Euro Area Stability Watch 2026.

Global shocks, domestic shields: Resilience under strain

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European Stability Mechanism

Main risks: geopolitics and US asset price correction

Re-escalation of Middle East conflict

- **Prolonged conflict/escalation will further raise inflation and weigh on growth**
  - → Higher energy prices, supply disruptions and second round effects
  - → Higher uncertainty and weaker confidence
  - → Tightening of global financial conditions
- **Longer-term GDP losses due to lower competitiveness and investment**

US asset price correction

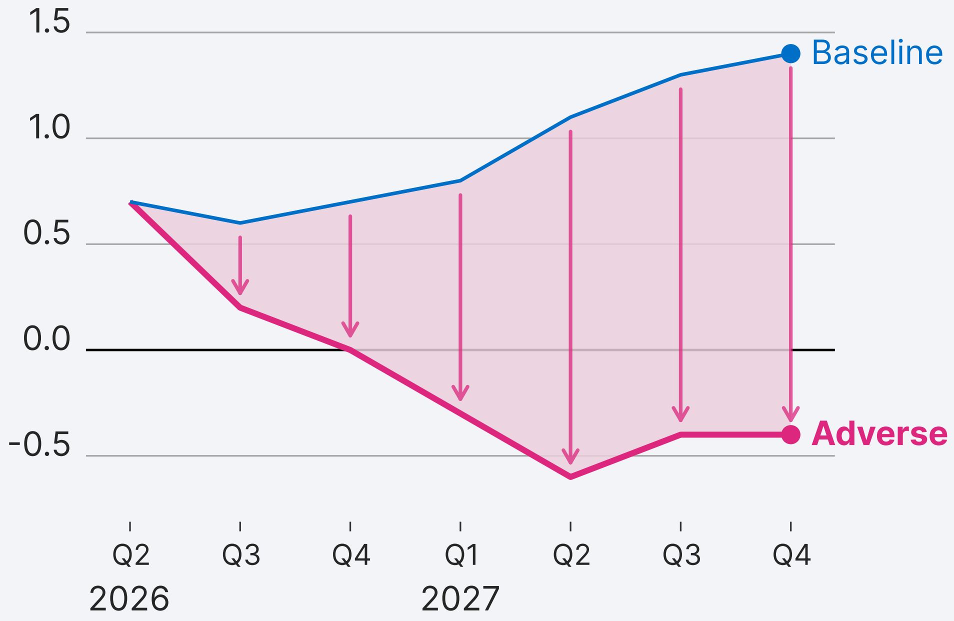
- **Higher US policy uncertainty:** lower demand for US assets → higher US yields
- **AI narrative challenged:** correction in US equity markets → global risk aversion
- **Spillovers to Europe**:
  - → EU holdings of US assets
  - → Global risk aversion
  - → Exchange rate and capital flows

Adverse scenario: prolonged Middle East tensions and US asset repricing

Combined shocks can push the euro area towards recession, with inflation soaring

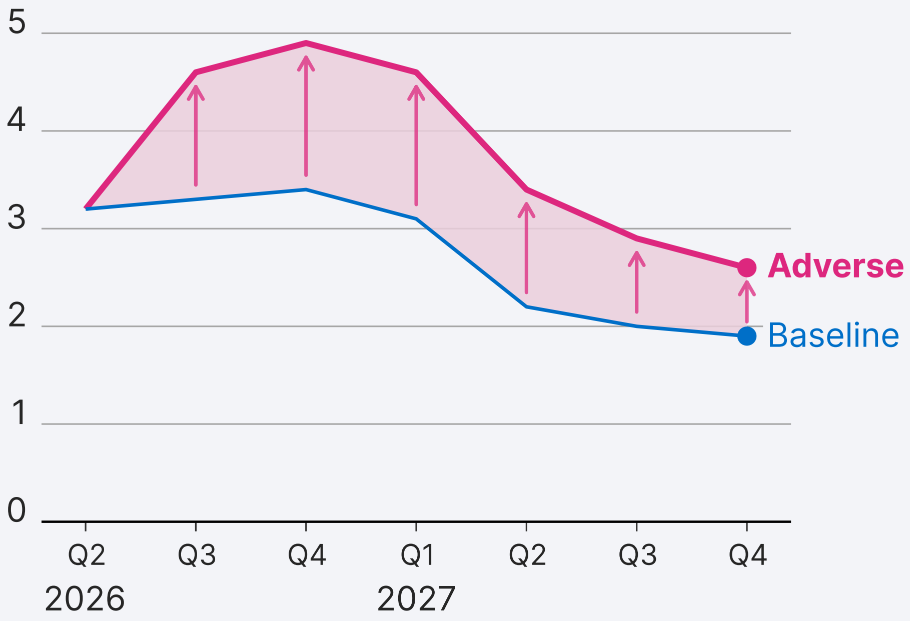
GDP growth

(%, year-on-year)



