Discussion by Coletta Frenzel Baudisch of "The Fragility of Government Funding Advantage", RBA-Treasury Conference, September 4th 2025

First, I would like to thank the organizers of the RBA conference for the opportunity to comment on Jonathan's paper.

The trilemma described between a high funding advantage of US treasuries, financial sector stability and fiscal policy devaluating debt applies – evidently - to the US. Financial repression is introduced as regulation favoring the holding of government debt

Jonathan and his co-author find the funding advantage of US treasuries to be endogenous: as a result of financial-monetary policies. They asses the funding advantage not to be a mere characteristic of safe haven bonds. When reading this with a European eye, I was wondering who is implementing financial-monetary policies, or more specifically about the independence of monetary policy. So, financial-monetary policies work quite differently in the Euro area. In my remarks, I will share some reflections from a European or possibly German perspective.

To anticipate the key points:

- Independence of fiscal and monetary policies are pronounced in the euro area, financial-monetary coordination possibly more difficult.
- I see two different kinds of demand generation for government debt that are relevant for fiscal policy:
    - First, in the case of the currency union, monetary policy shaping demand for government debt can have different outcomes for the individual member states. The creation of central bank demand for government debt by the central bank itself may eventually turn out to not be necessarily advantageous for safe havens.
    - **The reason for this lies in the short-term deposit rate replacing the bond rate for government bonds held by central banks**. The higher the difference, the better off are governments. I will explain this in more detail.
    - **Second, there are regulatory privileges which may create government debt demand of commercial banks**. The sovereign-bank-nexus fostered by this can be risky. Furthermore, these regulations could stand in the way of completing the European Banking Union.

The usual disclaimer applies: These remarks reflect my personal opinion and do not necessarily reflect the views of Bundesbank or the Eurosystem.

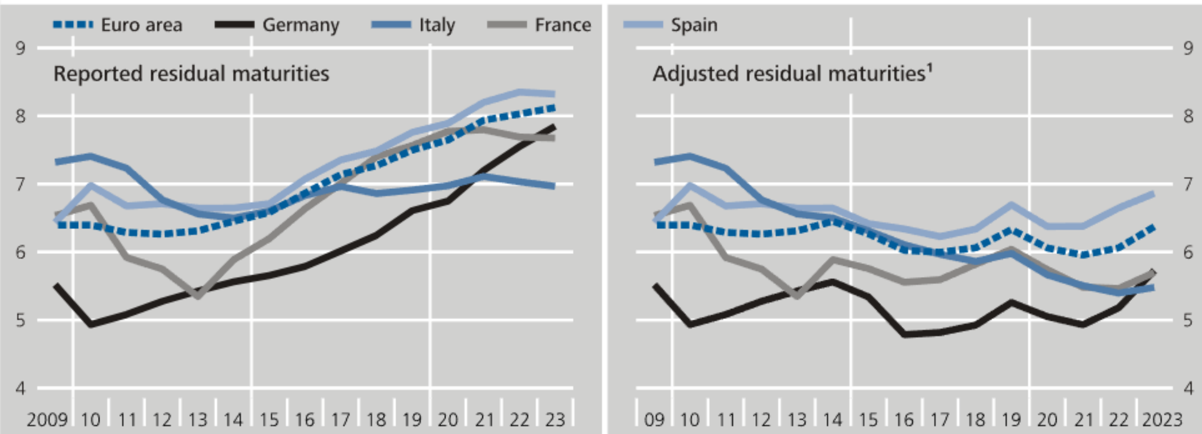
The main underlying difference between the US and the Euro Area might be obvious: monetary policy is set consistently at the European level by the ECB. However, responsibility for fiscal policy rests with the individual member states and is therefore not consistent. To correct for possible incentives to increase borrowing in a currency union, the Stability and Growth Pact represents a framework to prevent such outcomes. It contains rules to safeguard sound public finances with limits for annual budget deficits and debt ratios to be maintained. And: no-bailout. Meaning: member states must not assume liability for the debts of other member states. **The guiding principle of the monetary union was therefore individual responsibility**. This also means, that possible funding disadvantages of individual member states cannot be taken over by member states with such advantages.

