Navigating quantitative tightening: funding Europe’s future without rekindling the sovereign-bank nexus

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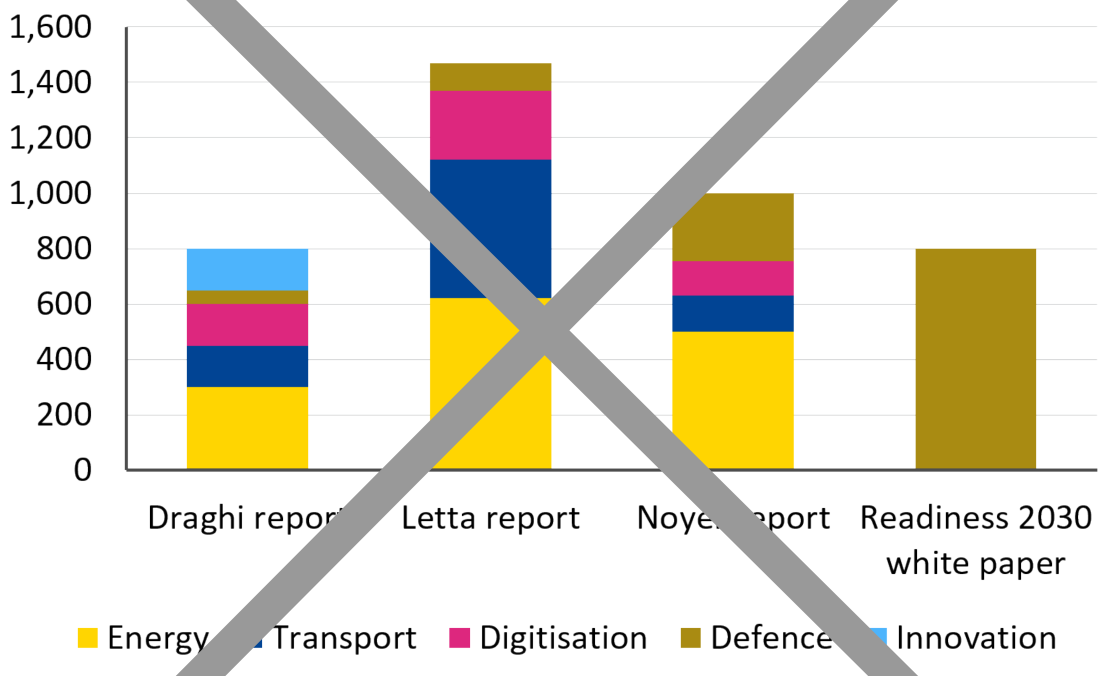
Europe faces substantial investment needs to tackle structural changes and to future-proof its economy, which will lead to rising levels of public debt. This burden comes at a time when the Eurosystem, the major buyer of sovereign debt over the past decade, has stopped net asset purchases and reinvestments. This brings the question: who will absorb the additional debt? In the past, banks played a major role, but the destructive force of the sovereign-bank nexus Europe acutely felt during the sovereign debt crisis exposed the financial stability risks of relying excessively on them. Following the European Stability Mechanism (ESM) mandate, we explore how a diverse investor base can help meet these financing needs without rekindling the sovereign-bank nexus.

Europe faces a defining moment amid mounting pressures

Recent high-level reports[1] have highlighted the challenges of shifting demographics and geopolitical landscapes that Europe must navigate while also financing the digitisation and green transition. Beyond this, the European Commission estimates that additional defence spending needs alone may eclipse previously estimated aggregate spending requirements (Figure 1).[2] Across the various reports, estimated financing needs vary in both amount and composition.

Figure 1: High-level reports have identified varying financing needs to transform the economy

(financing needs until 2030 in € billion)



Sources: Mario Draghi "The Future of European Competitiveness" report (2025), Enrico Letta "Much more than a market" report (2024), Christian Noyer "Developing European capital markets to finance the future" report (2024), and European Commission "White Paper for European Defence – Readiness 2030" (2025)

While expectations are high for the private sector to mobilise most of the required capital, it cannot shoulder the burden alone. Given that a number of the investment areas qualify

effort will increase the supply of sovereign debt, ultimately begging the question as to who will absorb it.[3]

