Great Depression Memorial, 2010 Washington, DC

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Ashley Potter talks to former Monetary Policy Committee member Andrew Sentance about the slow growth gripping the Western world and how we will have to get used to a 'new normal'

The crash still haunts us all

On August 9 2007 *The Guardian* ran a story on page 29 about French bank BNP Paribas blocking withdrawals from three hedge funds because of, what the paper called, "a complete evaporation of liquidity".

It seemed like another market jitter, another minor financial blip in the ongoing rise of the 'masters of the universe' – as bankers had become known.

But it wasn't. It turned out to be the first public glimpse of a devastating crisis which engulfed the global banking system as defaults in the US sub-prime mortgage market led to banks across the world literally running out of cash.

Governments had to bail banks out while financial behemoths like IndyMac and Lehman Brothers sunk and, as the panic spread, the US Federal Reserve pumped $700 billion into the money markets, with chairman Ben Bernanke warning, "if we don't do this we may not have an economy on Monday."

Total meltdown was avoided, but the International Monetary Fund estimates that large US and European banks lost $2.8 trillion from 2007 to 2010 and the world was plunged into recession. Indeed, global GDP fell in 2009 for the first time since the Second World War.

Andrew Sentance joined the Bank of England a year before that fateful day in August 2007, after helping steer British Airways through the airline industry's crisis following 9/11 as Chief Economist.

If he was hoping for a quieter time on the Bank's Monetary Policy Committee (MPC) he was sorely mistaken.

"Before I joined, Western economies were enjoying a period known as the Great Stability," says Sentance. "In hindsight, I should have been prepared for something disastrous to happen as it had done at BA when 9/11 rocked the airline industry and during my time at the Confederation of British Industry when we experienced double-digit inflation, interest rates at 15 per cent and the Exchange Rate Mechanism crisis. So perhaps I should not have been surprised when the financial crisis struck."

Eight years on, Western economies are still struggling to get back to where they were before the crash. In fact, Sentance believes we may just have to get used to what he has termed a "new normal".

"The global financial crisis has been a watershed for economic growth in most Western economies," says Sentance, who maps out his theories in his new book, *Rediscovering Growth: After the crisis*. "Though Western economies have recovered, growth has not been at pre-crisis levels and some southern parts of the Euro area are faring even worse.

"People have been questioning what is going on and why we are not returning to those levels of growth of the 1990s and early 2000s, but I think we will have to get used to it in the medium-term. Well-functioning and flexible economies can and do regenerate, and we are going through that phase now as the tailwinds that characterised growth up until 2007 have gone.

"The pre-2007 growth winds of easy money, cheap imports and confidence in the policy regime have disappeared. They all started to emerge in the 1980s, with a brief interruption by the 1990s recession, and then carried on until the crisis.

> "... the search for a fresh impetus to banish the memory of the worst financial crisis since the 1930s Great Depression goes on"

"We found confidence in policy became over-confidence. In particular, banks were over-confident in the ability of policymakers to prevent house prices falling in the US.

"But now the financial environment has changed. We have seen high and volatile energy and commodity prices, and confidence in the ability of governments and central banks to keep economies on an even keel has been eroded.

"We saw a similar trio of changes in the 1970s with the collapse of the Bretton Woods exchange rate system, shocks to energy prices and loss of confidence in the ability of governments to maintain full employment.

"Prolonged structural readjustment is underway in response to the crisis and there is a rebalancing between the East and West economies. We are now looking for new tailwinds to help us rediscover growth."

While much of the world flays around like a plug trying to find a socket, where will the impetus come from to re-energise growth across the Western economies?

Sentance believes businesses need to look to the East. By plugging into the growth opportunities in Asian emerging markets the Western economies can find one strong new tailwind.

"In many markets, the Western economies are becoming price-takers in the world economy and are increasingly influenced by Asia," says Sentance, now Senior Economic Adviser at PwC and a Professor of Practice at Warwick Business School. "The EU, US and Asia account for 75 to 80 per cent of world GDP, but the balance has changed. Asia now makes up a third of world GDP from less than 20 per cent in 1980. Beyond India and China, the rest of the so-called BRICS economies – Brazil, Russia and South Africa - have benefited from the upward pressure on energy and natural resources, but that situation has changed with the recent decline in the oil price."

Asia is the new land of opportunity for businesses; hence the many trade delegations from the UK and other Western powers to China and India in the last few years.

"The first five years of recovery in the UK saw more than 1.5 per cent growth, that is lower than the mid-1980s and 1990s recoveries, but in emerging Asian markets it was at nearly six per cent," says Sentance. "Asia-Pacific is the dominant region in the world economy now."

As well as looking to Asia, Sentance believes the UK and other Western economies need to concentrate on supply-side economics – that is lowering barriers for innovation and industry and investing in capital - to find new tailwinds to support economic growth.

"There has been a tendency to focus on the demand side," says Sentance. "In 2009 when I was on the MPC with the financial crisis deepening we pulled out all the stops; we cut interest rates and implemented quantitative easing, but now Western economies should be concentrating on the supply side.

"Technology is clearly important in driving productivity, and therefore has the potential to create business opportunities and new sources of economic growth. We need to see investment and policy adjustments in infrastructure, education and skills to create the environment for new technology and new businesses to flourish. The pressure on sources of energy means economies need to find new efficient uses of energy and resources to reduce costs as prices rise, another area for innovation. The recent fall in the oil price may also help growth prospects in the short-term by easing the squeeze on consumers and businesses.

"Based on what happened in the 1980s when major economies like the UK and the US restructured, reformed and found new sources of growth, we should see a new growth phase emerge in the second half of the decade. Some countries are better placed than others, and that is particularly noticeable in Europe where we have seen the emergence of a two-speed economy.

"Countries that have a flexible economy and are not so reliant on the public sector seem to be doing better, like the UK and Germany, while France and Italy are really struggling to reform their economies and adjust to the 'new normal'. The high share of public spending - more than 50 per cent of GDP in some EU member states – and inflexible labour markets are contributing to the difficulties of restoring growth in a number of European economies."

Those countries that have flexible economies look better placed to emerge more quickly in this 'new normal' economic climate, but the search for a fresh impetus to banish the memory of the worst financial crisis since the 1930s Great Depression goes on. ■

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