The shift in global investment

Assessing increased capital flows to the US

→ Higher US interest rates are playing a role in attracting capital flows to the US vis-à-vis the EU in the short-term; however, the US's strong innovation ecosystem and Europe's structural productivity challenges are set to reinforce this trend in the long-term.

→ To remain competitive in the global financial system, Europe needs to boost productivity and innovation by undertaking reforms, completing the capital markets union, and increasing investment; however, under current fiscal constraints and an unstable geopolitical context, these measures may prove difficult to achieve.

The shifting investment landscape

While the US's share of global GDP is about twice the size of the euro area's, it has attracted three times as much in capital inflows since late 2019

With investors pursuing opportunities for long-term growth and higher returns, capital allocations are increasingly gravitating to the US over Europe, compounded by the pull of higher US interest rates. However, over a longer horizon, US outperformance in attracting capital is largely based on the US's higher potential growth and better productivity record. Sovereign wealth funds, institutional investors, and corporations have taken note, and have adjusted their portfolios accordingly. Indeed, while the US's share of global GDP is about twice the size of the euro area's, it has attracted three times as much in capital inflows since late 2019.[1]

That said, there has been an uptick in interest in European stock markets in the first few months of 2025, which has supported stronger European equity asset performance as investors have become increasingly concerned with US policy uncertainty, possible stagflation, and elevated US valuations.[2]

Monetary policy divergence is a key near-term factor

US interest rates have exceeded euro area interest rates by a notable margin since 2022

US interest rates have exceeded euro area interest rates by a notable margin since 2022. Much of this divergence can be explained by the higher peak in the US monetary policy response following the pandemic-era inflationary surge and more persistent core inflation. Since late 2024, the Federal Reserve has pursued a cautious approach to easing, with markets expecting ongoing inflationary pressures against a backdrop of possible tariffs. While the US – euro zone interest rate differential has lessened since its peak, in recent months it has widened.

Structural productivity trends over the long-term
Structural productivity trends are driving capital allocations over the long-term with the US's productivity advantage over Europe predating the pandemic. Accordingly, from 2019 to 2024 the US's advantage was reinforced as labour productivity per person grew almost 9 percent in the United States but stagnated in the euro area.[3]

The US's greater capacity to fashion and harness leading technologies (*e.g.,* artificial intelligence, semiconductors, digital services, biotech, *etc.*) to boost business innovation is one of the principal drivers of US productivity outperformance.[4] For example, in the 25 years to 2019, the US's IT sector contributed around 20 percent to total hourly labour productivity growth compared to just 12 percent in the euro area.[5]

A vibrant innovation ecosystem with strong performance in emerging technologies, deeper capital markets, and a younger, more dynamic labour market have historically underpinned the US's advantage

Deeper and more diversified US capital markets also facilitate better risk sharing, especially through greater access to equity financing.[6] As a result smaller US firms enjoy easier access to capital, and can scale up more rapidly, driving more intense competition and innovation.[7] While European firms tend to rely more on debt, especially bank financing, the higher degree of equity funding in the US diversifies risk in a manner that allows firms to take on riskier ventures with higher expected payoffs.[8]

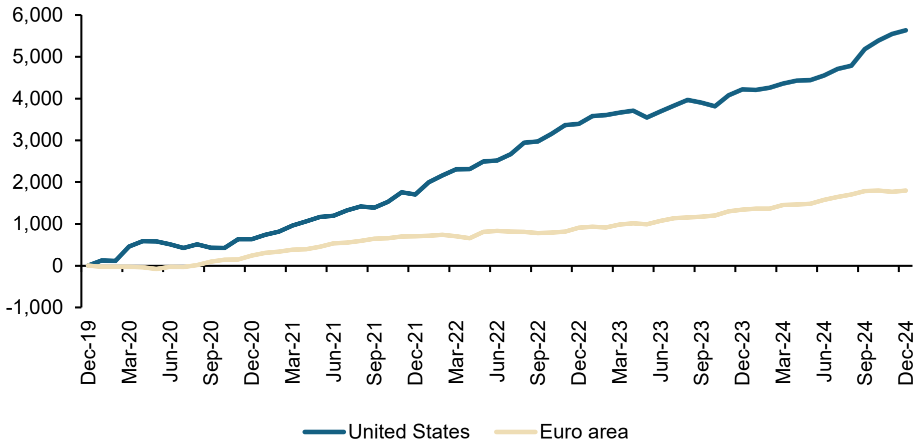
Europe's rigid labor markets have contributed to a weaker productivity record. For example, in Europe it tends to be more difficult to hire, fire, and allocate hours.[9] In the US such rigidities are lower, facilitating less costly and more rapid reallocation of workers into growing and more productive sectors.[10] Furthermore, Europe's older and slower growing labor force is associated with fewer new or younger firms, less innovation and adoption of new technology, and lower productivity gains.[11]

Completing the capital markets union is crucial for accelerating financial integration, increasing depth, and better facilitating cross-border capital flows. Doing so will also improve the attractiveness of the continent's assets for long-term investment, tapping into investor desire for diversification.