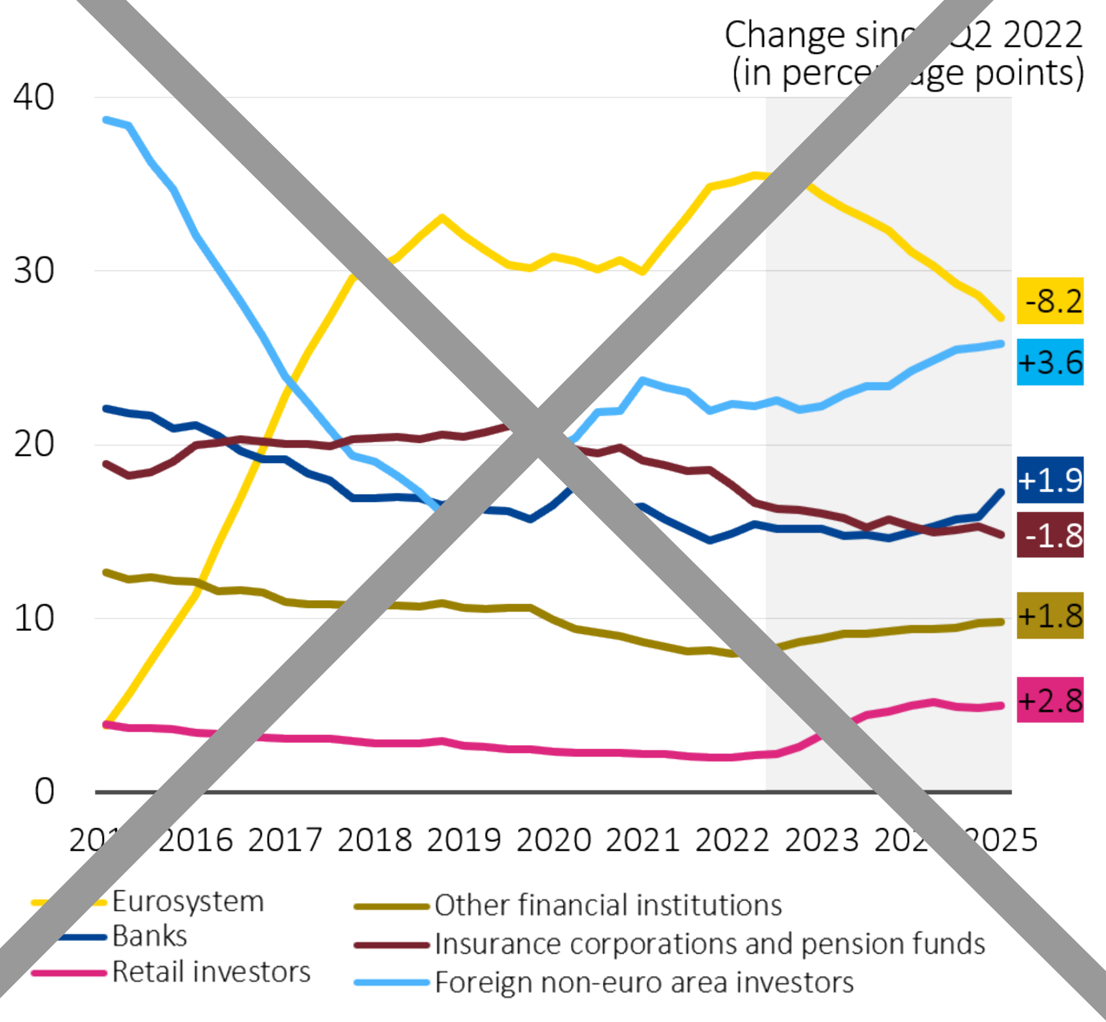
Sovereign-bank nexus has weakened and should not be rekindled

In the past, banks were a common buyer of sovereign debt, especially domestic debt. While on paper sovereign debt is often considered risk free, practice shows that this is not the case, as evidenced by the European sovereign debt crisis for instance. Where banks hold large quantities of sovereign debt, and concerns on the viability of this debt push down its price, the corresponding market value losses spill over into problems for the banking sector. As a result, banks' lending capacity becomes constrained, thereby impeding their ability to serve the real economy, starting a self-enforcing doom loop of economic deterioration.[4] The Eurosystem began a period of quantitative easing and purchased a significant amount of European government bonds (EGBs) between March 2015 and July 2022, thereby crowding out European banks and reducing their share of EGBs from 21% to 15% (Figure 2a,b). This has ultimately weakened the sovereign-bank nexus.

Figure 2: Euro area government debt securities: an evolving and heterogenous investor landscape

2a: Evolution of sectoral holdings of government debt securities

(market shares in %, issued by 10 euro area countries)



