Euronomics: Rising global yields and the fiscal challenge for Europe

By Rolf Strauch

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This summer's rise in long-term interest rates marks a sharp acceleration in the broader repricing of government bonds under way since late 2021. In the euro area, 10-year government bond yields reached nearly 4% on average in September 2026, their highest level in more than a decade. The synchronised rise in yields across major economies reflects global factors, which are changing expectations for monetary policy. At the same time, structural shifts in sovereign supply and investor demand could keep yields elevated or even push them to new peaks.

The fiscal consequences are likely to emerge gradually and vary across countries as government debt is rolled over at higher interest rates. Highly indebted economies, particularly those with greater rollover needs, weaker fiscal positions, and lower growth prospects are the most exposed. While governments cannot control the global forces pushing yields higher, credible fiscal plans, prudent debt management, and measures to strengthen potential growth can help prevent higher yields from translating into wider sovereign risk premia.

Global factors are the main drivers behind rising government bond yields

Over the last two years, average euro area 10-year yields have risen by around 100 basis points, reaching levels not seen in over a decade (Figure 1).

Figure 1

Euro area 10-year government bond yields swell to rates not seen in over a decade

(annual percentage rate, 2008–2026)

Notes: The euro area yields are 10-year spot yields based on ECB methodology for AAA-rated and all euro area countries (available at https://data.ecb.europa.eu/methodology/yield-curves). The latest observation is 5 October 2026.
Source: ESM calculations based on Bloomberg and ECB data

Our analysis quantifies the contributions of global and domestic drivers of this increase in yield levels and shows that common global factors outweigh domestic ones (Figure 2, left panel). A second analysis shows that higher expectations for real and nominal short-term rates across advanced economies account for most of the increase in yields (Figure 2, right panel).

The war in the Middle East and resulting price pressures have led markets to expect that monetary-policy rates will remain higher for longer in Europe, the United States (US), Japan and other major economies. Furthermore, expectations that artificial intelligence will continue to boost investment, productivity, and capital demand – most notably in the US – have also driven up longer-term real rates, with some spill-over effects on euro area sovereign bond markets.

Factors that drove euro area yields higher in the past contributed less this time around. For example, the term premia played a smaller role. The trust in ECB's response to rising inflation helped keeping the compensation required by investors for holding longer-duration securities contained. In addition, continued 'safe haven' demand for highly rated euro-area government bonds may have provided an additional offset to the underlying uncertainty.[1] Sovereign spreads, capturing country-specific credit-risk

premia, remain relatively contained compared to past crisis episodes and markets continued to function well.

Yet developments have differed across countries, and some more vulnerable sovereigns have experienced more prominent spread widening, notably in recent weeks amid increased political and fiscal uncertainty. (Figure 3).

Changing supply and demand dynamics in euro area sovereign markets

Changing demand and supply dynamics in euro area sovereign markets may result in structurally higher and more volatile yields than in the past.

First, the supply of government debt in the euro area is on the rise. The actual and expected supply of Germany's bonds have risen significantly since its 2025 debt brake reform. Additionally, governments across the euro area will need to finance greater spending on defence, the impact of ageing populations, and the green and digital transitions. Meanwhile, the European Central Bank (ECB) balance sheet normalisation means that private investors are gradually absorbing a larger share of net sovereign issuance.

Second, the euro area sovereign bond investor base is becoming more price sensitive. Demand from insurers and pension funds is declining while the presence of non-euro area investors and leveraged funds is growing, potentially amplifying yield movements. [2]

Third, governments may be competing more for demand for long-term bonds as large technology firms issue more long-term debt, increasingly in euros.

Finally, political and fiscal uncertainty in some European countries could trigger further bouts of volatility.

