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The Need for a New Policy Approach to European Capital Flows

The ruptured geopolitical world has accentuated the urgency for Europe to strengthen its economy through productivity-enhancing investment, including in new technologies and defence. The roadmap is laid out in the Draghi and Letta reports, but additional new aspects have been added because of US President Trump's threats. Europe's roughly €300 billion annual savings surplus needs to be actively incentivised, through taxation and regulation, to be invested in Europe rather than abroad. In addition, the stock of European investments in the US, particularly in US sovereign debt, should no longer be treated as risk-free capital.

The world has changed into a chaotic geopolitical landscape following the US' abandonment of its leadership of the world's liberal democracies. As this shift came so soon after Russia turned to large-scale military aggression, and as China continues to push ahead with its strategy of global dominance in key strategic sectors, Europe has been impacted more than any other major economy.

To complicate matters further, the new and increasingly hostile external environment coincides with the rise of nationalist, far-right political forces within most European countries. As a result, European liberal democracy – the very foundation of Europe's exceptional living standards – has become vulnerable. But it is within Europe's capability to create sufficient sovereign autonomy to defend the European way of life.

It cannot be known how long this new geopolitical regime will last, or what governing principles will come next, but a return to anything resembling the past seems unlikely. Waiting it out until normality returns is therefore not a realistic option for Europe.

This paper first summarises the four characteristics of the new world facing Europe. It then focuses on one specific aspect of the widely accepted policy prescriptions laid

out in the Draghi (2024) and Letta (2024) reports, namely the mobilisation of Europe's savings and the need to facilitate a more efficient allocation of them across the willing members of the EU.

Four key characteristics of the new geopolitical environment

The changes now rolling through the geopolitical landscape have been in the making for at least 15 years, but they have accelerated dramatically since Donald Trump's return to power in the US in January 2025.

The wave of economic liberalisation throughout the OECD area in the early 1980s, along with the fruits of Chinese Premier Deng Xiaoping's reforms in China, delivered immense growth in living standards to much of the world. By the end of the decade, the fall of the Berlin Wall, followed by the disintegration of the Soviet Union and its empire, brought in a period of near-complete globalisation and the "end of history" narrative, as coined by Francis Fukuyama (1989).

In addition to these geopolitical changes, the mid- to late-1990s ushered in the internet revolution, the World Wide Web and graphical browsers, which delivered previously unknown reach and speed of global connectivity for information, investment, trade and personal mobility to the benefit of a very large share of the global population.

However, the benefits were not shared adequately in most democracies. As illustrated by Lakner and Milanovic's (2015) so-called elephant chart, the less well-off in high-income countries gained relatively little, if measured in per capita income, while the poorest groups of the global population, particularly in China and other countries (mostly in Asia), as well as higher-educated groups in professional jobs in the US and Europe, gained the most.

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The global financial crisis in 2007-08 marked a turning point. For a couple of years during and immediately following the crisis, China delivered no less than two-thirds to three-quarters of global growth, justifiably raising the Chinese leadership's confidence in its economic model, while denting the standing of the "globalisation elite" in the US and Europe. Europe then descended into its own sovereign debt crisis, as the global shock exposed the insufficient construction of the euro system – a crisis which rolled straight into the refugee crisis of 2015 (itself largely a result of US interventions in the Middle East). The ground had now been fertilised for nationalist and extremist political forces across Europe and the US.

In 2016, Donald Trump was elected president in the US on an anti-establishment, anti-immigration platform, and the UK voted to leave the EU on the back of a populist narrative around anti-immigration and the supposed undesirability of sharing decision-making with the rest of Europe. The year after, Marine le Pen made it into the second round of the French presidential election – a feat she repeated in 2022, just months after Russia had launched its full-scale military attack on Ukraine, an event that led the US and Europe to weaponise their dominance of global finance.

In late 2024, the US voted with a measurable majority to return Donald Trump to the presidency on a turbo-charged "America First" agenda that claimed that basically every other country in the world was taking advantage of the US. By spring 2025, Trump hiked tariffs on most US imports, and by early 2026, the US had kidnapped Venezuelan President Maduro and his wife to stand trial in a US court and had made an explicit demand, under the threat of a military intervention, to bring Greenland – a NATO ally – under US rule.