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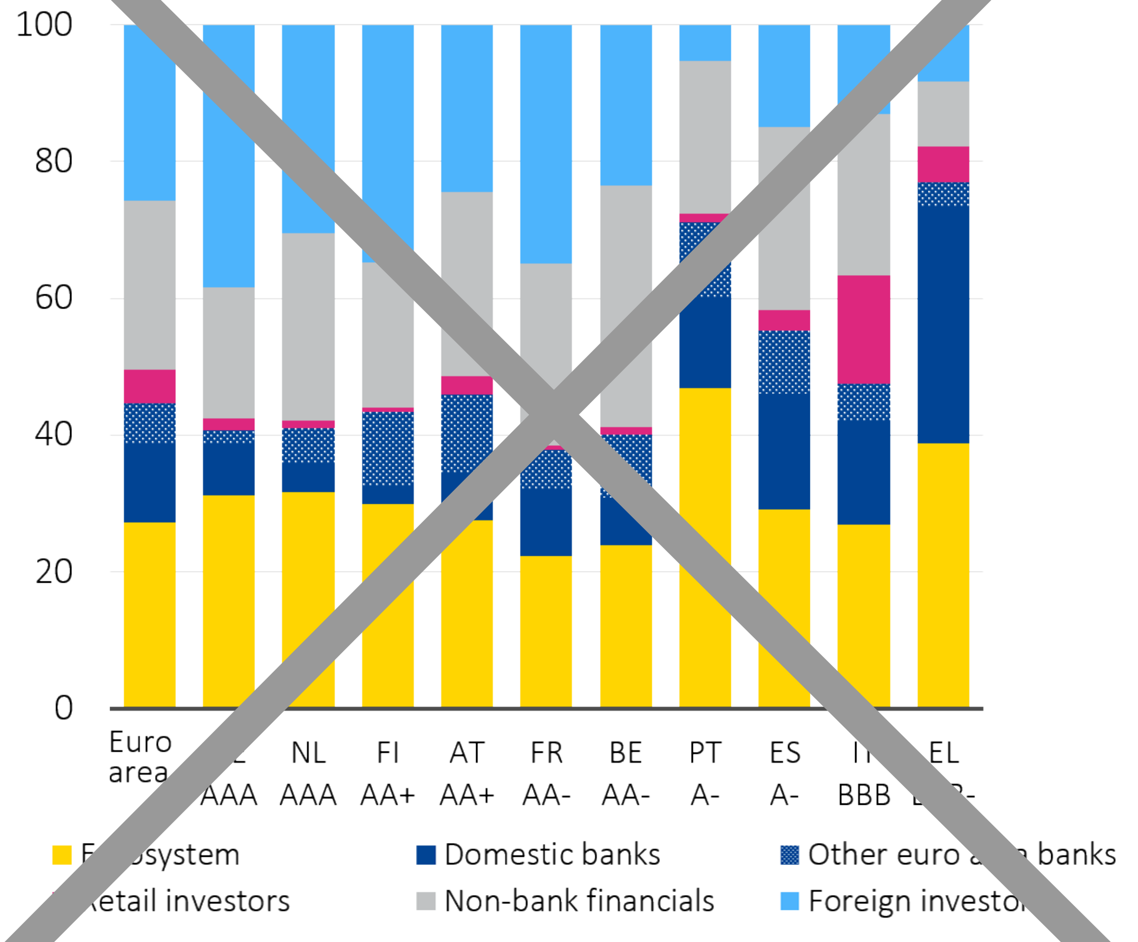
2b: Investor base by sector for 10 euro area countries

(market shares in %, as of Q1 2025)



Note: Aggregate based on a subgroup of 10 euro area countries for which data is available prior to the start of the European Central Bank's (ECB) quantitative easing. See endnote three for further details on government debt securities holders. Countries' ratings are the average from the ratings of Fitch, Moody's, and S&P

Source: ESM calculations based on ECB data

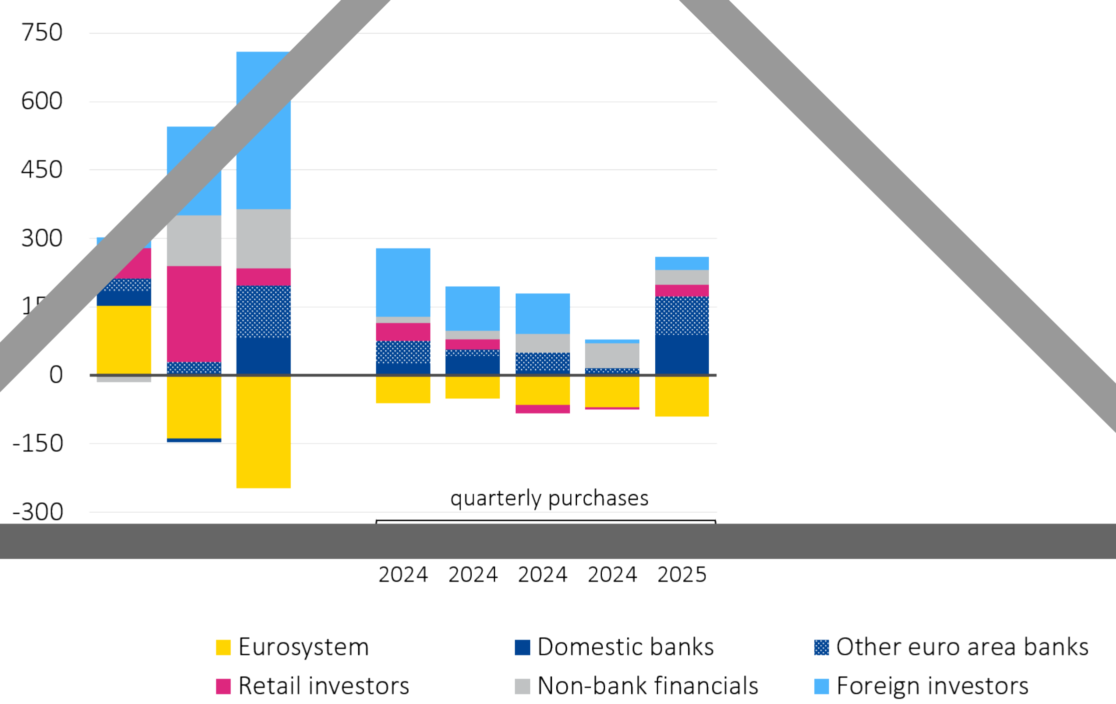
Banks resume sovereign bond purchases and increasingly look beyond national borders

