THE NEXUS BETWEEN BANKS AND GOVERNMENT DEBT REVISITED

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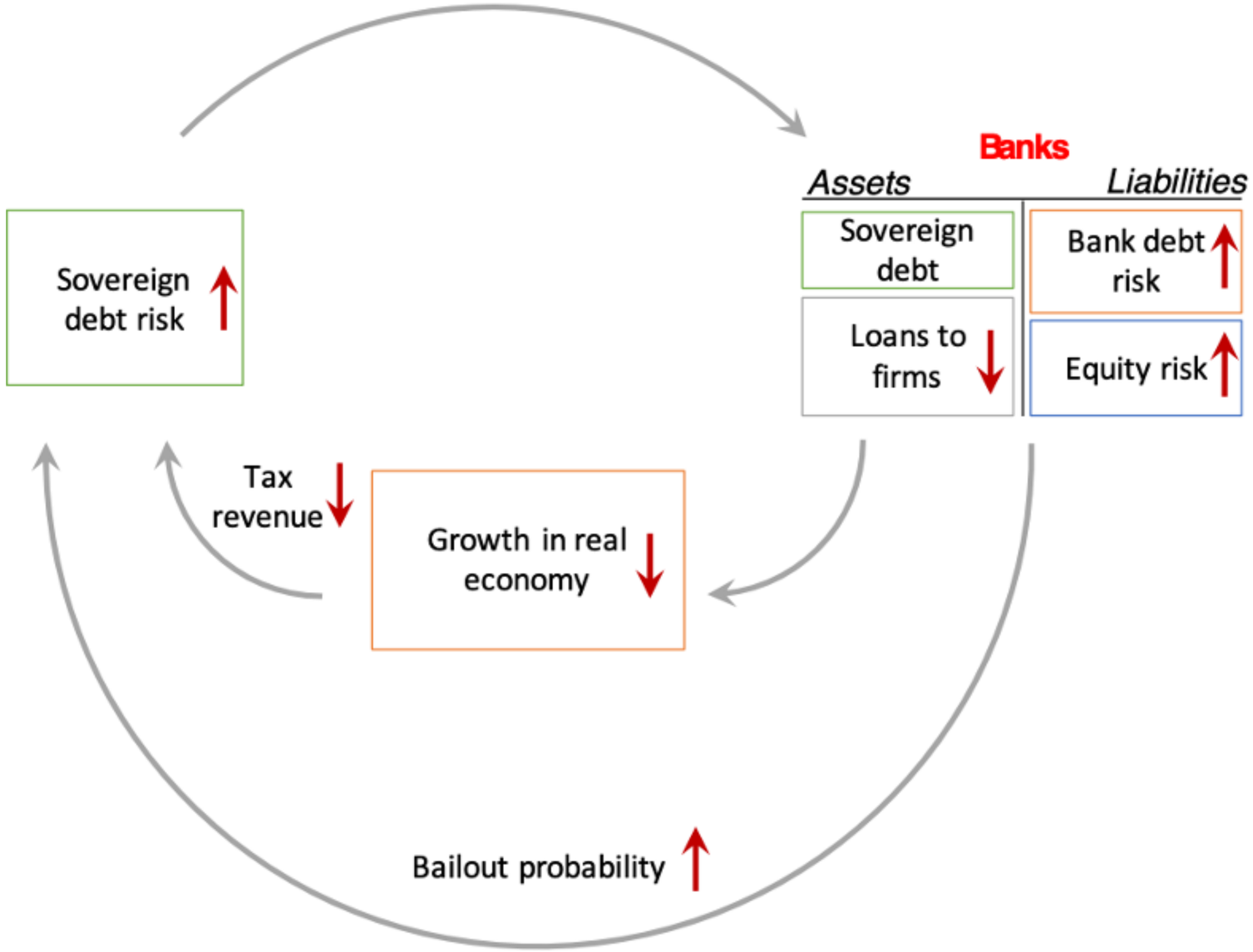
The nexus and the European crisis

