



REPORT ON THE ECONOMIC SITUATION

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The continued fragmentation of the European capital market

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Economic theory often talks about the efficiency of financial markets, where all available information about investors, companies, government economic policies or geo-strategic developments is already priced in. It does not mean that financial market participants have access to all of this information. Rather, they incorporate the information that is available to them into their decisions and as a result, each participant contributes information to the pricing process and the prices ultimately incorporate all of the available information. In this respect, it is assumed that the expectations of the financial market participants are rational.

According to this concept, the capital market is globally integrated, which leads to a global market rate that only varies across countries because of different transaction costs. The supply of capital is determined by investors and savers, while the demand for capital comes from investors looking for equity or debt capital for their investment projects, as well as private households wishing to finance long-term consumer goods such as owner-occupied residential property with credit.

Theoretical concepts such as these help structure how we think about financial markets. Therefore it is only natural that in real life, things may well be different. And so it makes sense to have some doubts regarding the efficiency of financial markets. However, I am not referring to anomalies or criticism related to behavioral economics, such as the herd mentality of investors. Rather, we have to examine the fragmentation of capital markets based on legal, regulatory and political differences.

Even for professional investors, this examination does not end with an assessment of the extent to which financial markets are globally integrated, or where this integration ends. Of course, there is such a thing as global context: a stock market crash in New York will trigger eruptions in all global markets. It is well known that capital is very mobile, like a shy deer that quickly moves to a different location at the slightest change in its environment.

Nevertheless, it is also true that the European capital market is fragmented while the American market is integrated. In the US, investors find it fairly easy to find providers of equity or debt capital. The American capital market has tremendous depth; there is a lot of money looking for lucrative investments. Therefore those seeking capital are not dependent on loans provided by banks as financial intermediaries. They can

access capital directly in the capital market. The situation is very different in Europe: Most investors will obtain debt capital from their banks. While established companies are able to draw on equity capital (created by retained earnings) or capital injections from their shareholders/owners, young companies and start-ups find it much more difficult to attract equity or debt capital providers. This has a negative impact on the innovative capacity of European economies.

Many reasons account for these differences between the US and Europe. On the one hand, the fragmentation of the European capital market is due to differences in the legal environment, including insolvency and liability laws, tax laws, regulatory bodies, and not least the related structural differences such as the particularities of the three-pillar system for banks in Germany. On the other hand, there are also differences in the way that the pension system is organized. The German pension system is dominated by unfunded statutory pension insurance, while funded elements (such as company pensions or tax-incentivized private retirement savings) are not as pronounced. In the Netherlands or Sweden, not to mention non-EU member Switzerland, funded pension components are much more common.

The European Commission and the member states have been aware of these deficits for some time, at the latest since the financial crisis and the subsequent EU debt crisis. Since then, the EU has been working on a capital market union. An integrated EU-wide capital market would make it easier to mitigate exogenous shocks, which tend to have asymmetrical effects. But not much has happened in the 15 years that have passed since.

Notwithstanding the recent forays in this area, it can be expected that the required minimum standards for a capital market union in Europe are still some way off. Therefore it is all the more important that member states take more decisive steps in the direction of a funded pension system. In Germany, this means strengthening company pensions and tax-incentivized retirement savings. There is still too much hesitancy in this regard.

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