Following a spike in inflation, the Eurosystem transitioned to quantitative tightening, stopping net asset purchases in July 2022 and ceasing the remaining reinvestment redemptions at the end of 2024.[5] This meant that other investors had to step in to fill this gap. Euro area banks have re-emerged as major purchasers of EGBs, particularly in 2024 and even more so in the first quarter of 2025 (Figure 3). During that quarter, banks acquired approximately €174 billion, nearly matching their total annual purchases of 2024. Notably, banks have been increasingly buying non-domestic EGBs, which account for around 60% of the total purchases since Q2 2022. As a result, the domestic concentration of banks' sovereign bond portfolios has declined despite the overall increase in banks' EGB holdings since mid-2022 (Figure 4).

Figure 3: Euro area banks' renewed interest in EGBs, with record acquisitions in early 2025

Net purchases of government debt securities by investor category

(10 euro area countries, in € billion)



Notes: Subgroup of 10 euro area countries for which data is available prior to the start of the ECB's quantitative easing. See endnote three for further details on the composition and categorisation of government debt securities holders.

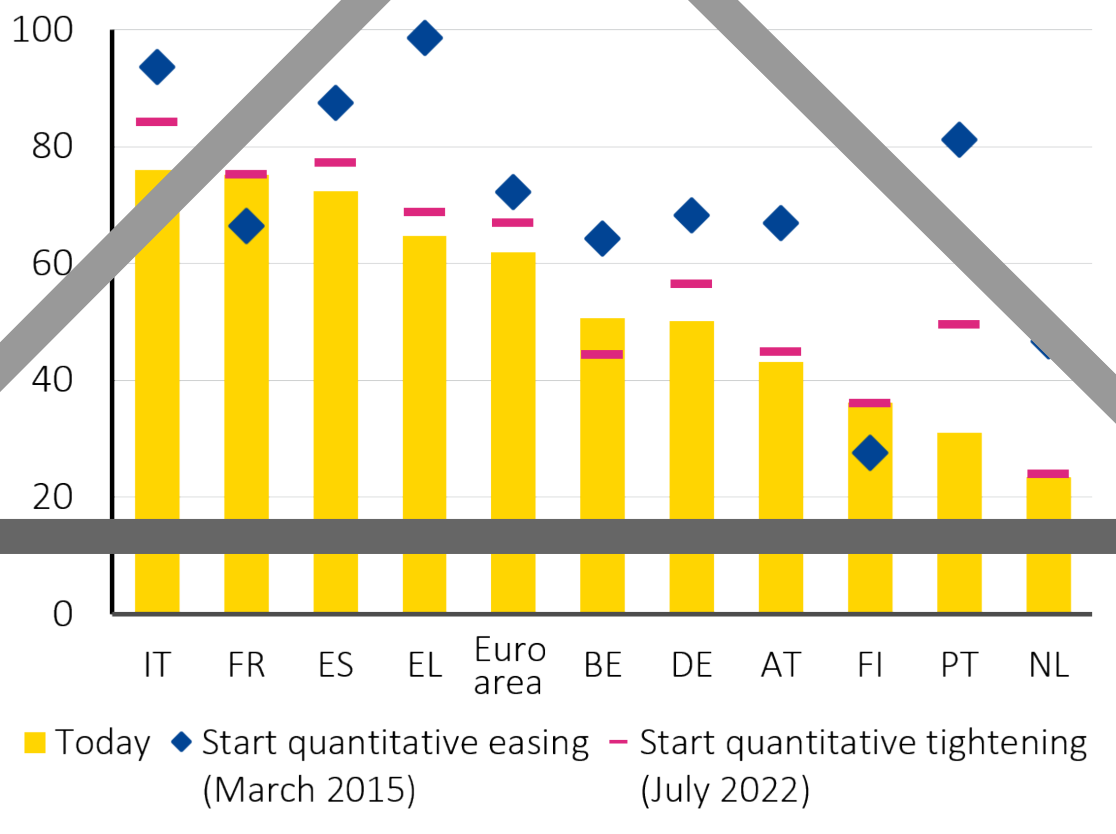
Source: ESM calculations based on ECB data