By addressing productivity gaps and simplifying regulations, Europe has the chance to remain competitive in the global financial system. With rising protectionism and an increasingly unfriendly external environment Europe must address its long-standing productivity challenges by committing to reform, completing the capital markets union, and investing in innovation. While critical next steps, the currently divisive political climate, together with fiscal constraints, will make taking already difficult measures even more challenging and at the same time more necessary.

By addressing productivity gaps and simplifying regulations, Europe has the chance to remain competitive in the global financial system

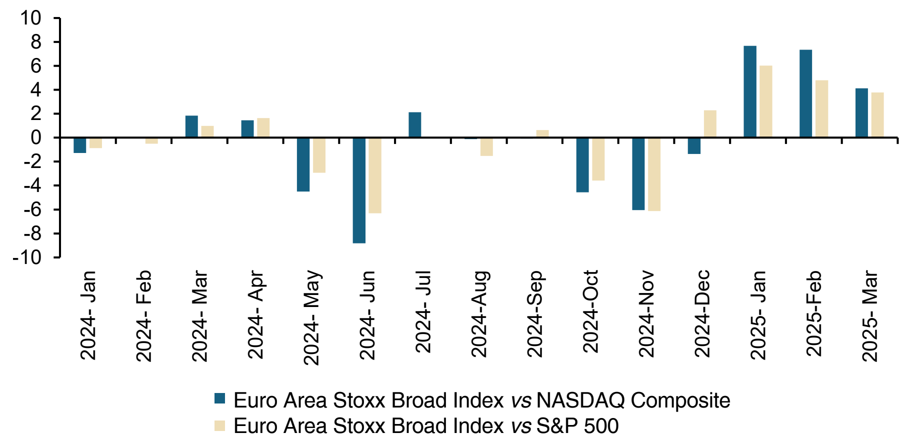
EXHIBIT 1.0 – CAPITAL FLOWS: UNITED STATES AND EURO AREA ($US, BILLIONS)



Note: Exhibit shows the accumulated stock of United States Net Treasury International Capital Flows ($US, Billion) and of Euro Area Capital Flows (converted to $US, Billions using average monthly exchange rates) since December 2019.

Sources: Investing.com via the U.S. Department of the Treasury; Trading Economies via the European Central Bank; and European Central Bank.

EXHIBIT 2.0 – OUTPERFORMANCE OF EURO AREA EQUITY INDICES OVER MAJOR US INDICES IN 2025



Note: Exhibit shows the month over month growth differential between the Euro area STOXX Broad index and the US NASDAQ Composite and US S&P 500.

Sources: WSJ, STOXX,Yahoo Finance.

Notes

1 GDP is measured in current, billions of U.S. dollars, using IMF estimates for 2025.

2 https://www.cnbc.com/2025/02/19/europe-stocks-are-outperforming-the-us-this-year.html

3 https://www.ecb.europa.eu/press/economic-bulletin/focus/2024/html/ecb.ebbox202406_01~9c8418b554.en.html#:~:text=In%20the%20same%20period%20the,–%20or%200.8%25%20a%20year.

4 https://www.aeaweb.org/articles?id=10.1257/jep.22.1.25; https://www.hoover.org/research/romer-or-ricardo

5 https://www.ecb.europa.eu/press/economic-bulletin/focus/2024/html/ecb.ebbox202406_01~9c8418b554.en.html#:~:text=Published%20as%20part%20of%20the,6.7%25%20in%20the%20United%20States.

6 De Fiore and Uhlig (2011) and Di Vito *et al.* (2023) (PDF 557.19KB) (*ECB Occasional Paper Series*).

7 https://www.centralbank.ie/news/article/speech-productivity-is-almost-everything-the-drivers-and-implications-of-productivity-differences-between-the-us-and-eu-remarks-by-governor-gabriel-makhlouf-at-the-global-interdependence-center-philadelphia-17-jun-2024

8 De Fiore and Uhlig (2011) and Di Vito *et al.* (2023) (PDF 557.19KB) (ECB Occasional Paper Series); https://www.centralbank.ie/news/article/speech-productivity-is-almost-everything-the-drivers-and-implications-of-productivity-differences-between-the-us-and-eu-remarks-by-governor-gabriel-makhlouf-at-the-global-interdependence-center-philadelphia-17-jun-2024

9 https://www.nber.org/system/files/working_papers/w13365/w13365.pdf

10 https://www.tandfonline.com/doi/full/10.1080/13600818.2023.2276702

11 https://cepr.org/voxeu/columns/demographics-and-technology-explain-secular-stagnation-and-more; https://www.stlouisfed.org/on-the-economy/2024/nov/link-between-falling-population-productivity