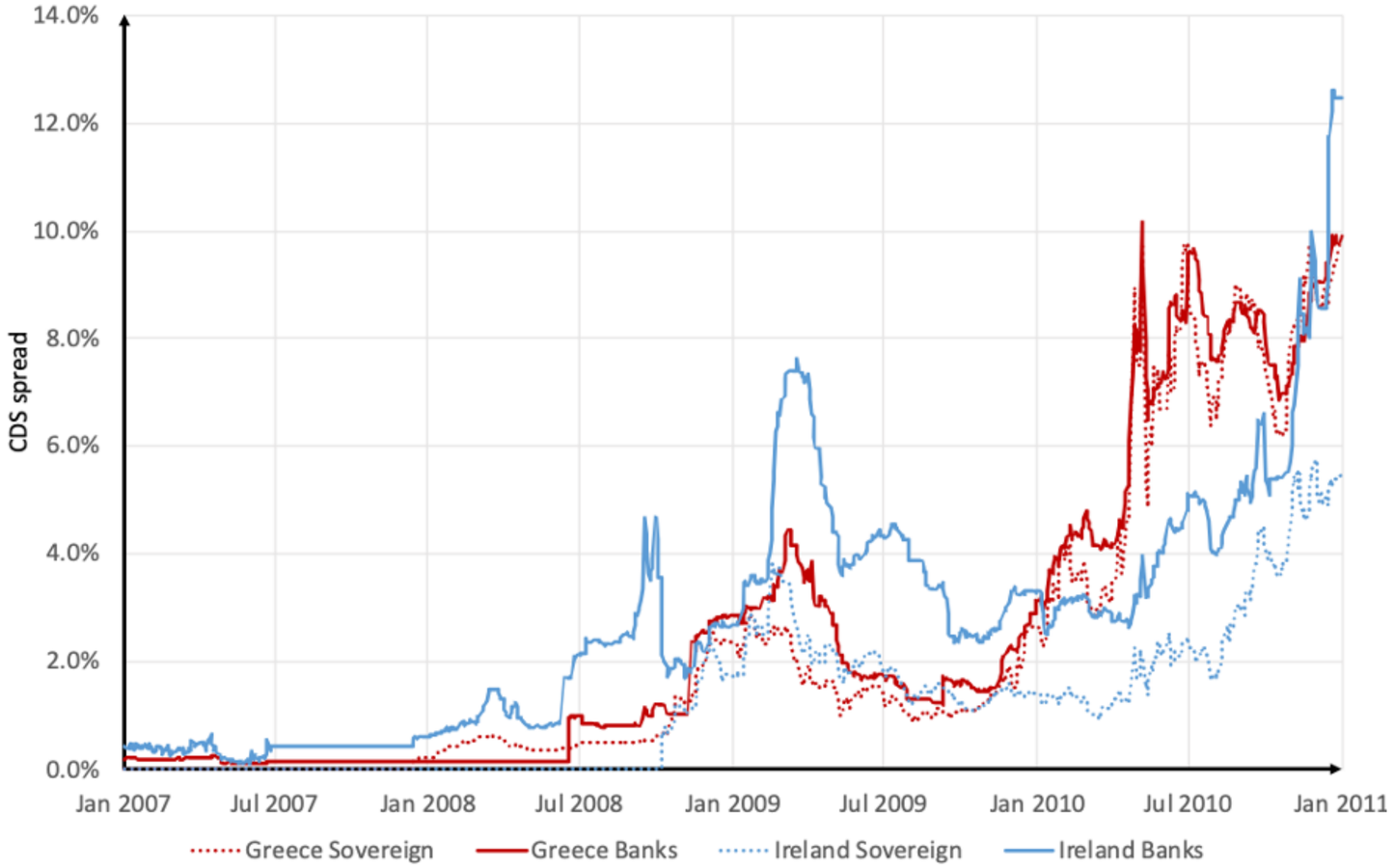


- Banks hold government bonds
  - Regulation, moral suasion, central bank operations, primary dealers
- Banks borrow wholesale and offer those bonds in repo
- Governments provide explicit and implicit guarantees of bailout
- Asset price spirals:
  - Losses spiral: value of assets falls, repay wholesale funding
  - Margins spiral: raise margins in anticipation of price drop

Source: Brunnermeir Reis (2023) *A crash course on crises*

Especially prevalent for European banks

Default risk for Irish and Greek sovereigns and banks



(1) Banks were more likely to hold national sovereign bonds, all four motives

(2) Sovereign bonds were treated as fully safe by regulators

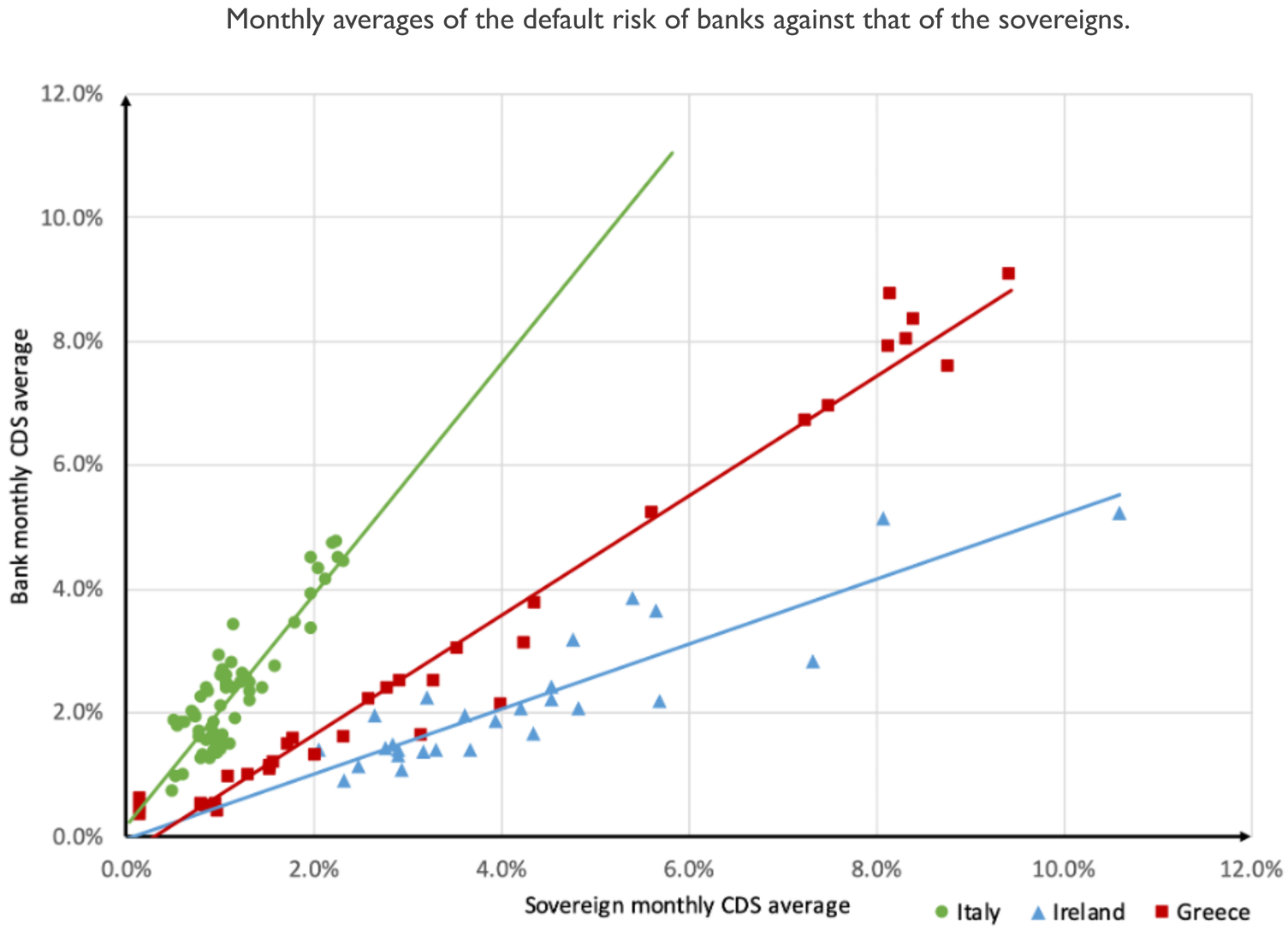
(3) ECB accepted sovereign bonds of every country in exchange for reserves

(4) Public debt markets were not very liquid and relied heavily on banks as primary dealers

(5) Per country, very few very large banks, so sovereigns would always bail them out

Source: Brunnermeir Reis (2023) *A crash course on crises*

Correlation between bank and sovereign risk



- Including Italy in the more recent 2014-2017 period, a time of low default risk, to show this is not gone

- <u>Reforms</u>:
  - Independence of regulators from the ministry of finance
  - Concentration limits (or risk weights) on bond holdings
  - International diversification (ESBies, SBBS)

Source: Brunnermeir Reis (2023) *A crash course on crises*

Looking ahead: fiscal pressure, financial repression, and the US risk

Different times: focus on fiscal pressure

- **In absence of a crisis**:
  - Higher bond holdings (i) lower interest payments on debt right away, but (ii) crowd out private lending, real activity and tax collections in the future.
  - Present bias of politicians is the problem. Institutions and political cycle

- **With a fiscal crisis lurking in the background**
  - If regulator tries to fight the diabolic loop and lower banks bond holdings, then this causes a fiscal crisis, which itself triggers a financial crisis.
  - Unpleasant macro prudential arithmetics (Fed and its support of the Treasury market.)
  - Regulators are captured into financial repression

