articles 108, 109 or 73 of the Treaty).

i) For operations involving financial loans and credits, monetary operations or deposits, the liberalization rules should be more flexible and better suited to their nature. One possibility would be to provide, for this category of transactions, a specific safeguard clause which was less binding than the one in Article 108 of the Treaty⁽¹⁾. A safeguard clause of this kind, incorporated in the basic Directive, could be activated by the Commission, after consulting the Monetary Committee, if the corresponding movements of capital lead to disturbances in the conduct of the monetary policy of a Member State and are liable to harm the stability of

(1) Article 108 applies to situations in which a Member State is in difficulties or seriously threatened with difficulties as regards its balance of payments. Under this Article, the Commission may grant protective measures only on completion of a prior procedure consisting of : (i) examination by the Commission of the position of the Member State and the sending of a recommendation; (ii) the adoption of a position by the Council on the possible granting of mutual assistance. The scope of the protective measures is not confined solely to capital movements, but may concern any other Community obligation.

exchange rates in the Community. The derogations authorized would be the subject of a periodic examination within the Monetary Committee.

Consequently, the instruments provided for by the 1972 Directive on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity could be put into operation between the Member States only pursuant to this safeguard clause.

ii) This important step towards the full liberalization of capital movements should logically be accompanied by:

- ending the possibility of resorting to a dual market, save by invoking a safeguard clause;
- a tighter formulation of the obligations applying to unconditionally liberalized operations: such obligations would have to cover not only the lifting of exchange restrictions and measures having equivalent effect which do not directly derive from the exchange control regulations, but also all other types of discrimination, taken for reasons of domestic control (in particular tax treatment or placement rules imposed on institutional investors).

iii) In the light of experience and of the development of financial techniques, the revision of the rules governing the liberalization of capital movements should be seized as an occasion for clarifying and bringing up to date certain definitions and provisions which are over 25 years old. This would mean taking account of the new techniques which have emerged, for example, in the field of transactions in

securities or with regard to lending instruments; or clarifying the content of certain headings, e.g. those relating to blocked funds or to transfers of assets by migrants.

On the basis of these guidelines, the Commission intends to prepare a new Directive which could be presented to the Council in the first half of 1987.

II. The other implications of financial integration

A high degree of liberalization of capital movements is a necessary but not sufficient condition for the Community's genuine financial integration. It is therefore important for liberalization to be paralleled by provisions designed to ensure the cohesion and identity of this financial area. Also, a truly integrated financial market is bound to have consequences for the conduct by the Member States of their monetary policies.

The Commission intends to embark immediately on a forward-looking analysis of these questions. Only the broad lines of this analysis are presented here.

A. The cohesion of the European financial area

1. The objective goes beyond the establishment of a financial free trade area in Europe; it is the establishment of a Community-wide integrated financial system. The intensification of intra-Community financial relations, favoured by the lifting of restrictions, will naturally derive support from the progress already made and to be continued in commercial integration and the convergence of economic and monetary policies. It will have

to be accompanied by parallel progress towards the creation of a common market in financial services. The objective is to establish fair conditions of competition which will favour the development of a diversified range of high quality financial instruments and to enable users to exercise their activities throughout the territory of the Community without having to fragment their financial relationships.

2. The integration of the European financial area must therefore be preceded by some standardization in the Community of the laws or administrative provisions governing access to financial activities and the exercise thereof.

The main guidelines adopted in this area were described in the White Paper, completing the internal market(1). The Luxembourg Act offers additional legal means of advancing along this road.

- Harmonization must as a priority concentrate on the establishment of a minimal basis of common rules for the protection of the users of financial services and the supervision, by the country of origin, of the suppliers of these services. This harmonized system of prudential rules would guarantee the quality of the financial services offered in the Community.

- It would also be necessary to establish rules for the mutual recognition of financial techniques rather than to carry out standardization of an administrative nature, which would damage this sector's innovative capacity.

- Lastly, the liberalization of financial services within the Community implies the establishment of common rules applying to third country suppliers.

Also, as the Monetary Committee has noted, the development of the use of the ECU as a vehicle for trade could play a useful role in unifying this market.

(1) COM(85) 310 final of 14 June 1985.

The forward-looking analysis which the Commission intends to make would inter alia have as its object to identify the obstacles to the creation of a homogeneous network of financial services, and in particular the structural difficulties characteristic of certain countries; it would define its links with the liberalization of capital movements and evaluate its economic significance.

3. Apart from its function of mobilizing and allocating savings in the Community, an integrated financial system must permit the establishment of an effective network of payments between the residents of the various Member States for the performance of all current transactions.

