Euro Area

From resilience to transformation

Europe has proved resilient in the face of a new energy shock, but increasing its growth potential will require a sustained investment cycle that delivers a lasting improvement in productivity and competitiveness. In 2027, investment could accelerate thanks to fiscal support, but this push needs to be complemented by stronger private investment.

Concepción Sanz Gómez

The euro area exhibited an unexpected degree of resilience in 2026. We expect gross domestic product (GDP) to grow by 1.0% in 2026, showing a notable capacity to adapt to higher energy costs and uncertainty arising from the Middle East conflict.

This resilience reflects several factors. First, the economy is less dependent on gas and has lower energy consumption than at the beginning of the 2022 crisis. Second, households have drawn on part of their savings to cushion the impact on disposable income and sustain consumption. Finally, domestic demand is benefiting from higher defence spending, the expansionary German fiscal stance and the global increase in technology investment, including artificial intelligence (AI)-related investment.

Inflation has risen, but the impact on underlying inflation remains limited. Wage growth has moderated and, so far, there are no clear signs of second-round effects.

We expect stronger growth in 2027, but the challenges are also greater. We expect euro-area GDP to grow by 1.4% in 2027. The main boost is expected to come from a gradual recovery in investment, supported by defence spending, German infrastructure plans and investment in digitalisation and AI. The labour market will continue to provide stability for households. We expect employment to grow and the unemployment rate to stay at historically low levels.

However, growth could continue to be uneven across countries and sectors. Germany is playing an increasingly important role, supported by higher defence and infrastructure spending, while other economies face tighter fiscal constraints. At the same time, stronger Chinese competition is putting further pressure on the euro area's external competitiveness. In addition, part of the new spending on defence and technology will translate into imports, limiting its direct impact on European GDP.

Inflation will remain a key risk in 2027. We expect inflation to moderate, but probably stay above the European Central Bank (ECB)'s 2% target for most of the year, with risks tilted to the upside. The main concern is that persistently high energy prices raise business costs and progressively feed through to wages and broader goods and services prices. Against this backdrop, we expect the ECB tightening cycle to extend into 2027.

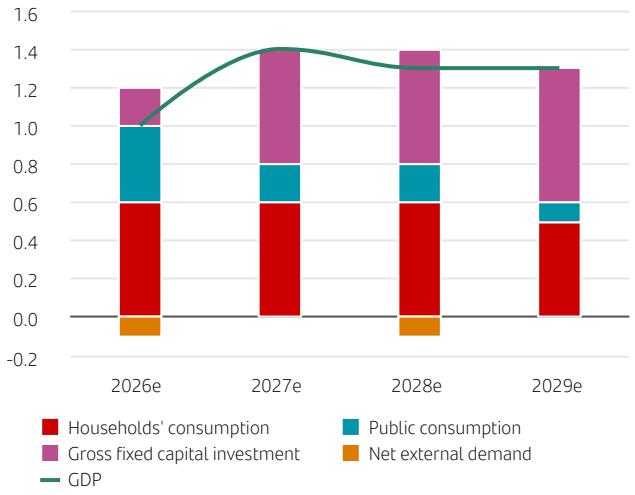
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Fiscal policy support could become more uneven. In 2026, fiscal policy has been having a mildly expansionary effect, driven by public investment, defence spending and measures aimed at cushioning the energy shock. We expect the budget deficit to increase to 3.5% of GDP, from 3% in 2025. In 2027, the fiscal stance will be mildly restrictive for the euro area (we expect the budget deficit to be 3.6% of GDP), although with significant differences across countries. Germany will maintain an expansionary stance. Elsewhere, the end of NextGenerationEU (NGEU) funds and the need to consolidate public finances will have a contractionary effect.

Against this backdrop of uneven fiscal capacity, mobilising private investment will be crucial to support the public investment push, as it is private capital contributions, together with an uptick in firms' productive capacity and adoption of new technologies, that will determine the effect public investment has on potential growth.

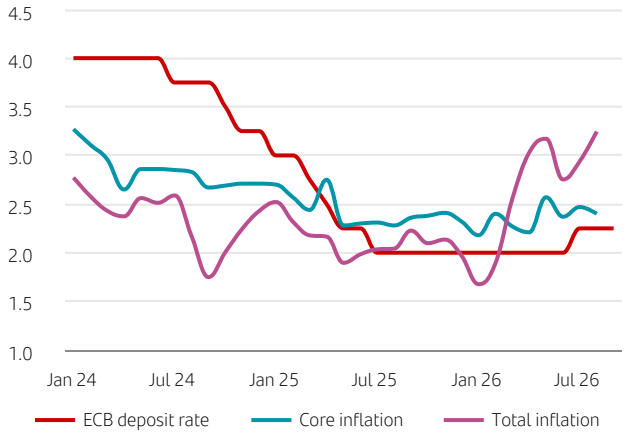
Ultimately, 2027 could mark the beginning of a transition towards an economy in which investment plays a greater role in supporting growth, alongside its capacity to absorb shocks. How this develops will determine whether resilience can translate into durable economic expansion.