Inflation

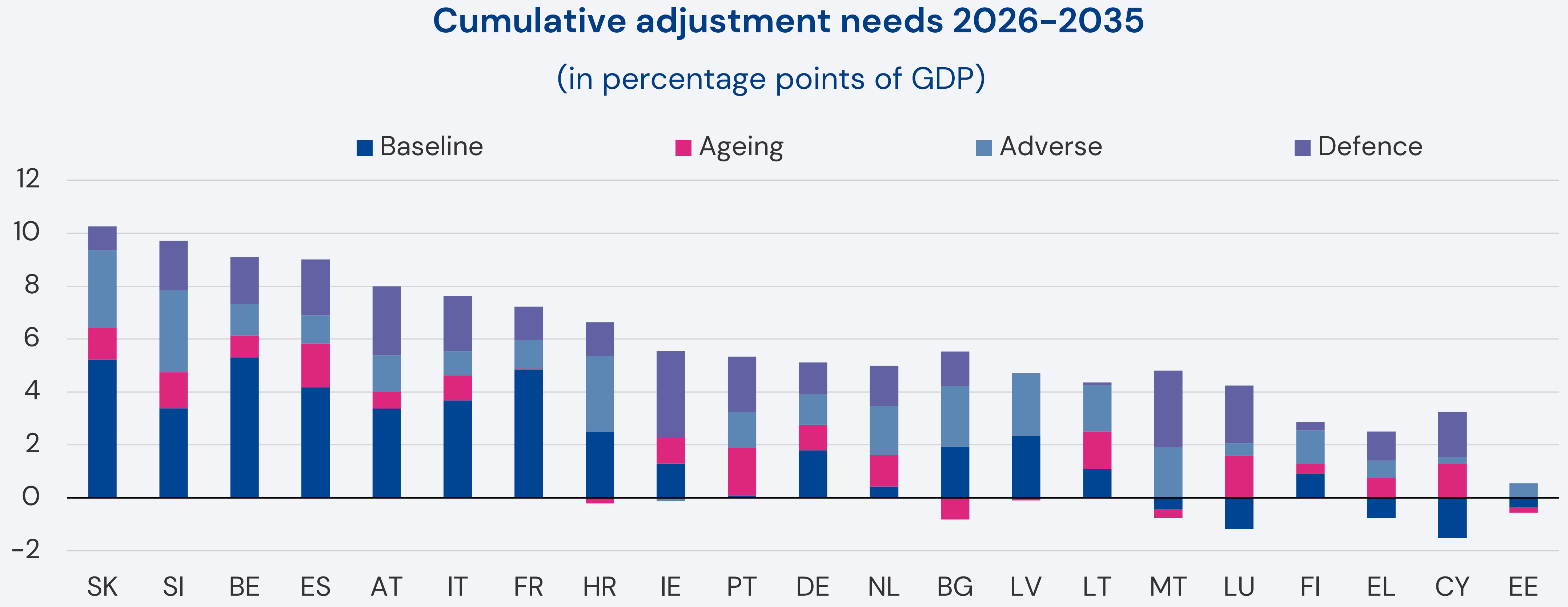
(%, year-on-year)



Source: ESM calculations based on European Commission Spring Forecasts April 2026 and Eurostat data