The complete liberalization of capital movements will do away with the indirect barriers which may result from national provisions relating to exchange control (e.g. rules governing forward cover for import and export operations), the organization of the foreign exchange market (e.g. the use of multiple exchange rates) or rules on methods of payment (restrictions on the free choice of method of settlement).

In the communication of November 1984 on developing the EMS, the Commission indicated a need for enhanced surveillance, by the Community, of the external payments systems of the Member States. The achievement of an integrated market by 1992 reinforces this need so long as the process of liberalizing capital movements has not reached completion. This would mean, for example, defining at Community level, in a legal form to be agreed, certain rules of conduct with the aim of prohibiting certain practices of a restrictive nature, unless a derogation were granted by common accord.

B. The conduct of monetary policies

1. Substantial progress towards the full convertibility of the European currencies, while respecting the exchange rate disciplines of the EMS, will inevitably create new conditions for the management of the System.

At the present time, there are two classes of participant in the EMS exchange rate mechanism. Five Member States operate a liberal system, or one which at least complies with existing Community obligations in respect of movements of capital. In this first group of countries one currency performs a guiding role on the monetary policy of the other Member States, which are smaller in economic dimension and, for the most part, are extremely open to the outside world. By contrast, the other three participating Member States maintain a relatively strict system of exchange controls and one of them benefits from a wider margin of fluctuation for its currency. In this mixed situation, the system has been managed satisfactorily in terms of the objectives pursued of stability and convergence, and the progress made in these areas opens the way to the greater liberalization of financial flows.

A system broadened to include other participants and in which the principle of the free movement of capital would become the rule would inevitably be far more sensitive, from the point of view of the variability of interest and/or exchange rates, to cyclical lags and to the expectations of economic groups. It would therefore require a substantial reinforcement of

convergence but also of the effective coordination of the monetary policies of the Member States. In its turn, this closer coordination will increase the dynamism of economic policies and increase confidence and investment throughout the Community.

2. The pace at which coordination can be reinforced and the procedures for achieving it will have to be determined in the light of experience and it would be largely artificial to wish to specify all the details in advance. Especially since the chief requirement, as the Commission stressed in its Communication to the Council of November 1984, would be to make full use of the coordination system which exists, by a more explicit affirmation of the objectives pursued and a stricter application of existing procedures. In other words, coordination should be brought in at a fairly early stage in the definition of the monetary policies of the Member States, in order to prevent divergences rather than to aim for a correction, however rapid, of the imbalances.

As for the management of monetary policy instruments, account will have to be taken of the fact that a higher degree of liberalization of capital will make management by interest rates and the removal of barriers between domestic sources of financing inevitable in the long run, and this will lead to greater uniformity within the Community of the techniques of monetary control.

3. The reinforcement of coordination will raise similar questions with regard to the Community's external monetary relations.

In the first place, closer coordination of the monetary policies of the Member States will contribute, at international level, to the stabilization of exchange rates between the major currencies.

Also, Article 70 of the Treaty gives the Community the legal means for the progressive coordination of the exchange policies of Member States in respect of the movement of capital between those States and third countries. Clearly there can be no question of establishing a Community system of exchange control between it and other countries. The principle, adopted by the Monetary Committee, must remain that of liberalization "erga omnes". However, it would be appropriate to update in good time the 1972 Directive on regulating international capital flows, notably in order to limit the use of the instruments provided for therein solely to relations with third countries and to coordinate their implementation.

III. Timetable for the Commission's forthcoming initiatives

- In view of the easing of exchange controls which has taken place in France and Italy, the Commission will without delay repeal the Decision taken pursuant to Article 108(3) of the Treaty relating to France - this Decision being no longer applicable - and will revise the Decision relating to Italy, so as to reduce its scope solely to the protective measures which remain in force; the period for which the Decision is valid will not be changed.

- Taking account of the discussions which will have taken place within the specialized Committees, the Commission will present, early in the summer of 1986, a proposal for a Directive extending Community obligations as regards unconditional liberalization to long-term commercial credits, transactions in securities not dealt in on a stock exchange and operations for the admission of securities to the capital markets, and introducing uniform conditions for the functioning of a dual market.

- In close collaboration with the Committee of Governors and the Monetary Committee, the Commission will initiate a forward study on the implications of financial integration for monetary cooperation and on the liberalization of financial services, and more generally on the inter-relationships necessary between the different aspects of the internal market (including the approximation of tax systems). The results of this study will as soon as possible be the subject of a communication to the Council.

- On the basis of this study and the guidelines which will be adopted by the Council and the specialized Committees consulted for this purpose, the Commission will prepare a new proposal for a Directive establishing the principle of extending the liberalization obligation to all movements of capital. The text of this proposal could be presented to the Council in the first half of 1987.