This development is welcome from a financial stability perspective as it reduces the risk of a feedback loop between banks and their sovereigns in times of stress, particularly now that these sovereigns have become more indebted (Figure 4b). While European banks' market share of EGBs remains lower than a decade ago (17% versus 21%), it would be desirable to further diversify the investor base for sovereign debt, rather than increasing banks' exposure and possibly rekindle the sovereign-bank nexus.[6]

Figure 4: Bank holdings of government bonds: declining home bias but rising sovereign risk

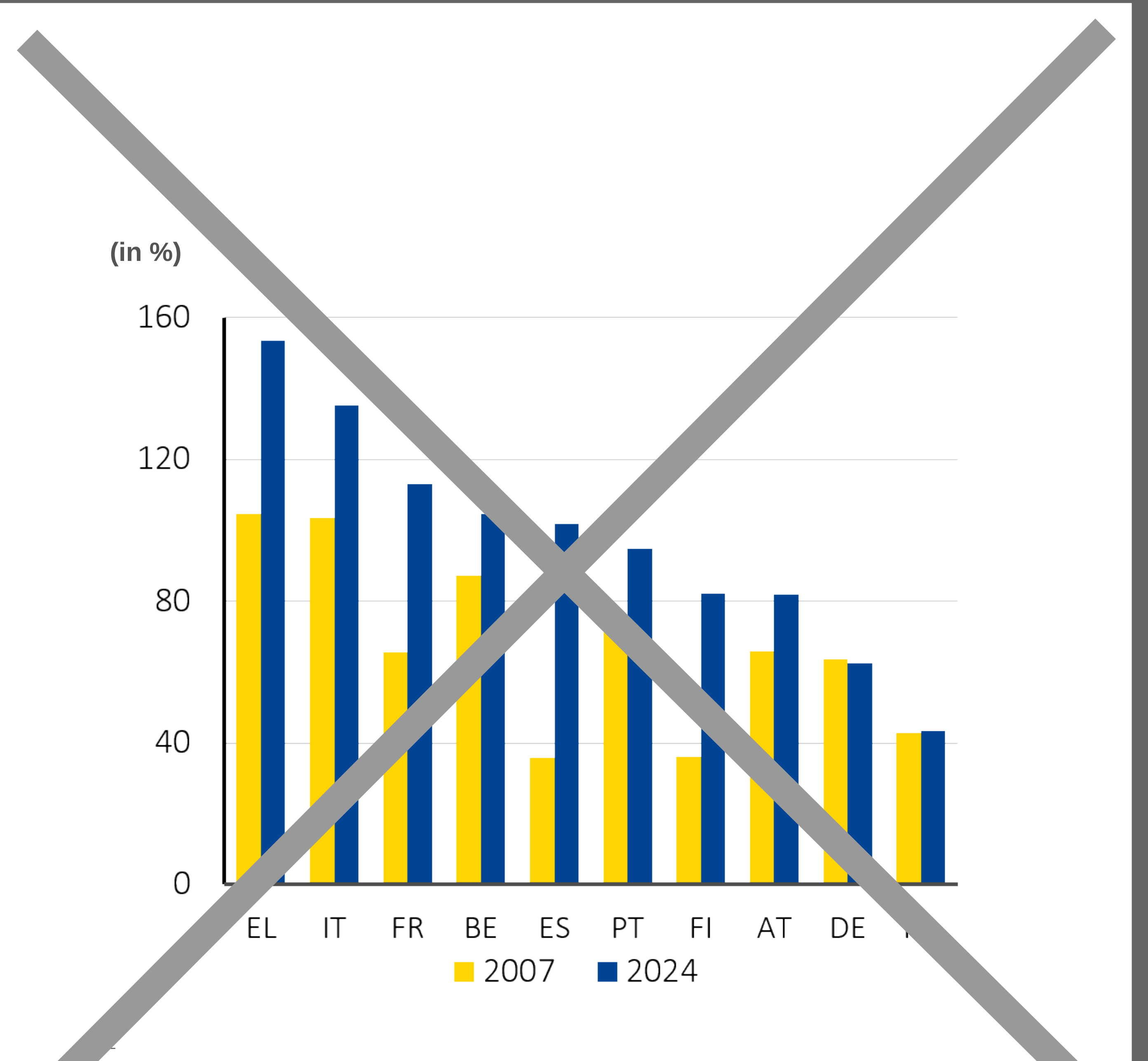
4a: Domestic EGB holdings as a share of total EGB holdings by banks in the reference country

(in %)



Source: ESM calculations based on ECB's BSI data

4b: Outstanding sovereign debt as a share of gross domestic product



Source: Eurostat

International investors are back, but opportunities come with challenges and risks

As euro area demand alone cannot absorb all net sovereign issuance, foreign non-euro area investors have long been — and will remain — essential to diversifying the sovereign investor base and lowering borrowing costs. Historically the dominant holders, foreign investors saw their share fall sharply during quantitative easing and the decade of ultra-low yields, from around 37% in 2015 to 21% by mid-2022 (Figure 2a). With the Eurosystem no longer buying EGBs, they stepped up their purchases, attracted by higher returns across the region.[7]

Since mid-2022, international investors have been the largest buyers of EGBs, particularly those issued by Germany, France, Finland, and the Netherlands, as they initially sought to lock in high yields ahead of an expected easing cycle. With the ECB having cut its policy rates at a faster pace than other major central banks, 200 basis points compared to 100 basis points for the United States (US) Federal Reserve and the Bank of England, foreign demand has begun to soften since late 2024 (Figure 3) and their appetite appears more selective. While France saw outflows and demand for German bonds remained muted early this year, net purchases shifted towards Italy, Spain, and Portugal, where yields remain attractive even after currency risk is hedged.

