Economic Policy and Justice – How Government Bonds Have Become the Fairest Way to Stimulate the Economy in Hard Times

In life there are winners and there are losers. During recessions, policymakers have the difficult task of minimising the losers.
In past crises, central banks have reduced the base interest rate as a tool to prop up spending and investment, to stimulate the economy. As recessions have become deeper and more complex, reducing the base rate has not only been ineffective due to liquidity traps but has also increased wealth and income inequalities: the average household sees the value of their savings fall, whereas high-income individuals who have the resources to invest in financial assets will accumulate wealth.

During the 2008 crisis and the Covid pandemic, central banks turned to quantitative easing instead, and the Bank of England's total stock of government bonds now totals £875bn. The purchase of government bonds both by the private sector and central banks has arguably become a fairer and more efficient way of boosting the economy, as it results in both monetary and fiscal expansion, and benefits most groups in the population.

The most obvious impact of the purchase of bonds is funding government borrowing, which in turn will result in a fiscal stimulus.
As a result of the Covid-19 crisis, public borrowing is set to hit £394bn this year, the highest since the second world war. This has been raising currency crisis alarm bells: when the Debt Management Office increases the supply of bonds, you would expect the price to fall and the interest rate to increase, causing government debt to accumulate over time. However in most developed countries, the opposite happens as bonds are seen as a safe asset, so private sector demand will outstrip the supply.

Quantitative easing will cause demand to increase further, resulting in a fall in yields; even though half-a-trillion pounds worth of bonds were issued in 2020, the yield almost fell by a factor of 4 and is lower than inflation on all bonds. Borrowing at a very low and even negative cost allows the government to engage in expansionary fiscal policy, such as the furlough scheme, of which 30% of the workforce were recipients at its peak in May. Thus this prevents inequalities from rising as much as they would have otherwise.

Low-interest rates on government bonds have historically increased the size of the public sector in the long run. Following World War II, France had accumulated high amounts of public debt but the 13% inflation rate in the 1950s meant that real interest rates on the debt were low, allowing them to recover and engage in reconstruction. As a result, the value of public capital increased to 100% of GDP at its peak in 1950, while it was at -100% in England, where the inflation rate was only 3%. In the long run, this meant that the welfare state in France was stronger and that more social security measures were put in place, causing living standards to improve.

Bonds have become essential to all aspects of the economy since the 2008 Financial crisis, as the relationship between governments and the private sector strengthened, (private investors and financial institutions not only use bonds for regulatory purposes but also as collateral and as a safe asset during recessions). The greater interdependence between the government, the private sector, and central banks is demonstrated by the fact that the Bank of England held 0% of bonds towards the end of Thatcher's leadership in 1988, whereas it purchased 50% of debt between February and October this year. Central banks can no longer afford to follow the laissez-faire attitude proposed by Friedman and solely control inflation – intervention in the bond market is necessary for stimulating the economy and is fairer than many other policies.

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