

Markets have lost faith in the politicians

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COMMENTARY

YOU always get market turmoil in August. It is the main holiday month for the western world and the way markets work means that though there is less activity, it is likely to cause proportionately greater movement in prices.

And those price swings are compounded by inexperience. As the bosses set off for the beach their parting words to those left behind is not to screw it up. This added level of pressure further clouds their decision making and means they do just that.

Most of them are not stupid. However, it was once wisely observed that for evil to prosper, good men need only to do nothing. It is the same with markets. For mayhem to ensue, all that is needed is for the sane to sit on their hands while the minority give full rein to their panic.

It is also a feature of modern markets that sanity costs you money. So much trading these days is carried out by pre-programmed computers which automatically sell when markets look weak, and buy when they are going up. No single rational investor has the firepower to stand against them and will get wiped out if they try. Technology has condemned us to much greater volatility and far more violent booms and busts.

That is what we are seeing now, though in fairness to those contemplating a final jump out of the window it is not the whole story and there are real reasons for concern – it is just that they have been with us for years and should not have been

ignored until now, or really to have come as such a surprise. The basic problem is that the world is going through a tectonic shift in economic power from the West to the East, but our expectations and desires have not adjusted to this changing reality.

More specifically, the imbalances in world trade and growth over the last decade have been hidden from the average voter by the ability of the West to borrow. This has allowed consumers and governments in Europe and America to maintain their living standards and neither recognise nor adjust to the fact that the economic tide has turned against us. It's like being unemployed. For a while you can pretend nothing is happening while you run up an overdraft or max out on credit cards. But eventually it's payback time.

It could hurt a lot. The Centre for Economic and Business Research published a paper today which suggests our living standards could fall by as much as 25 per cent over the next quarter-century as we adjust not only to the pressure from much cheaper Asian labour, but also to far

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greater demand from them for their share of scarce oil and other raw materials. If that drop sounds extreme it is in fact no more than an extrapolation of what has already happened. CEBR says UK living standards have dropped by 4.8 per cent over the last five years. We just have to continue that trend for us to drop a quarter over a generation.

However, Micawber-like, markets always thought something would turn up so that it would not be so

bad. So did the politicians, who have worked on the principle since 2008 that if they could only hold on long enough, growth would resume, solving the problem, and we could then borrow more to get consumption going again. A windfall pay rise would allow us to settle the old bills and run up new ones.

But in the last few weeks markets have lost their belief that something will turn up, along with their faith in politicians to manage the crisis. The debacle over the US debt ceiling has convinced many that American politics has become dysfunctional and they don't see how President Obama will be able to respond to mitigate the economic slowdown there. Similarly, the political weakness at the heart of Europe has been cruelly exposed by the faltering, slow and fractious response to the sovereign debt crisis in Greece and elsewhere.

So markets have had to confront the fact that there is no fairy godmother, the debts cannot all be repaid and someone is going to lose a lot of money. Most likely it will be the banks and that is where it becomes a problem for us all, because weak banks mean less credit, and less credit means even slower growth.

When markets break like this it is impossible to see what will stop the fall, but eventually people get too tired to run and a battered calmness returns. That may take a day or two yet and is certain to leave a lot of people seriously damaged. But even after the chaos of the past few days markets are still just about higher than they were a year ago. And in the underlying economy nothing has changed. We were in trouble before and we still are. If the difference now is more people realise that, we're more likely to do something sensible to put things right.

■ Anthony Hilton is Evening Standard Financial Editor.