Get ready for the repeats

***Manoj Pradhan** argues that the recent ructions in the UK's gilt markets are just a foretaste of some of the difficult economic and policy trade-offs that an increasingly ageing society will have to manage*

It turns out that, if you want real drama, you don't need a telenovela from Brazil. Just tune in to the effect of UK policy on financial markets. And, like the telenovela, it promises many episodes and a long run.

The UK drama unfolded when the yields on long-term gilts rose sharply and the swap positions of pension funds were left exposed. With margin calls coming thick and fast, the only option was selling gilts. As is almost always the case, a forced unwinding only exacerbated the problem…until the central bank stepped in…but only for a while. The Bank of England's firm position on ending its emergency bond-buying program as scheduled put fiscal policy almost back to where it was before this all started, but left the economy worse off. The aftermath will continue politically and economically, but politics and economics are not the only factors.

Demographic shifts will ensure that such challenges endure into the distant future. An ageing society will mean a massive expansion of the economic role of pensions. A rapid increase in the incidence of dementia will mean a huge increase in government debt. And the question marks over how that debt will be financed will determine how financial markets behave.

The rocky tenure of Prime Minister Truss may have given us a glimpse of the dangerously thin line that policy, financial markets and the economy will collectively have to tread as we wade deeper into our demographic future. For starters, take the stark trade-offs – if not outright conflicts – between the monetary and fiscal policy objectives. They inevitably mean conflict between Downing Street and Bank Street. The incoming Truss administration's fiscal package was partly ideological, and partly an attempt to support growth. The ideological part of the package was a rookie mistake – it could easily have been delivered 6-9 months down the line (assuming inflation would have cooled at least somewhat by then).

The timing, cyclical implications and unfunded nature of the proposed fiscal expansion, however, were more than a mistake. Not only would it have been a massive boost to inflation, around which the Bank of England has been treading warily with limited interest rate rises, but it would also have required a huge quantum of unfunded debt financing that financial markets would need to absorb. This they refused to do without a premium.

The Bank of England was then forced to reverse both of its pre-fiscal package stances. A bigger interest rate hike is still likely to materialise despite a mammoth (but not complete) fiscal U-turn, and quantitative tightening has been more or less abandoned for the foreseeable future.

Demography is likely to generate a similar conflict if Charles Goodhart and I are right about the stagflationary future. First, governments will attempt to use their fiscal powers to support growth and their own political future. At the same time, the central bank will struggle to keep that demand-led inflationary impulse from exacerbating the supply-led, demographic inflation impulse that it can do little about. The policy conflict that we have witnessed has only just begun.

> *Demographic shifts and an ageing society will ensure that such challenges endure into the distant future*

Second, financial dominance will increasingly make its presence felt. Demography, ageing and the gigantic economic cost of caring for those suffering from neuro-degenerative conditions will mean a massive increase in government spending. It will dwarf the increase in debt during the pandemic. How that spending is deployed and funded will become a key question to which financial markets will demand answers. If they see a lack of policy direction and coordination like the recent times the reception will be frosty.

Finally, governments, central banks and financial markets will have little choice but to accept inflation as part of the economic and financial landscape. Bringing inflation lower with higher interest rates would not just stifle economic growth, but also put a burden on the private sector as the prime candidate for funding government debt. If these last few weeks are anything to go by, that burden can lead to a catastrophic increase in the premium that financial markets demand. A modest but persistent increase in inflation in our societies will seem like a far less insidious side effect of the demands of an ageing society. ■

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