Reserve currency status underpins and underwrites the issuing of government bonds in advanced economies

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Abstract

Bonds are traditionally more stable and less volatile than equity as instruments to safekeep one's money. But, bonds, by its conceptualization and construction, are illiquid assets. Such illiquidity provides a gap which can be exploited by manipulators and speculators in the bond market. Similar in nature to corporate bonds, government bonds are also an instrument for safe investing by retail investors trying to earn a higher interest rate compared to fixed income deposits. However, government bonds carry with them an additional level of stability and security given that they are underwritten by a country's treasury. But, is that so? Knowledge and observations from the recent Greek debt crisis that involves massive default on government issued sovereign bonds illustrate the real problem may not just be that Greece does not have control over the currency in which the government bonds are denominated in. What is perhaps more important is that a country needs to have a reserve currency that it issues in order to underwrite the issuing of government bonds with less risk of massive economic outage when the country defaults. To understand this point, consider the case where a country issues government bonds to finance operational expenditure of the government and civil service. Such issuance carries a higher risk of default because it indicates that the government lacks cash and operational means to finance the civil service. But, in the case of a government with a reserve currency such as the United States, this fact could be forgiven as the government would print more money through quantitative easing to ameliorate any anxiety in the bond market should government finance shows any signs of weakness. Basically, the operating principle for issuing government bond with support of a reserve currency is that the sheer size of international holdings of the reserve currency such as U.S. dollar provides critical ballast for supporting and ameliorating any possible negative effects should the U.S. government default on its debt. This monetary effect could be explained by the buttressing role of a reserve currency. But, it also cast a mirror on other countries' need for prudency in issuing government bonds since they do not have the stabilizing support of a reserve currency. Crucially, as the Greek debt crisis shows, a country needs to own the reserve currency to enjoy its stabilizing benefits on government bond issuance, a borrowed reserve currency like in Greece's case does not work.

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