Thus, within the past four years, the geopolitical world has changed in at least four key aspects:

- Russia cemented its role as a military predator occasionally threatening the use of nuclear weapons.
- The US, supported by Europe, has weaponised the dollar's global reserve currency status and its financial system.
- Decades of gradual liberalisation of global trade and the movement of labour have been reversed with the sharp increase in tariffs and new restrictions of the cross-border movement of people.
- With President Trump's extensive linkages of security and economic policies, US Treasuries can no longer

be considered risk-free for non-US residents. Political risks have therefore emerged also for US financial markets more broadly.

How to source and distribute the funds for additional private investment in Europe

Facing this new world, it is important to appreciate that Europe starts from a better position than generally perceived, and in some ways better than the US.

Measured in nominal common-currency terms, Europe's GDP has grown considerably slower than that of the US during the past 10-15 years. The difference, however, can be accounted for almost entirely by three factors. First, the appreciation of the dollar against the euro from about 1.40 in 2010 (still close to the OECD's estimate of long-term equilibrium) to 1.17 today. Second, slower population growth (3% in the eurozone vs 11% in the US). Third, the fact that Europeans worked, on average, 5% fewer hours per year during this period, while the US population made no material changes to its average work hours. As a result, productivity per hour worked, compared in PPP terms, has not been materially different between the US and Europe.

Moreover, after the COVID-19 pandemic, the difference between European and US GDP performance was further exaggerated by the 2022-23 commodity price shock, which caused a terms-of-trade loss in Europe of about 7%, while delivering 8% terms-of-trade gains to the US, as well as by the vastly different directions in fiscal stimulus.

Large US fiscal deficits in recent years have contributed to a staggering increase in US public sector debt, to about 120% of GDP, almost as high as the most indebted European countries, such as Italy and France. But because of the much lower tax take as a share of GDP in the US, almost 20% of all US federal revenue must now be allocated to interest payments, a share that is almost double the share in Italy and some four times higher than in France. The fiscal burden of the US debt and the political pressure that comes with it are therefore magnitudes greater than anywhere in Europe.

In addition, the negative US Net International Investment Positions (NIIP) has increased to about 85% of GDP, while the major European economies' positive NIIP position increased slightly. Meanwhile, virtually all indicators for quality of life, including life expectancy and infant mortality, have improved further in Europe, whereas they have deteriorated in the US.

Finally, as the rule-of-law-guided key governing institutions in the US and their independence are coming under

attack, Europe stands out as the only major economy still working with truly independent central banks, departments of justice, courts and other institutions.

Europe's investment challenge

All that being said, the geopolitical changes have exposed Europe's excessive reliance not only on US financial markets, but also on US security and technology. This leaves Europe facing major challenges.

The Draghi (2024) and Letta (2024) reports provide an excellent and widely accepted roadmap for European policy reforms. This includes the need for €800 billion in additional annual investment to close the estimated productivity gap between Europe and the US (although that gap is almost certainly overestimated in the Draghi report, as argued above).

Of Draghi's estimated €800 billion in additional investment, roughly €650 billion would have to be in the private sector. To be sure, even if that number were to be "only" e.g. €300-€400 billion per year, it would still need specific policies to attract the additional capital and more integrated and efficient capital markets to help distribute it efficiently.

The prevailing assumption in the Draghi report is that once European domestic demand is boosted (via the public-sector component of the investment drive and higher spending on defence, as well as via deregulation for the private sector and the introduction of a proper capital markets union), capital will flow naturally to meet the increased demand. This will include existing – presently mostly passive – savings in Europe sitting in, for example, bank deposits, as well as from parts of the roughly €300 billion annual savings surplus (the current account surplus) which is now financing investments abroad, rather than in Europe (Draghi, 2024).

That greater demand for productive investment will attract capital is, of course, a reasonable assumption, but the reports stay mostly quiet on the implications for monetary conditions. All else being equal, a measurable increase in demand for capital to finance the additional investment will drive yields higher – and thereby tighten monetary conditions – in order to attract the capital.