Fiscal constraints require difficult policy choices

Credibility is essential for fiscal resilience

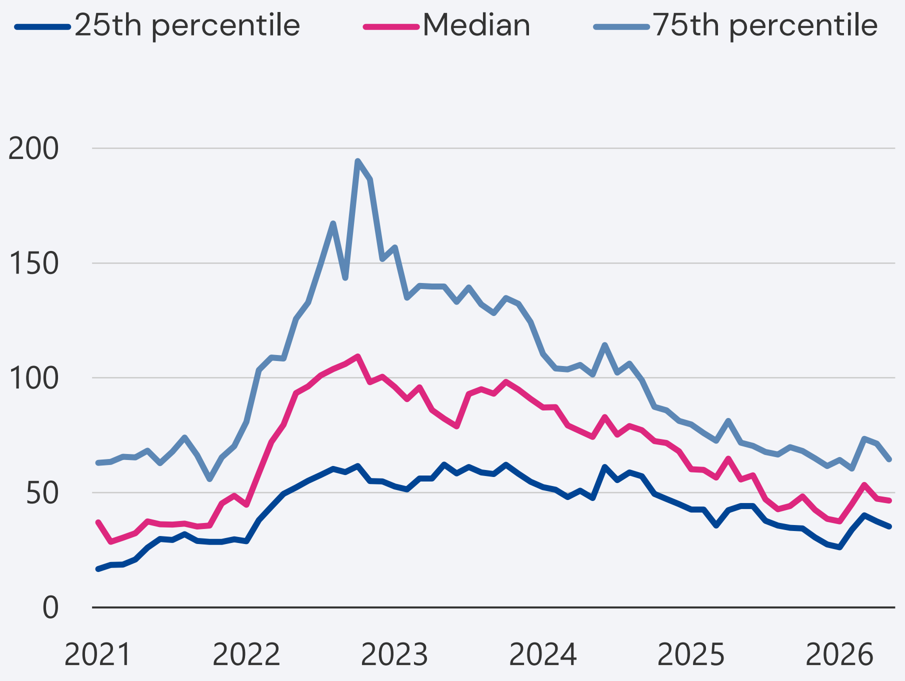


Notes: Adjustment needs are split into (i) baseline needs stemming from initial budgetary conditions (ii) additional needs to offset adverse economic conditions; and (iii) long-term spending pressures from defence to reach NATO's 3.5% of GDP target by 2035 and costs of ageing (2024 Ageing Report). Austria, Cyprus, Ireland, and Malta are not NATO members, but an increase in defence spending up to 3.5% of GDP target is also included in the exercise.

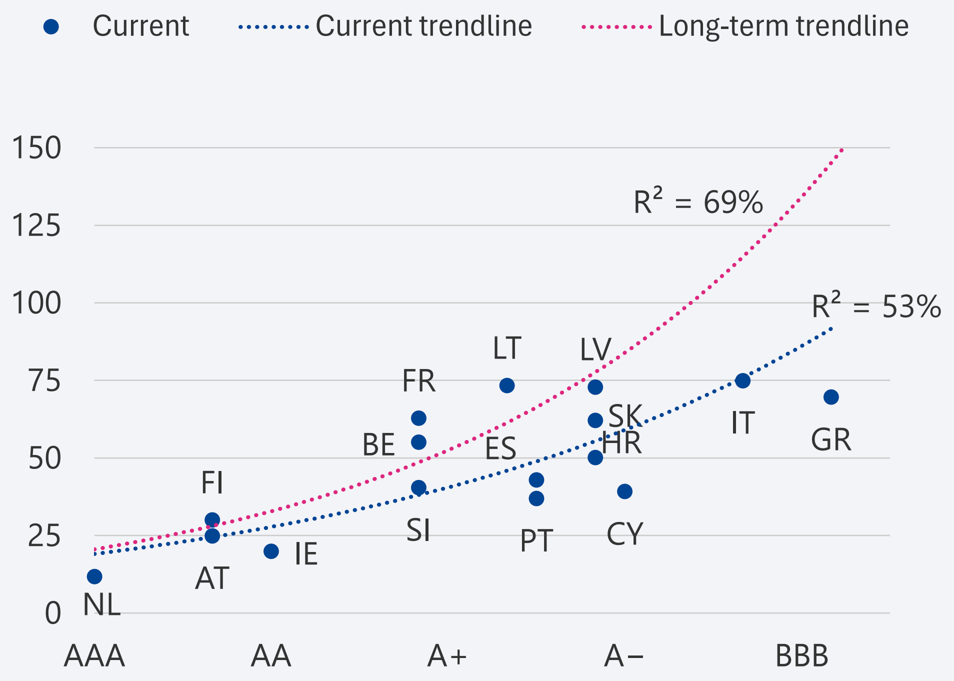
Source: ESM calculations based on European Commission's AMECO data, spring 2026 package data and the 2024 Ageing Report

Euro area sovereign bond spreads appear compressed

Distribution of euro area sovereign spreads
(in basis points)



