Corona crisis

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The sovereign-bank nexus is tightening

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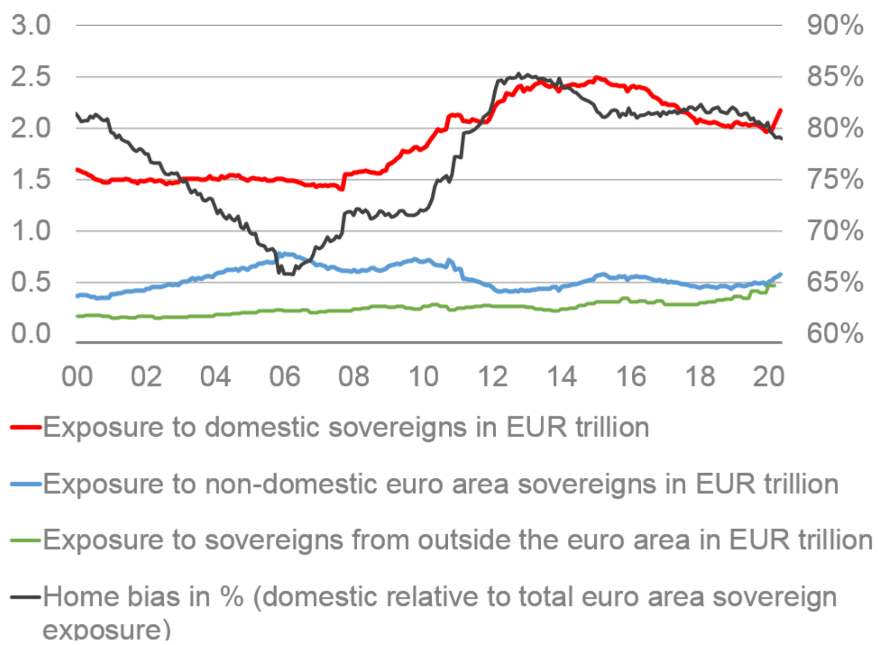
Governments in many countries are facing growing funding needs as they implement large fiscal stimulus packages to counter the severe economic downturn caused by the corona pandemic. Besides central banks, banks are financing more than half of the rising expenditures, which is affecting the composition of their balance sheets.

Next crisis, next rise of sovereign debt on banks' balance sheets

Euro area banks' exposure (left), home bias (right), until May 2020



Sources: ECB, Deutsche Bank Research

In March, euro area banks began to strongly raise their domestic sovereign exposure, which consists of both debt securities and loans. This marks the end of a trend of falling or stable claims which had prevailed since 2015. Banks boosted their exposure by EUR 61 bn in March, EUR 82 bn in April and EUR 52 bn in May, which adds up to the strongest growth in three consecutive months ever recorded. At the end of May, the total outstanding reached EUR 2,173 bn. During the same period, banks also expanded their claims on other euro area sovereigns by EUR 67 bn to EUR 580 bn (+13%, vs +10% for domestic exposures). This, in relative terms, even greater gain slightly diminished the home bias – the ratio of banks' domestic to all euro area sovereign exposure – to 79%.

Claims on the domestic sovereign also rose in relative terms. In relation to total assets, they grew by 30 bp to 6.4% despite a considerable increase in assets to EUR 35.2 trillion at the end of May. Banks accommodated surging credit demand from companies and also strengthened their own liquidity buffers at the central bank. Capital and reserves, by contrast, remained almost unchanged which pushed up the ratio of domestic sovereign exposure to equity from 78% at the end of February to 86% at the end of May. Banks' exposure to all euro area sovereigns climbed to 7.8% of total assets and 109% of equity.

A look at the national banking markets reveals sizable differences within the euro area, even though all banking systems (except for the Dutch) increased their domestic sovereign exposure in absolute and relative terms. Among the five largest countries, banks in Italy and Spain recorded the strongest increase and the highest share of domestic sovereign exposure. In France and Germany, the share is below the euro area average. Dutch banks are financially the least exposed to the domestic government.

Domestic sovereign exposure of banks in the largest euro area countries in 2020

		Total assets	Domestic sovereign exposure			
		End of May	March through May	End of May		
		EUR bn	EUR bn	EUR bn	%	%
		Total	Increase	Total	in total assets	in capital and reserves
Banks in	Euro area	33,907	195	2173	6.4%	86%
	France	10,214	62	426	4.2%	64%
	Germany	8,916	19	435	4.9%	74%
	Italy	3,890	55	706	18.1%	199%
	Spain	2,815	36	273	9.7%	103%
	Netherlands	2,625	0	78	3.0%	52%

Sources: ECB, Deutsche Bank Research

The overall increase in sovereign exposure was mainly driven by exceptionally large purchases of debt securities, while there was no comparable surge in loans to the public sector. This suggests that banks mostly financed central governments, as state-level authorities rely less heavily on securities and local governments mostly use loans to cover funding needs. National governments jump-started expansionary fiscal programmes in March in order to mitigate the economic slump caused by the corona lockdown. At the same time, the net issuance of debt securities by governments ballooned. In March, it was EUR 84 bn, twice the long-term average. In April, it skyrocketed to EUR 172 bn. Hence, banks are funding a sizable share of the fiscal expansion.

Euro area banks are financing a large part of the fiscal expansion in 2020

	Debt securities issued by euro area sovereigns	Bank holdings of debt securities issued by euro area sovereigns
	Net issuance in EUR bn	Increase in EUR bn
May	n.a.	76
April	172	89
March	84	74
February	55	17

Sources: ECB, Deutsche Bank Research

Banks could be investing in euro area sovereign debt for safety reasons given the economic downturn. Moreover, banks may be buying government debt to turn it in for liquidity at the ECB. But bonds from peripheral countries had also become more attractive due to rising yields. Obviously, given ECB funding at zero or negative rates, the carry trade from such investments helps banks to generate much needed interest income. Whatever the reason, the sovereign-bank nexus in the euro area is currently tightening again.