The debt ratios of the individual member states vary widely. They ranged (end of 2023) from 20% in Estonia to over 160% in Greece. So, you can tell from these numbers that the sustainability of fiscal policy is not a homogeneous concept in the Euro area.

Residual maturities of government sector debt securities

Chart 4.4

Number of years, year-end data



Sources: Eurostat, ECB and Bundesbank calculations. **1** Residual maturities where the average interest rate fixation period has been adjusted for the balance sheet link between central banks and government finances. For bonds held by Eurosystem central banks, the residual maturity of an overnight deposit was applied. The balance sheet link between central banks and government finances is explained in Chapter 2 of the Monthly Report; the methodology and the data used are explained in the Annex.

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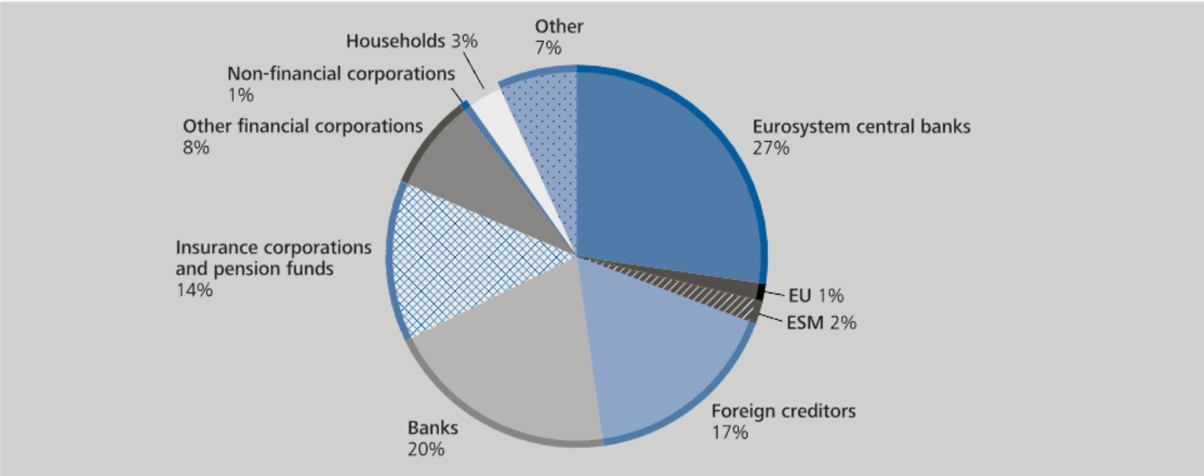
Source (as for all graphs in this discussion): Bundesbank (2024), Government debt in the euro area: current developments in creditor structure, Monthly Report, April 2024.

The average residual maturity of government debt has been relatively high in recent years. However, owing to central banks' extensive holdings, government finances are less well hedged against interest rate increases than you might think from the impression residual maturities give. Why is that? High residual maturities usually go hand in hand with interest payments being fixed for longer periods (exceptions exist as inflation-indexed Bunds in Germany). Therefore, interest rate changes would only have a very lagged impact on government finances. **Yet, in a holistic view, the balance sheet link between central banks and government finances has to be taken into account**. As a result of the central bank's holdings, the current short-term deposit rate replaces the bond rate as the effectively relevant rate. This link is independent of the residual maturity. My colleagues at Bundesbank adjusted the average interest rate fixation period for this effect: it might be two years shorter than indicated. I will get back to this link after giving you a quick overview on the creditor structure of European government debt.

Creditor structure of the government debt of the euro area, by sector* Chart 4.6

% of debt, end-2023 data



Sources: Eurostat, ECB, ESM, European Commission and Bundesbank calculations. * For more information on the methodology and the data used, see Annex to the Monthly Report.
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The creditor structure of government debt has shifted strongly in the Euro area since 2015. The reason for this shift lies in the asset purchase programs conducted by the central banks of the Eurosystem. This reduced the share of assets held by commercial banks in the Euro area and by creditors outside it. In response to high inflation, the central banks of the Euro area are tightening the monetary policy reins and are now reducing their holdings of government bonds. **Nevertheless, as of end 2024, national central banks were still the largest creditor accounting to roughly a quarter of government debt.**

Let me now explain in more detail – nonetheless simplified - how bond purchases of the Eurosystem affect national government finances: national central banks' bond purchases convert the rate of interest paid on government debt from the country-specific medium to longer term bond rates (including any risk premia) to a variable interest rate. This variable interest rate is the monetary policy deposit rate, set by the ECB, homogeneously across the Euro area, and it is risk-free.