Euro area sovereign spreads and credit ratings
(x-axis: rating, y-axis: spread in basis points)



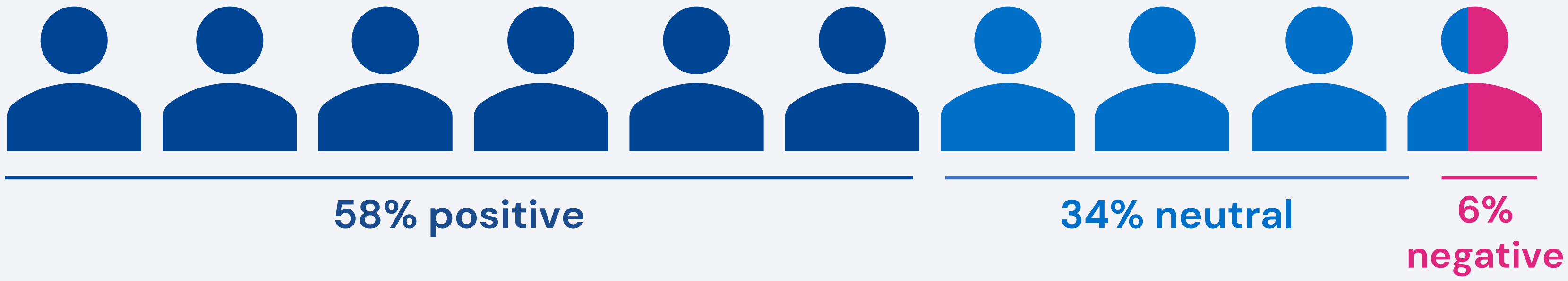
Notes: Monthly data of daily average spreads of 10-year sovereign bonds vis-à-vis German bonds. Panel b) shows the average ratings from Fitch, Moody's, and S&P, excluding Germany. Dotted lines represent the exponential trendlines. Current as of May 2026. Long-term average based on the available monthly data for euro area countries since January 2005.

Source: ESM calculations based on Bloomberg, Fitch, Moody's, and S&P data

Positive sentiment amid a challenging risk landscape

Results from the ESM Sovereign Sentiment Survey

Overall sentiment towards euro area sovereign bonds is positive …
(share of respondents)



Foreign investors seen as **3× more likely** to hold negative view (10%) than domestic counterparts (3%)

… but a challenging risk landscape seen ahead
(share of respondents)

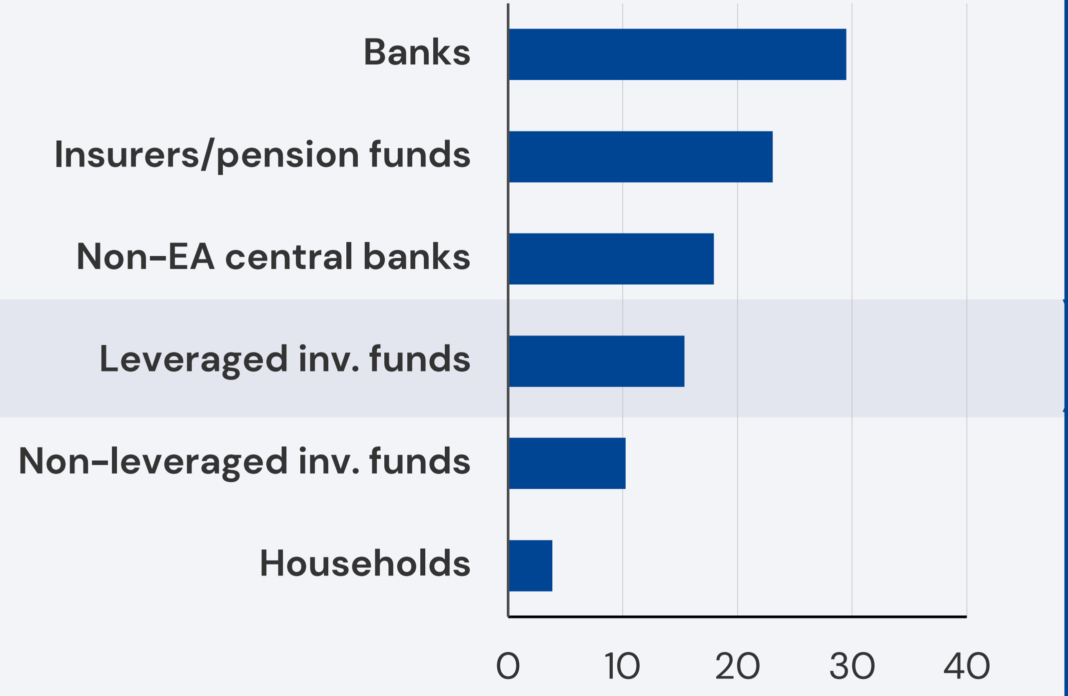
Other risks cited:
Fiscal path: 36%
Slowdown: 36%
Price correction: 19%
Trade tensions: 13%