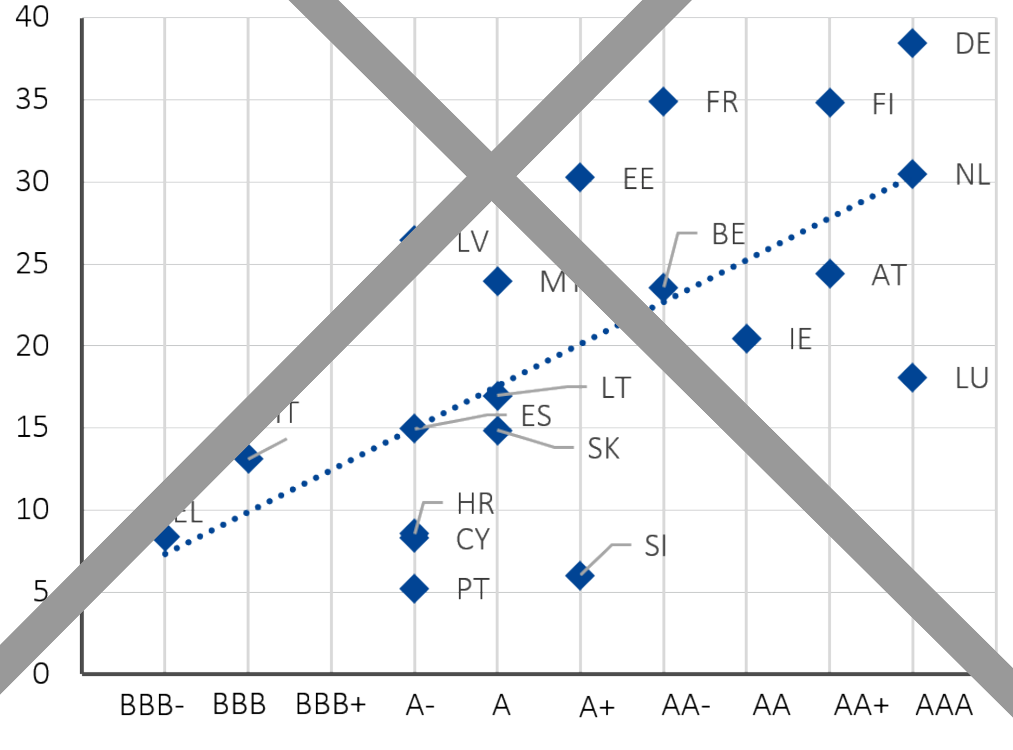
Foreign investors form a diverse group with differing motives, yet tend to favour liquid, high-quality papers (Figures 5a). Private investors, such as investment funds, primarily seek returns, while official investors — mainly foreign central banks — hold sovereign bonds as foreign exchange reserves, aiming to balance safety, liquidity, and returns. Central banks' allocations, though still largely guided by trade links and foreign debt issuance, are increasingly shaped by geoeconomic considerations, including liquidity and credit risks arising from geopolitical shocks. Beyond economic rationales, political factors may also influence their decisions, posing risks to euro area external financing, especially as around one-third of foreign holdings of EGBs are held by central banks in geopolitically distant jurisdictions.[8]

Looking ahead, with volatility now a defining feature of the global landscape and interest rates stabilising above zero in most major economies, a key question is whether foreign investors can be relied upon to absorb rising euro area sovereign issuance. While their share has recovered to around 24%, it remains well below their pre-quantitative easing [illegible] US fiscal sustainability and political uncertainty are prompting investors to gradually diversify away from US dollar assets.[9] In this rebalancing, the euro is well-positioned to gain traction — not only as a diversifier, but increasingly as a credible safe haven supported by more predictable policy, stronger institutional fundamentals, and a demonstrated ability to manage crises. Seizing this opportunity, however, will require reinforcing the region's foundations through deeper capital markets, a higher supply of safe assets, and fewer investment barriers.[10]

Figure 5: Investors are driven by different motives when investing in sovereign debt

5a: Foreign investors tend to favour higher-rated sovereign debt

(foreign-held sovereign debt securities by external credit rating, share in % as of Q1 2025)