Euro area: Fixed investment to make an increasing contribution to GDP growth
(%)



Source: Santander Research.

Euro area: Inflation will remain a key risk in 2027
(%)



Source: ECB.

Macroeconomic forecasts

	2026e	2027e	2028e
GDP growth (%)	1.0	1.4	1.3
Unemployment rate	6.4	6.3	6.3
CPI inflation	3.1	2.6	1.9

Source: Santander Research. Annual average.

Eurobonds: the debate shifts from desirability to institutional design

The case for eurobonds is changing. A debate that was initially about preventing financial fragmentation and sovereign debt crises is increasingly becoming a discussion about how Europe can finance its strategic priorities, deepen capital markets and strengthen the euro's international role.

Why Europe needs a common safe asset

1. Europe faces substantial investment needs in defence, the energy transition, digital infrastructure and technological innovation. These investments are difficult to finance exclusively through national budgets or private markets because their benefits extend beyond national borders and often display the characteristics of European public goods. Given the scale of the investment required and the fiscal constraints facing many member states, around 80% of the necessary investment would need to come from private capital[1]. A common European safe asset could provide an appropriate tool for delivering the financing capacity needed to support these investments.

2. The international role of the euro remains constrained by the relatively limited supply of euro-denominated safe assets[2]. The contrast with the United States is striking: US Treasury securities exceed 30 trillion US dollars in outstanding volume. German Bunds, the closest equivalent to a European safe asset, represent less than one-tenth of that amount, while European Union (EU)-issued bonds are much smaller in scale still.

3. A common European safe asset would strengthen the euro area's financial architecture and improve the functioning of its system in several ways. A larger supply of high-quality collateral would deepen repo markets, derivatives and other financial markets, improving risk management and financial intermediation. It could also bolster financial stability by reducing banks' dependence on domestic sovereign debt to satisfy liquidity requirements, thereby weakening the sovereign-bank nexus. Moreover, it would provide a common benchmark yield curve, which could reduce the fragmentation that still characterises European capital markets and improve the transmission of monetary policy by narrowing differences in financing conditions across countries[3].

[1] European Parliament (2026), 'Financing competitiveness in the EU: One year on from the Draghi Report' (PE 783.090), Directorate-General for Internal Policies of the Union.
[2] Villeroy de Galhau, F. (2025), 'The international role of the euro and the development of European safe assets', speech, Banque de France, 2 October.
[3] Lane, P. R. (2026), 'Expanding the supply of euro safe assets', keynote speech at the European Systemic Risk Board workshop 'A European Safe Asset and Financial Stability', European Central Bank, Frankfurt am Main, 22 April.

4. A deeper market for euro-denominated safe assets could promote innovation and competitiveness by supporting the development of stablecoins and other digital financial instruments, much as US Treasuries underpin dollar-based markets. More importantly, it would complement the objectives of the Savings and Investment Union by making it easier to channel European savings towards productive investment.

Obstacles

Traditionally, the main obstacle to eurobonds has been the risk of moral hazard. Countries with stronger fiscal positions have worried that common borrowing could weaken incentives for fiscal discipline and ultimately create implicit transfers towards more indebted member states.

That concern has eased somewhat as the fiscal position of peripheral economies has improved. Moreover, there is growing recognition that Europe would benefit from an adequate supply of euro-denominated safe assets. As a result, the debate is gradually moving towards how to design an appropriate institutional framework for a European safe asset.

Here, views still diverge. Some policymakers argue that common debt should be accompanied by stronger governance arrangements at the European level and, potentially, by greater EU revenue-raising capacity. Others favour faster solutions based on converting part of the existing stock of national debt into a common instrument.

Fiscal credibility remains central to the discussion. Recent analyses argue that the principal obstacle no longer lies in the design of the fiscal rules themselves but in their effective enforcement[4]. Overcoming this resistance would require consistent application of the fiscal rules by member states.

Debate also continues regarding the allocation of common expenditure. A stronger political case can be made when borrowing is clearly linked to genuine European public goods — such as defence, energy security, research, innovation and cross-border infrastructure — where the benefits are shared across countries[5].

Conclusion

A common European safe asset could strengthen the EU's financial architecture by reducing financing costs, fostering financial integration, enhancing financial stability and reinforcing Europe's strategic autonomy. The main controversy is no longer whether Europe needs such an asset. It is about what institutional design would make one compatible with fiscal discipline and the effective provision of European public goods, making a European safe asset economically efficient, financially credible and politically acceptable. Finally, its implementation may also require the right timing, both from a fiscal and a market perspective.

[4] Arnal, J. (2026), 'Why Eurobonds will never fly without credible fiscal enforcement', EUobserver, 26 May.
[5] Rehn, O. (2026), 'A European safe asset: From crisis pragmatism to strategic necessity', welcome address at the European Systemic Risk Board workshop 'A European Safe Asset and Financial Stability', European Systemic Risk Board, Frankfurt am Main, 22 April.