Results of the ESM Sovereign Sentiment Survey are based on a survey of 31 financial market participants active in euro area sovereign bond markets, conducted between 27 March and 17 April 2026. Percentages above denote shares of respondents.

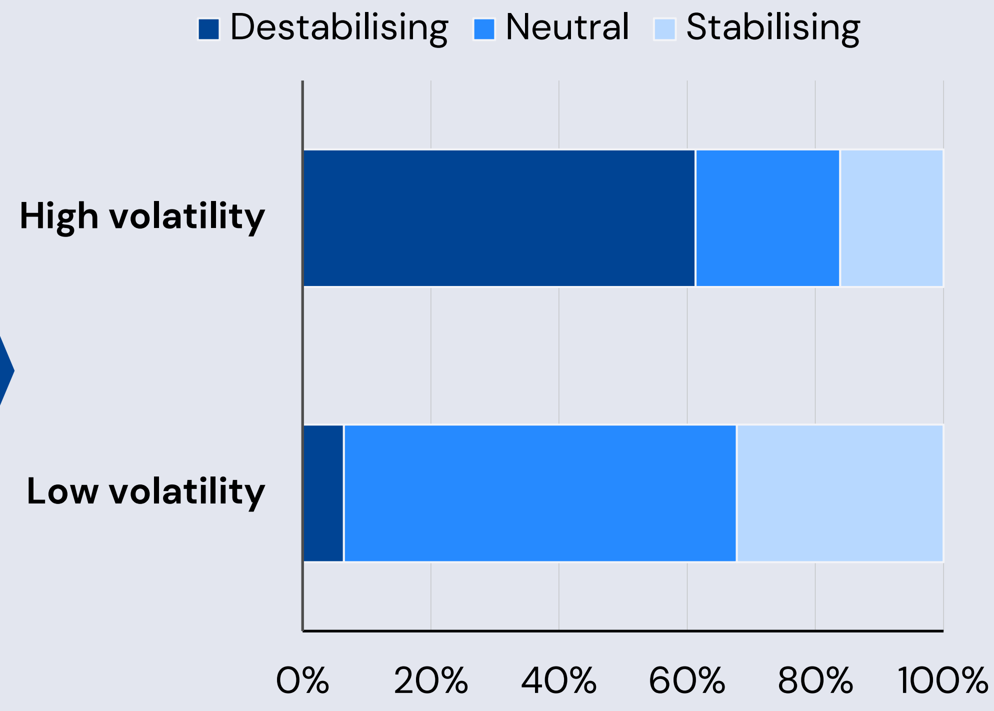
Leveraged investment funds could amplify volatility

Results from the ESM Sovereign Sentiment Survey

Absorption of euro area sovereign bond net issuance
(share of respondents)



Leveraged investment funds in different environments
(share of respondents)