Source: Reis (2021) *The fiscal footprint of macroprudential Ppolicy*

The pandemic fiscal scars and the Iran conflict

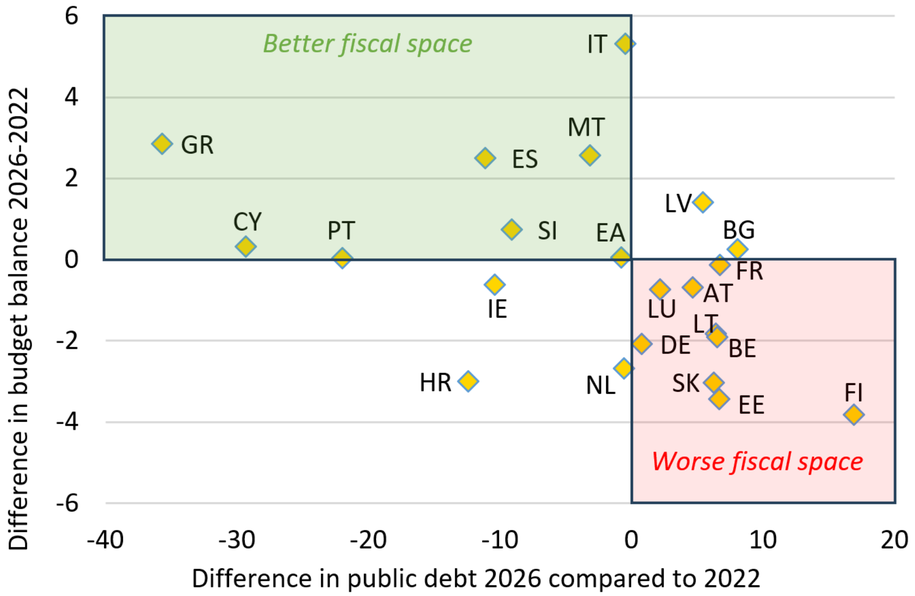
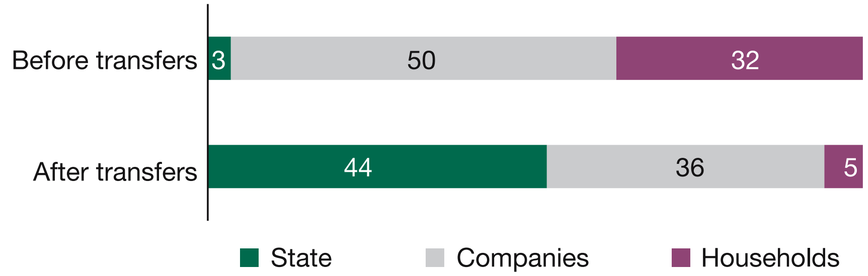
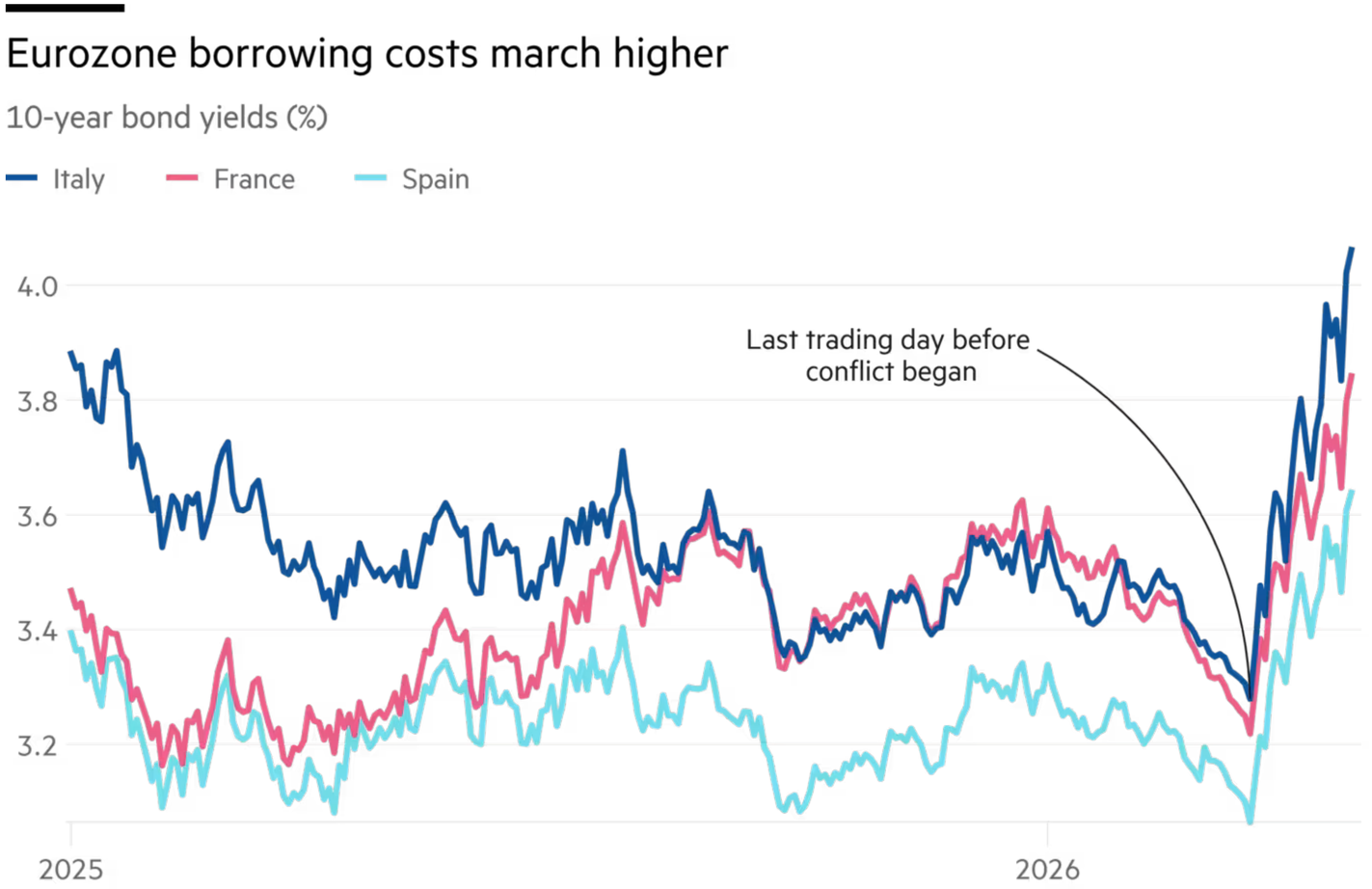


Figure 1

Distribution of gross revenue losses linked to the energy import bill increase in France, 2022 vs 2019