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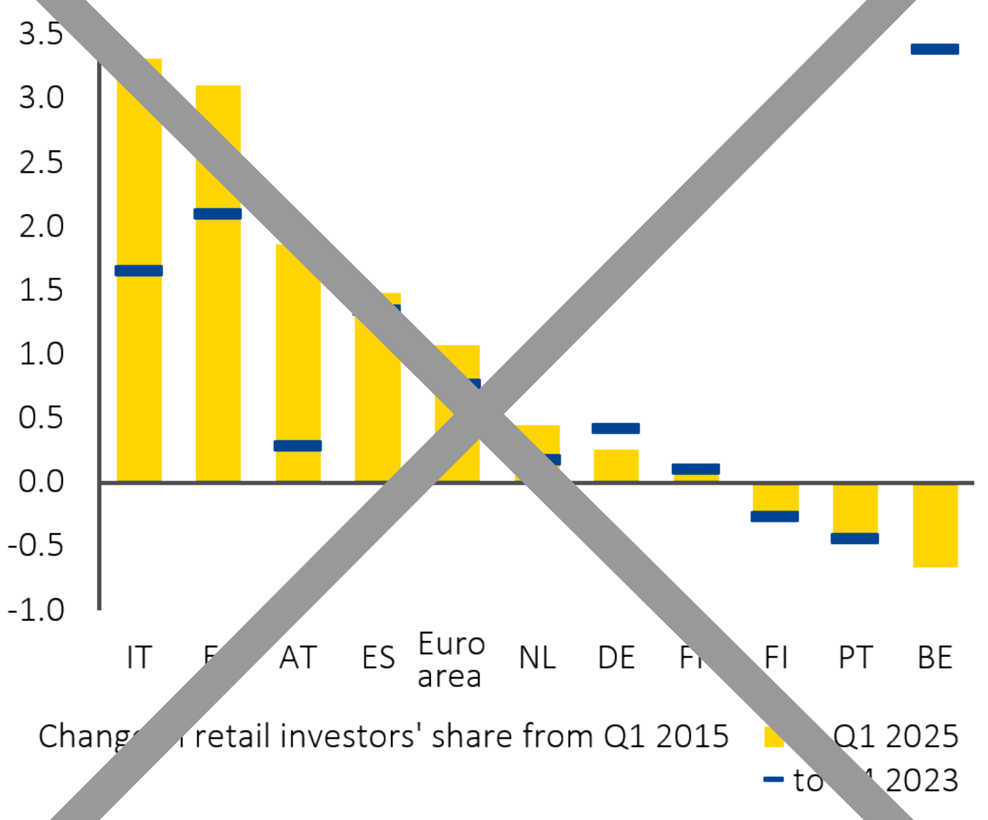
Note: The rating is the average from the ratings of Fitch, Moody's, and S&P.

5b: Retail investors' share of sovereign debt surpasses pre-quantitative easing levels

(in percentage points)



Note: [illegible] aggregate based on a subgroup of 10 euro area countries for which data is available pri[illegible] the st[illegible] of the ECB's quantitative easing. Positive numbers indicate that the holding share of retail inv[illegible]rs, [illegible] of the latest data, is already above its pre-quantitative easing level (Q1 2015). We also examine change as of Q4 2023, as some governments (such as Belgium) introduced temporary initiatives to encourage banks to raise their deposit rates.

Source: ESM calculations based on ECB data

A broader role of households could be a mutually beneficial endeavour

Households could play another important mutually beneficial role in absorbing the additional sovereign debt.[11] First, they too were crowded out by the Eurosystem's asset purchase programmes, creating space to reclaim. Indeed, recent data show a return of retail investors to sovereign debt markets, even beyond pre-quantitative easing levels for some countries (Figure 5b). Second, household debt absorption can help contain borrowing costs, supporting the public purse and social cohesion.[12] Third, bonds often yield more than bank deposits, drawing larger holdings, where this advantage is compounded by preferential tax treatment (Figure 2b).[13]

Yet, where retail participation increases subsequentially, households' home-bias towards their sovereign warrants attention, as it tightens the link between government solvency and private wealth. Against this backdrop, initiatives such as savings and investments union are welcome to strengthen retail investor participation while encouraging diversification. Examples such as the Dutch or Swedish savings and investment accounts and a simplified treatment of cross-border taxation[14] could reduce this home-bias by channelling savings from domestic to other euro area capital markets as well as other asset classes. With such diversification, greater household involvement can broaden and stabilise the sovereign investor base, as households are typically less prone to sell during periods of market stress.

Completing savings and investments union: a path to diversifying sovereign investor base

While net issuances have been smoothly absorbed since the end of quantitative easing — with foreign and retail investors playing key roles and banks reemerging as strong buyers — the vast investment needs ahead raise concerns about reigniting the sovereign-bank nexus, something closely monitored by the ESM. Diversifying the investor base is therefore crucial to mitigating this risk. To support greater participation from households and foreign investors, policy initiatives such as savings and investments union should be pursued without delay. Doing so would remove investment barriers within the region, thereby deepening capital markets and helping finance productivity-enhancing investments, boosting Europe's investor appeal. The benefits thereof are mutual: foreign investors would find stable investment opportunities and households can earn higher yields while diversifying across geographies and asset classes. As a result, the ownership of sovereign debt would naturally diversify and possibly contain rising yields at a time of quantitative tightening despite public spending pressures.