Figure 2

Higher expected policy rates are the main driver of increase in euro area long-term government yields

Decomposition of change in 10-year euro area government bond yields (in basis points, October 2024–October 2026)

Notes: Principal component analysis has been employed to identify global and euro area factors (the yield curves of the US, United Kingdom, Japan, euro area, and Canada have been used to decouple foreign from domestic drivers). Credit risk proxied by the spread between euro area all and AAA-rated spot yields based on ECB methodology (available at https://data.ecb.europa.eu/methodology/yield-curves). The decomposition between risk-free rate expectations and term premia was produced for euro area AAA-rated spot yields using an affine term structure (fitted on 3-month, 1-year, 2-year, 5-year, 7-year and 10-year maturities, as well as 12-month and 24-month market expectations about the 3-month Euribor). Data computed as monthly average for October 2024, and average 1-5 October 2026.
Source: ESM calculations based on Bloomberg and Haver Analytics data

Figure 3

Euro area sovereign spreads have remained contained overall

10 year sovereign bond spreads against Germany
(in basis points, January 2021-October 2026)

Notes: Calculated based on the 10-year zero-coupon rates for individual member states with sovereign debt above 100% of GDP. The latest observation is 5 October 2026.
Source: ESM calculations based on Bloomberg data

A gradual but growing fiscal burden

Higher yields do not lead to an immediate substantive drag on government budgets. The average remaining maturity of euro area government debt is close to nine years. This limits short-term refinancing risks and allows governments to absorb the impact of higher market rates gradually, depending on rollover needs and the magnitude of public deficits.

However, governments will face higher interest costs and will need to offset these costs through spending cuts, higher revenue, or a mix of both, while remaining compliant with the European Union (EU) fiscal framework. This comes at a time when European resilience is already under strain, as argued in the ESM's **Euro Area Stability Watch** published in July this year.

To illustrate the pressure from the higher interest rate environment on national budgets, we compare two debt paths: the first using the market rate assumptions as of early-October 2026, and the second using those that prevailed in late 2024, when governments presented their medium-term fiscal plans.[3] This exercise isolates the direct effect of interest rate increases on debt, deficits and adjustment needs under the EU fiscal rules. Euro area public debt reaches 109% of gross domestic product (GDP) by 2035 under current fiscal policies and expected interest rates, about 7.2 percentage points above the level that would prevail with 2024 rate assumptions (Figure 4). As a result, governments would need to adjust their 2028 fiscal plans by around 0.8% of GDP on average to offset the impact of higher interest rates and achieve compliance with the EU fiscal framework by 2035.

This effect is not uniform across euro area countries. Adjustments will be comparatively more manageable for countries with lower debt, more robust nominal growth, and solid fiscal positions.

Figure 4

Rising government yields to weigh on public debt dynamics

Public debt dynamics under new interest rates path, no policy change
(in % of GDP)

Note: Debt paths use the European Commission's T+10 growth projections, under a no-policy change scenario whereby the structural primary balance is held constant at its 2027 level. Data computed as monthly average for October 2024, and average 1-5 October 2026.
Source: ESM calculations based on European Commission 2026 Spring forecast data

Fiscal credibility is the first line of defence

In an environment of elevated risk-free rates, fiscal prudence and credible medium-term adjustment plans are the first line of defence. Fiscal prudence will require reprioritising expenditure, improving the quality of public spending, and developing realistic fiscal plans that remain credible under less favourable financing conditions.

Sound debt management can reinforce this defence. Governments should balance active maturity management against the need to limit refinancing risks by maintaining smooth redemption profiles and preserving a diversified investor base.

Because the impact from higher interest rates on debt servicing cost will be gradual, there is a risk that this impact may be ignored. But governments should act now while room for manoeuvre remains.

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Footnotes

[1] **Less special, less contagious? US Treasury supply spillovers to Bund yields | European Stability Mechanism**

[2] In the ESM Sovereign Sentiment Survey, 61% of respondents expected leveraged funds to have a destabilising effect in high-volatility environments.

[3] All other assumptions are identical.