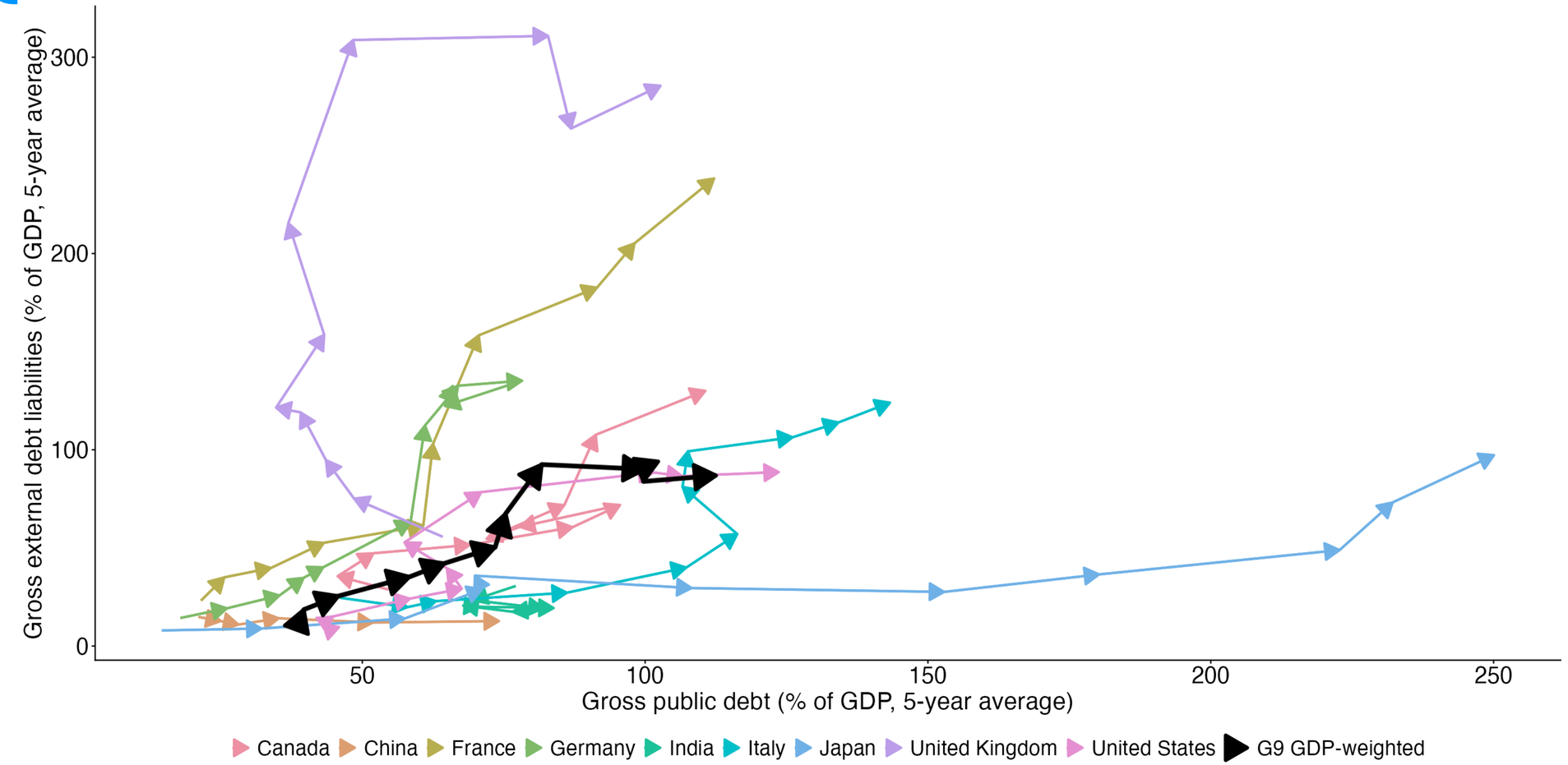
in billion euros





Source: LSEG

Background: twin debts and financial repression



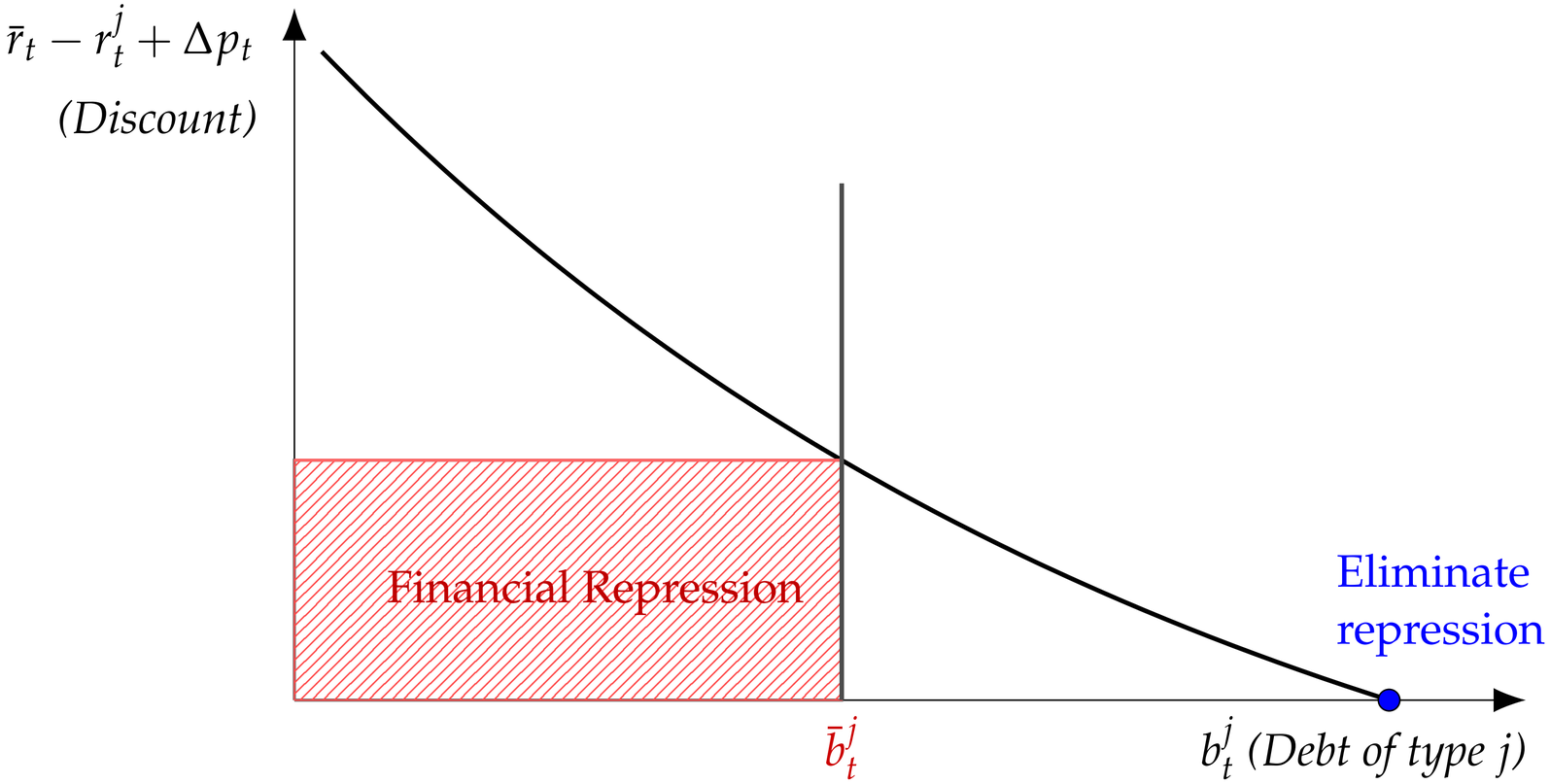
- ***Financial repression***: policies that reduce the twin debts—they loosen the budget constraints in terms of the required surpluses to service the debt—by transferring resources from holders of public or external debt to the domestic government/economy

Source: Reis (2026) *Financial repression in the XXIst century*

Government budget constraint and discounts

Debt = EPV (net income) + fall in market value of the debt

+ EPV (discounts on debt returns)



- Service: reason to accept the inferior monetary return.
- Segmentation: so deep pockets agents do not drive it to zero.