Proactive policies should, therefore, be introduced to incentivise directly the European savings surplus, at present invested abroad, to be redirected to finance European investment.

When designing policies to this effect, it is important to incorporate the new key characteristics of the geopolitical landscape. These include the reversal in the liberalisation

trend of virtually all types of cross-border flows, including for goods, services and labour, with the noteworthy exception of capital, which has seen no such reversal. It also includes a US administration newly hostile to Europe that has deepened the linkages between commercial and security policies, introducing a new risk to financial exposure to the US.

Eurozone governments therefore need to consider the safety of their residents' €12.4 trillion (80% of GDP) assets currently invested in the US, roughly half of which are in portfolio investment (European Central Bank, 2025). This includes the holdings of banks, pension funds and insurance companies seeking supposedly risk-free assets at a higher yield. Under present policies, this exposure is growing continually. Eurozone financial firms buy net €50-€100 billion of US treasuries per year, and in one of the most bizarre agreements ever struck, last year EU Commission President von der Leyen pledged a further US \$600 billion in European investment in the US during the next two to three years.

Such flows are not consistent with the Draghi report's call for the mobilisation of Europe's savings surplus for European investment – and they would not align with the new reality of safe versus less safe asset allocations.

At the most fundamental level, European regulation should be changed to acknowledge that securities issued by European sovereigns are safer – for European financial institutions – than anything else. Ultimately, the sovereign is the sovereign – the authority that sets and enforces the rules across society. Only in emerging markets can the credibility of the sovereign be seen as inferior to that of a foreign sovereign.

Concretely, Europe should change its financial sector regulatory regime in acknowledgement of the fact that the world – and with it relative creditworthiness – has changed. For European banks, the leverage ratio should be reformed to treat European government bonds as preferred assets relative to non-European sovereigns (which, incidentally, would be no different from what US Treasury Secretary Scott Bessent is reported to be contemplating for the treatment of US Treasury debt on the balance sheets of US banks).

For other financial institutions, including pension funds and insurance companies, the regulatory treatment of balance sheets should also be updated to reflect the new world order. Specifically, the principles-based approach to pension fund balance sheets, as well as national rules, need to be adjusted to recognise the greater risk – by definition – of anything outside Europe that was previously

considered safe. Similarly, the solvency capital requirements for insurance companies need to reflect the fact that previously risk-free, or low-risk assets, including in the US, are now more risky, relative to European risk-free assets.

In addition to such adjustments to the regulatory regimes and guidelines, a more active use of taxation incentives should be considered. Differentiating tax rates for yields and/or capital gains for fixed income securities has long been part of the toolbox to encourage investors to favour certain, typically domestic, assets. The US tax code included an interest equalisation tax between 1964 and 1974 to discourage capital outflows; and still today, US state and municipal bonds are generally exempt from federal taxation. In Europe, several countries also offer preferential tax treatment to their national retail sector for sovereign bonds.

Hence, using the tax code to encourage and discourage certain behaviour in the private sector's asset allocation has precedent. There are many arguments for introducing a differentiated tax on yields and dividends of domestic vs foreign assets, possibly constructed to be revenue neutral. If all 27 EU member states were to sign up to such changes, the tax could be designed as a direct revenue stream to the EU. More realistically, however, such policies would be agreed only among a smaller group of the willing. The tax would then be national – but coordinated among the participants.

Once a sizable part of Europe's capital export has been incentivised – via the suggested carrots and sticks – to be invested in Europe instead of abroad, there would be need for a full-fledged savings and investment union to allocate the capital as efficiently as possible.

The two key components would be the introduction of a 28th regime for EU-wide legal and regulatory matters, as well as a coordinated shift in regulation and taxation for financial assets to incentivise equity over debt financing.

Most of all, Europe needs a common capital market in which risk-willing capital can be allocated efficiently to finance not only startups, but also next-generation financing to build scale. These requirements are well laid out in the Draghi (2024) and Letta (2024) reports.

Yet, before the additional capital can be allocated in Europe, asset allocators need to be incentivised to invest it in Europe rather than abroad. Such incentives should be designed both to boost capital available to meet Europe's investment needs, but also in recognition of the changed risk profiles for global assets.

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