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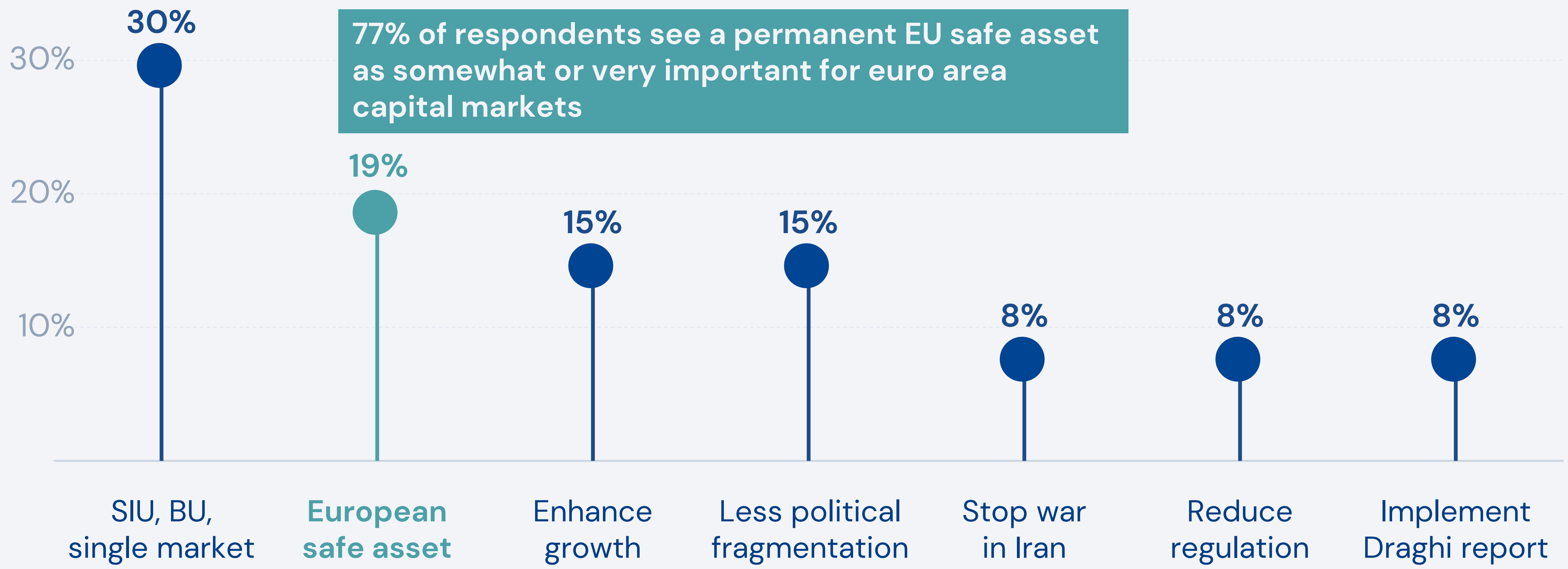
A European safe asset could finance common goods

Results from the ESM Sovereign Sentiment Survey

Most important factors to achieve foreign capital inflows into the euro area
(share of respondents)



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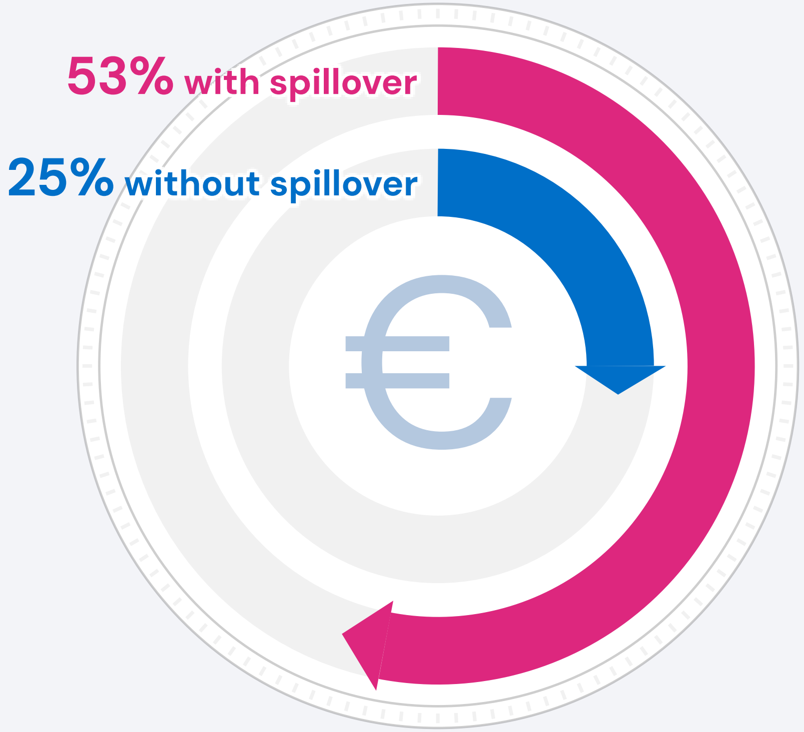
Well-designed defence spending can partly pay for itself

Productivity spillovers to the civilian economy yield higher growth and revenues

Self-financing ratio of defence spending

(% recovered in the long-term)



- Targeted to investment and R&D
- EU sourced
- Backed by public spending reallocation
- Anchored in a credible fiscal framework

Source: ESM

Check the report

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