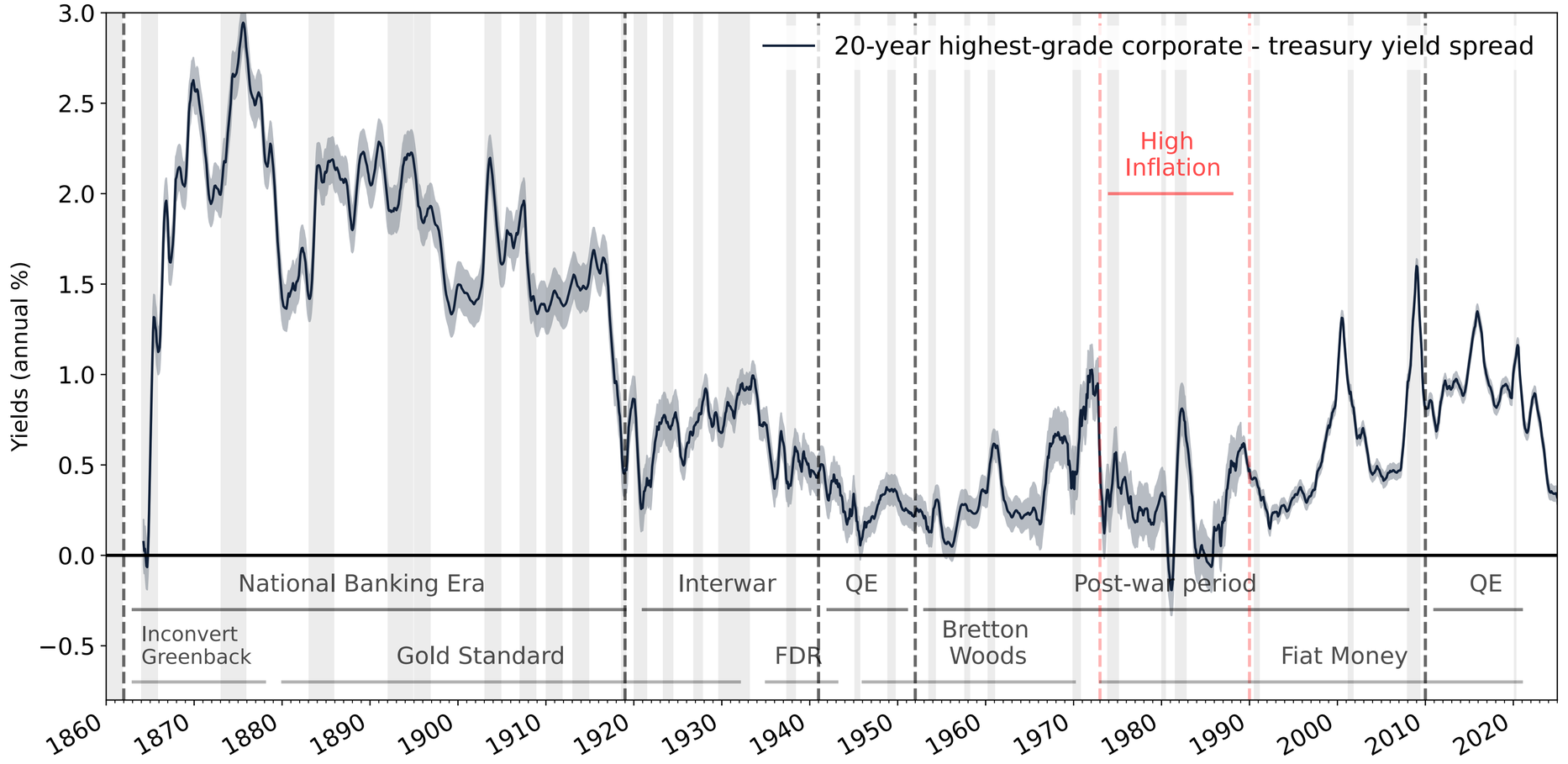
- Repression two forms:
  - Restrict supply
  - Push out demand

Source: Reis (2026) *Financial repression in the XXIst century*

Narrow measures: AAA-corporate bonds

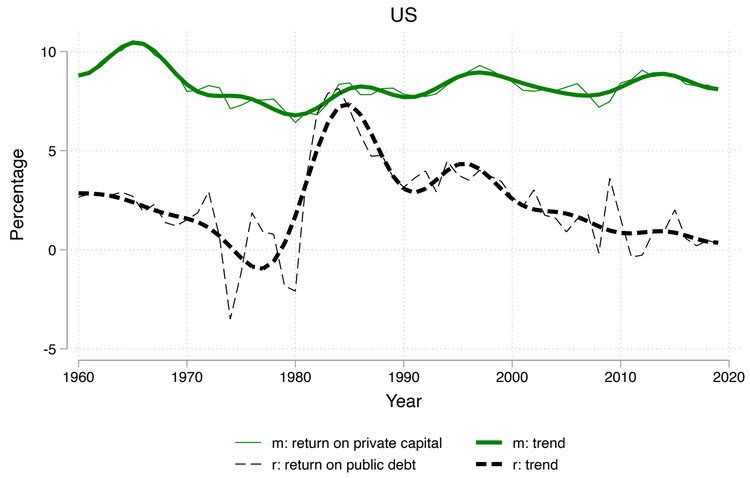
$$\underbrace{\chi_t^{(j)}}_{\text{Funding advantage}} := \underbrace{\tilde{y}_t^{(j)}}_{\text{Highest-grade private debt}} - \underbrace{y_t^{(j)}}_{\text{US Treasury debt}} > 0$$