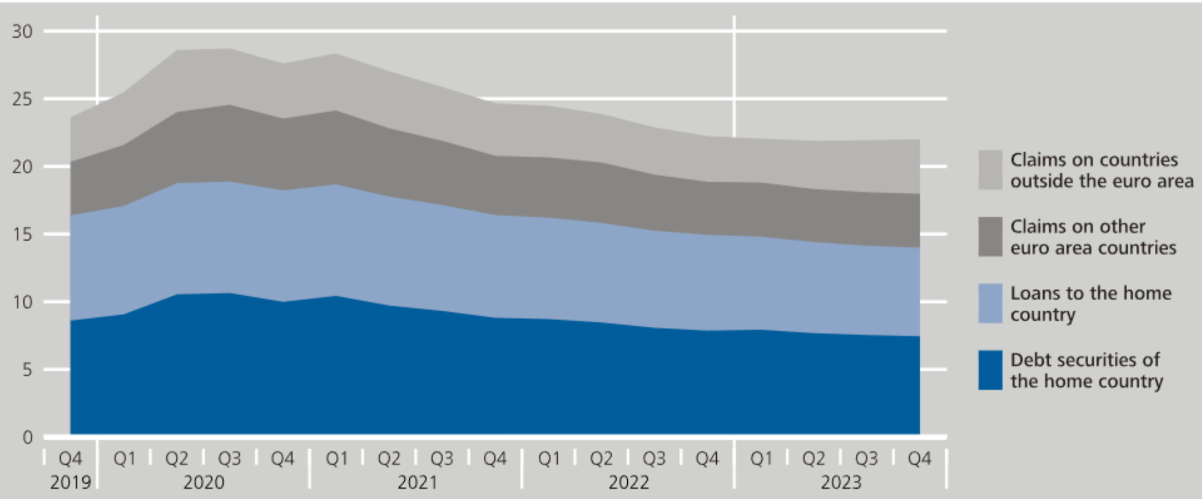
Interest payments on the purchased government bonds go to the national central banks. With growing bond purchases, commercial banks' deposits at the national central banks grow as well. In turn, national central banks pay interest (deposit rate) on these. **The difference between income from bond holdings and expenditure on the deposit facility affects central**

bank profit. If the interest rate on bond holdings is higher than that on deposits, net interest income of the central banks is positive. In the reverse case, the opposite holds. Central bank profit is distributed to the government, hence impacting government finances**. The higher interest rates on bonds (including risk premia) are, the better off are the central banks. The reason is: euro area countries are paying the market rates on their national central bank's holdings of their bonds to themselves. Hence, fiscal sustainability is not rewarded – or put differently, possible funding advantages of individual member states do not pay.** At the same time, government budgets become more dependent on changes in the short-term interest rate – which again is out of their hands.

Claims of banks in the euro area on countries

Chart 4.10

% of euro area GDP, quarter-end data



Sources: Eurostat, ECB and Bundesbank calculations.
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National commercial banks continue to be a significant creditor group. At end 2024, they held 21% of government debt. **The holding of government bonds does usually not require capital to be held against it. This regulation makes it attractive for banks to hold them, but it is associated with risk**. In crises, problems with states or banks could still reinforce each other today.

Additionally, large exposure limits do not apply. As a result, in some cases very large stocks of a sovereign's bonds are being held. Banks continue to be very closely interconnected with their home countries and exposed to the fiscal risks of those. In case of arising doubts about the sustainability of government finances, this can rapidly engender additional risks to financial stability. How could these risks be mitigated? It could make sense to reduce regulatory privileges. That would also facilitate negotiations to complete the banking union by establishing a European deposit insurance scheme.

Thank you.

References

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