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Footnotes

[1] See Draghi, Letta and Noyer reports.

[2] See Readiness 2030 report.

[3] Evidence in this blogpost on general government debt securities holders, drawn from ECB data, primarily focuses on a sample of 10 euro area issuers: Germany, France, Italy, Spain, Belgium, the Netherlands, Austria, Portugal, Greece, and Finland. This grouping is used because the available data enables historical comparison prior to the start of the ECB's quantitative easing. Sovereign holdings are broken down by creditor type, distinguishing between non-euro area foreign investors, euro area investors, and the Eurosystem. Euro area investors are further disaggregated into banks (monetary financial institutions excluding the central bank), retail investors (households and non-financial corporations), insurance corporations and pension funds, and other financial institutions (including non-money market investment funds). General government holdings of government debt are excluded from this analysis. Where noted, bank holdings are further broken down into domestic and other euro area banks. Insurance and pension funds, together with other financial institutions, are occasionally grouped under the category "non-bank financials."

[4] At the same time, vulnerabilities in the banking sector can also spillover to the sovereign. In the past, this was exemplary observed, were ailing banks were bailed-out by their sovereign, which in turn became more indebted and hence found it more difficult to issue new bonds in the market and/or service existing debt. Legislative changes since the European sovereign debt crisis have aimed to reduce this transmission channel, by changing from a bail-out to a bail-in approach, that is the write-down of an ailing bank's liabilities to create additional loss-absorbing capital.

[5] Under the ECB's public sector purchase programme, reinvestments were fully stopped by July 2023. For their pandemic emergency purchase programme – launched during the Covid-19 pandemic – reinvestments of redemptions lasted until December 2024.

[6] Although their footprint is significant, euro area non-deposit financial institutions are not considered in this analysis. Insurers and pension funds' exposures are mostly concentrated towards the long end of issuances and are hence constrained in their ability to support a broad range of sovereign debt issuances. In turn, investment funds and asset managers are unlikely to invest through the cycle and are therefore not seen as a stable source of demand.

[7] See ESM blog, January 2024. Higher interest rates attract investors to euro area sovereign debt but pose challenges for public finances

[8] See ESM Blog, October 2024 Geoeconomic fragmentation looms over euro area financial stability and ECB's special issue "Geopolitics and foreign holdings of euro area government debt".

[9] April ECB balance of payments data shows preliminary signs that euro area sovereign securities are capitalising on this momentum, with foreign investors purchasing €26 billion in EGBs. In contrast, April US Treasury International Capital data shows a €56 billion selloff of US government debt by foreign investors — mostly private — while they had been strong buyers in recent years.

[10] Geopolitical risk has become a key factor in central banks' reserve management, prompting a renewed push for diversification — most notably away from the US dollar toward global alternatives such as the euro. According to the Official Monetary and Financial Institution's Forum's Global Public Investor 2025 survey of 75 central banks, 31% now cite geopolitics as the top near-term investment driver, up from just 4% in 2024. Although the US dollar remained the most in-demand reserve currency in 2024, sentiment shifted in 2025 amid political and fiscal concerns, even as over 80% still regard it as offering superior safety, liquidity, and return. Driven primarily by diversification motives, a net 16% of central banks plan to raise their euro holdings — the highest for any currency and more than double last year's share — with this figure even higher among those most concerned with geopolitics. Euro assets, however, still face headwinds from relatively low prospective returns and the region's broader economic outlook. See also the UBS Annual Reserve Manager Survey 2025 for broadly aligned observations.

[11] Households also invest in sovereign debt through instruments other than marketable debt securities—e.g. savings and treasury certificates held by households in Portugal represented close to 16% of total consolidated general government debt at face value in Q1 2025, while their debt securities holdings accounted for only 1%. Additionally, households can gain indirect exposure through investment funds, insurance corporations, and pension funds. Therefore, the figures we present underestimate their total exposure to total government debt.

[12] [illegible] Sovereign Default Models." Federal Reserve Bank of Richmond Economic Brief, No. 23-22, and Aguiar, M. The Costs and Consequences of Sovereign Borrowing. IMF Econ Rev 73, 1–19 (2025). https://doi.org/10.1057/s41308-024-00248-9

[13] A recent example comes from Belgium, where the issuance of a special retail bond attracted broad attention, confirms that there is corresponding demand from retail investors. Similarly, Greek households have allocated notable shares of their savings to EGBs, earning a higher yield than on bank deposits.

[14] See, exemplary, the Faster and Safer Tax Relief of Excess Withholding Taxes (FASTER) Directive, which aims to ease the complexity of withholding tax procedures across the EU, thereby facilitating cross-border flows of capital.