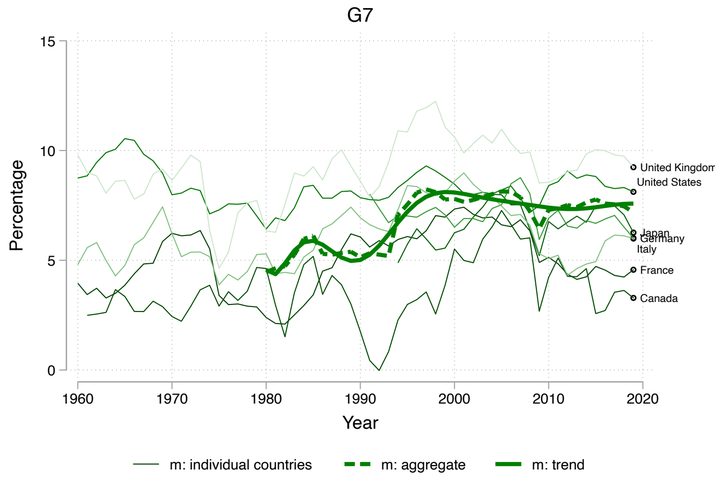
US Funding Advantage 1860-2024

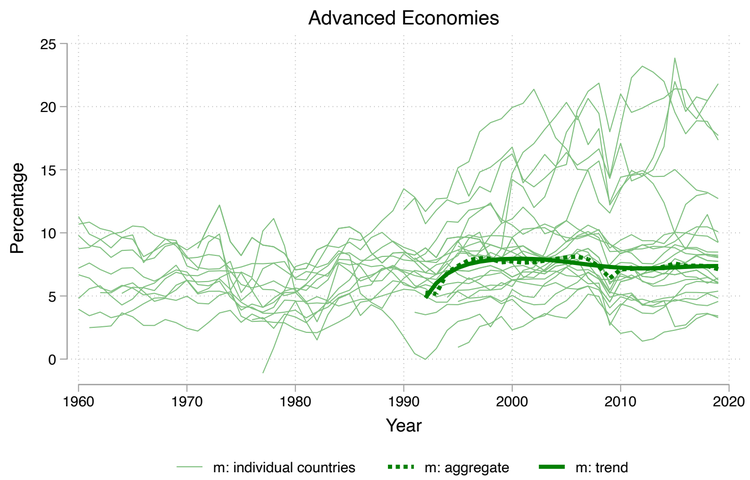


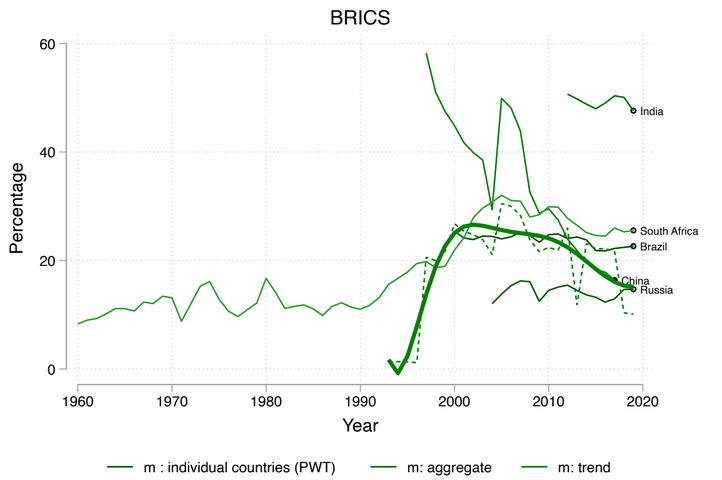
Source: Lehner, Payne, Shurtleff, Szoke (2026) *The US treasury funding advantage since 1860*

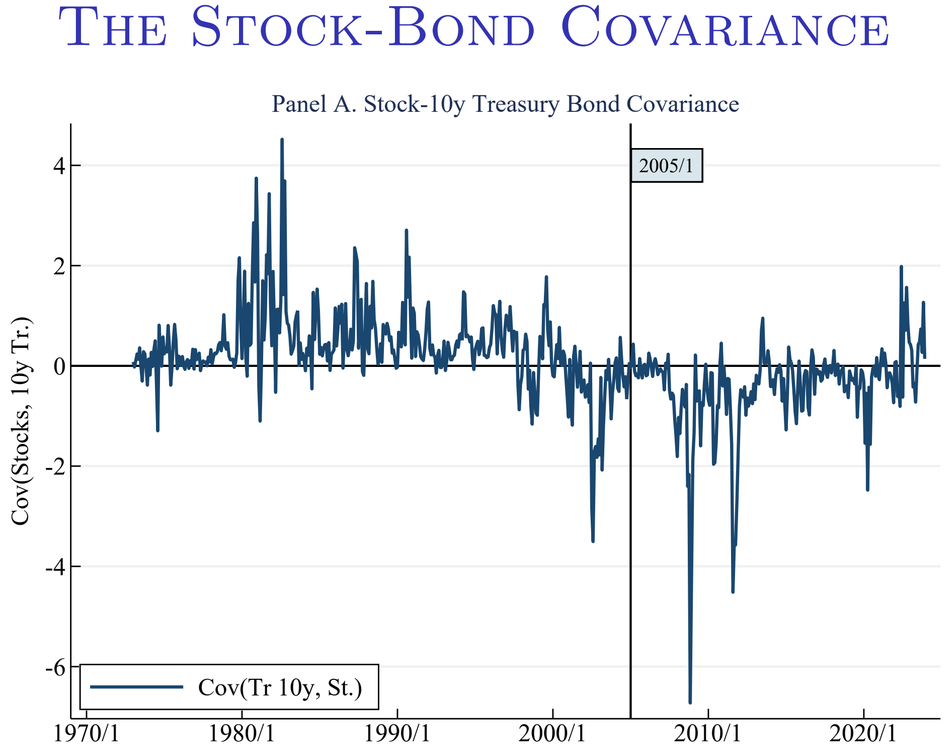
Broader measure: Modigliani Miller and hedging







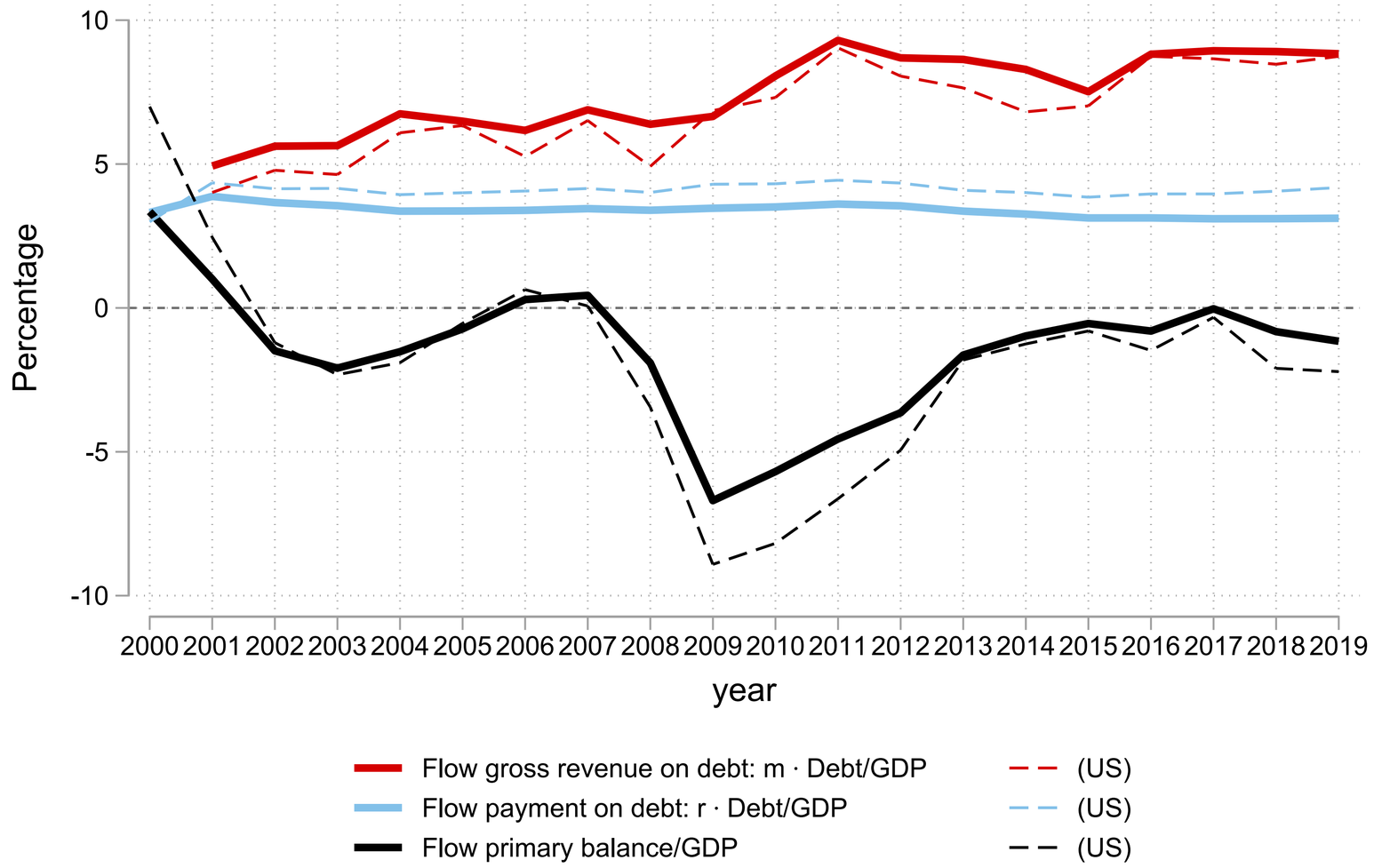




Source: Reis (2024) *Which r-star: public bonds and private investment* and Acharya and Lariats (2026) *When do Treasuries earn the convenience yield? A hedging perspective*

Debt revenue became the dominant revenue

Figure 1: The flow budget components as a ratio of GDP for the G-7 countries and the US

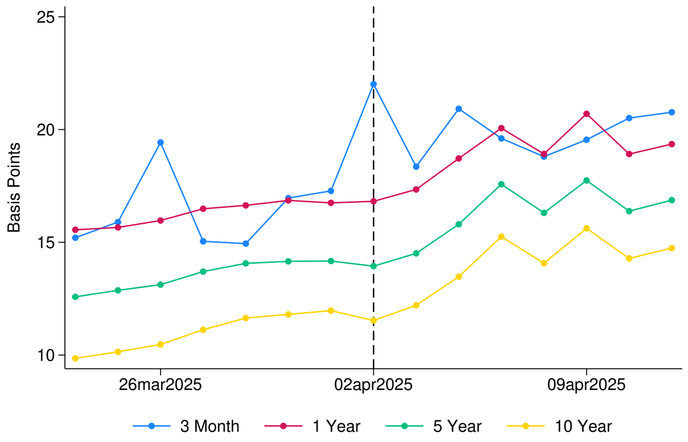


- G7: average 3.8%, and 6% in 2019
- US: average 3% and 6% in 2019
- Present value: 95% of GDP in 2019
- Actual and forecasted primary balances: negative or zero

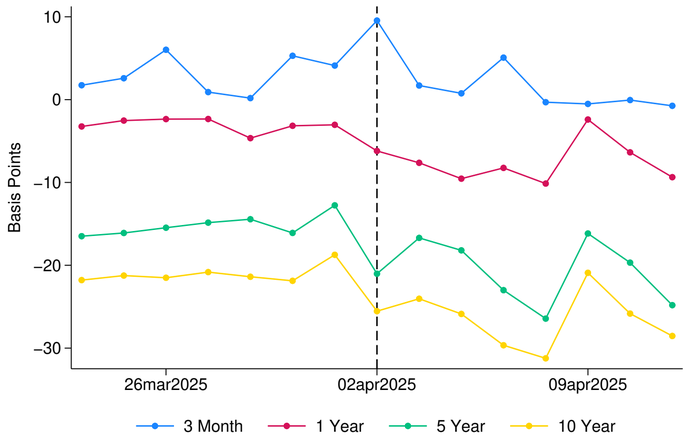
Source: Reis (2022) *Debt revenue and the sustainability of public debt*

Recently: the loss of the UST convenience yield

(a) Benchmark CIP During Tariff War



(b) Government CIP During Tariff War



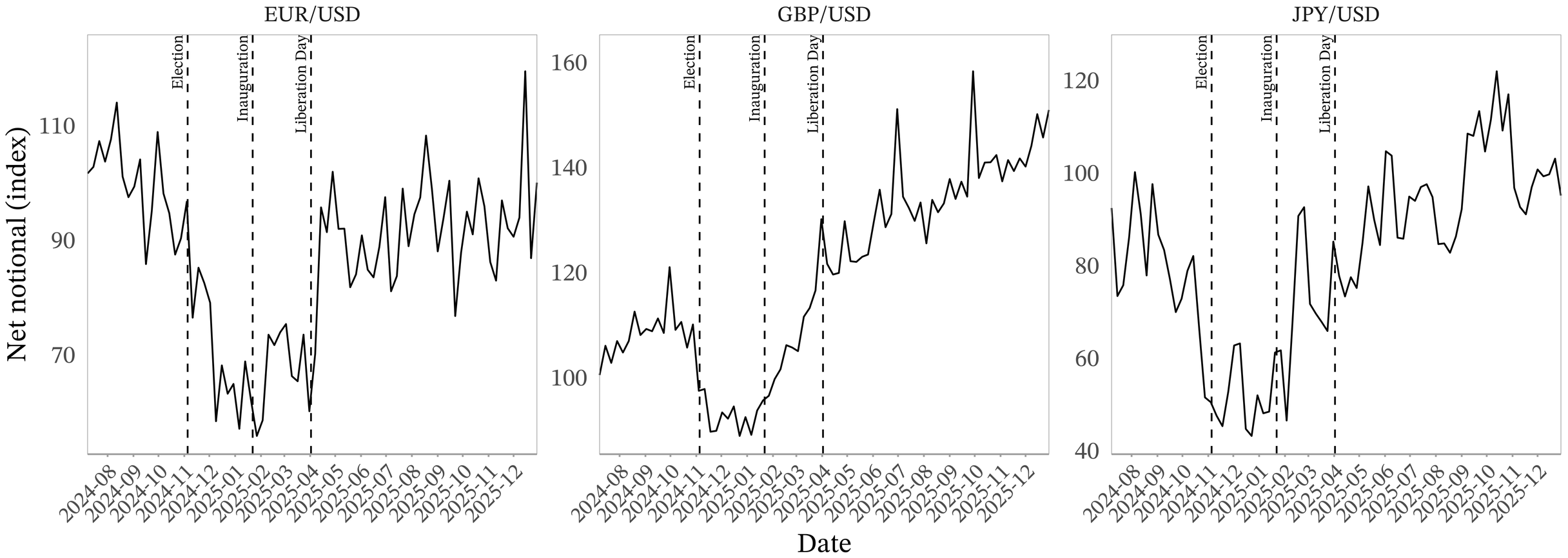
Benchmark CIP - 3m	8.19**	3.48	5.60***
	(3.64)	(2.57)	(1.96)
Benchmark CIP - 1y	3.85**	1.60**	1.85***
	(1.52)	(0.75)	(0.45)
Benchmark CIP - 5y	2.72***	0.85**	1.60***
	(0.92)	(0.36)	(0.37)
Benchmark CIP - 10y	2.44***	0.62**	1.34***
	(0.73)	(0.28)	(0.41)

	$\Delta \log(\text{VIX})$		
	'10-'15	'16-'20	'21-'25
UST Premium - 3m	5.72	6.28	4.23
	(3.98)	(4.54)	(2.79)
UST Premium - 1y	8.65**	-0.40	-3.21***
	(3.94)	(1.61)	(0.93)
UST Premium - 5y	6.37***	-0.02	-5.50***
	(2.17)	(1.02)	(1.47)
UST Premium - 10y	4.69**	-1.10	-4.54***
	(2.00)	(0.79)	(1.57)

- Compare returns on 10y Treasuries and Bunds with FX difference swapped; and USD and EUR money market rates.
- Loss of faith in Treasuries is quite dramatic, and already even there post pandemic.
- Seems to partly go into US equities.

Source: Du, Keratin and Schreger (2026) *Decoupling debt and treasury privilege*

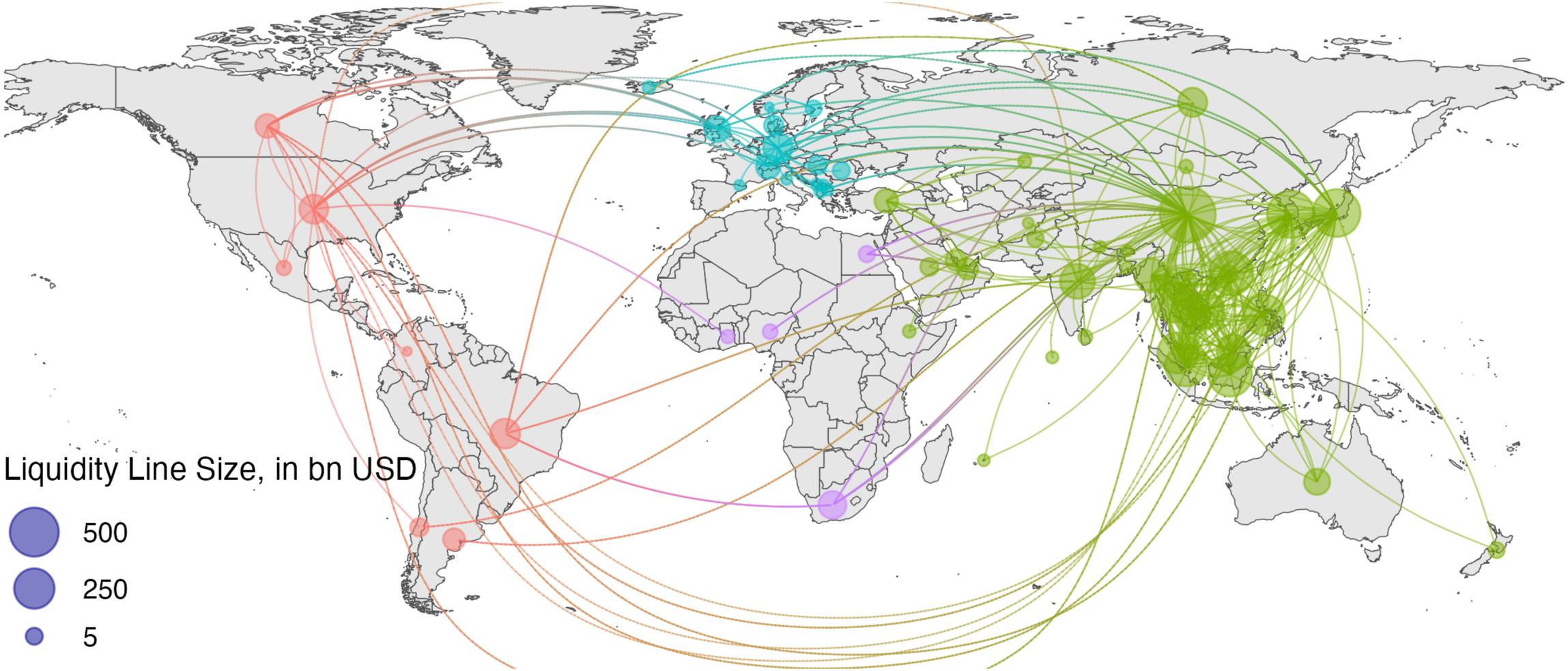
Demand for USD protection



- Demand for hedging of USD risk by foreign investors has greatly increased.
- So far, because USD has been depreciating, intermediaries have taken naked forward positions, increasing supply of forwards, so price (cross-currency basis) has stayed low.

Source: Bahaj, Carvalho, Czech and Reis (2026) *Dollar risk and dollar insurance: hedging supply and forward risk taking*

Central bank swap lines networks



Source: Bahaj, Fuchs and Reis (2026) *The global network of liquidity lines*

Conclusion

Conclusions: banks and government bonds

- **The classic diabolical / doom / nexus loop**
  - Unavoidable. But can be minimized and is closely monitored today.

- **Fiscal dangers in the horizon**
  - Unpleasant macro prudential arithmetics and the twin debt problem

- **Convenience yields and the debt revenue**
  - All measures show large shrinkage, especially for the US.

- **Focussing on the US, its Treasuries and currency**
  - Hedging costs have been low, but this may be temporary, and swap lines under threat
  - Can European banks survive a stress test on their US Treasuries holdings?