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Treasury Committee

The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Belsey and Dr Andrew Sentance

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Volume II

Oral and written evidence

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury and its associated public bodies.

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Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk. Media inquiries should be addressed to Laura Humble on 020 7219 2003.

List of witnesses

List of written evidence

Oral evidence

Taken before the Treasury Committee

on Thursday 12 October 2006

Members present:

John McFall, in the Chair

Angela Eagle
Mr Michael Fallon
Mr David Gauke
Mr Andrew Love
Kerry McCarthy
Mr Brooks Newmark
Mr Mark Todd

Witness: **Professor Tim Besley** gave evidence.

Q1 Chairman: Good morning Professor Besley and welcome to the Committee. Congratulations on your appointment.
Professor Besley: Thank you very much.

Q2 Chairman: Can I you introduce yourself, please?
Professor Besley: My name is Tim Besley. I am professor of economics and political science and newly appointed member of the MPC.

Q3 Chairman: First of all, how were you appointed to your role as a member of the MPC? When did the appointments process begin, what did it entail and who did you speak with?
Professor Besley: My first point of contact was with Nick McPherson, the Permanent Secretary of the Treasury, who called me at home in early July and asked me if, in principle, I would be willing and interested to serve. I told him it was something I would need a little time to think about. It turned out that because I was heading off on holiday the following Friday I did say it was something I did not want to hang over to the following week if possible because it was not something I thought should interrupt our holiday. I agreed with him that he would call me back two days later which he did and he formally offered me the appointment. I said I would like to speak to the Governor at that point to discuss what it entailed and also how it might fit with my other commitments. I did so early on during the Friday morning and before leaving for vacation on Friday lunchtime I formally accepted the appointment.

Q4 Chairman: There is no doubt that you are an extremely competent economist but some have suggested in the media that you have little in the way of research background in monetary policy. Could you comment on that? Secondly, in which particular areas do you feel you can make the greatest contribution to the MPC?
Professor Besley: Beginning with the first point you raise, I think the general competence I have as an economist will complement the specific expertise that others have. I also think that it is easy to believe that somehow there is a big division between the kinds of issues that I dealt with in my research and the kinds of issues that are dealt with by the MPC in evaluating the data and looking at what should be done by way of interest rate decisions. I would say at a level of general competence I have a lot to bring. I have also dealt—this perhaps goes a little to your second question—with a variety of issues which I think are first order importance in the kinds of things that the MPC is worried about: issues of pricing, decisions by firms, issues of financial markets, issues of labour markets and other broader public policy questions. This was an issue during that 48 hours when I was thinking about it, what kind of contribution can I make and the way I view it is that the MPC is a team with different competences—some have particular strengths in one area or another—and I think there is a role for good micro-economics on the MPC.

Q5 Chairman: Are there any research projects that you think you would initiate as a member of the MPC?
Professor Besley: Absolutely. In fact there are two areas where I am already exploring research. One is in the area of personal debt and the other is in an area of business services and in particular in the service economy, and issues surrounding service economy.

Q6 Chairman: The Committee is very interested in both of them. We are particularly interested in the first one because we are engaged in an inquiry on that so anything you have for us on would be very welcome.
Professor Besley: I hope it will be in time to be useful to you.

Q7 Mr Gauke: There have been some comments on your appointment that some years ago, in your early days as a tutor, you taught Ed Balls. Are you aware of whether Mr Balls was in any way involved in your appointment? Did you discuss it with him at all?
Professor Besley: No, I have had no contact whatsoever with Ed during this process or any issue related to this. You are absolutely right, when I was a post-graduate student I took on a part-time

tutoring job at the time and Ed was one of my students. That is correct, and I have seen him on a few occasions professionally since.

Q8 Mr Gauke: How well do you know him?
Professor Besley: As I say, my interactions with him have been entirely professional and through occasional work that I have done in the Treasury for example, but I would not say that I know him well. I do not think that would be a fair comment.

Q9 Mr Gauke: You do not know whether the fact that he knows you of old may have influenced the decision to appoint?
Professor Besley: Not at all. I have no reason to believe that it did; I have no information relevant to that at all.

Q10 Mr Gauke: Prior to the interest rate increase in August, Ed Balls made a speech that could certainly be interpreted as suggesting an interest rate would be appropriate, do you respect his opinion on these matters?
Professor Besley: He is clearly entitled to make speeches on whatever issues he wishes to do so and to make suggestions as to the direction of policy. At the end of the day the job of the MPC is to look at the data, at the conjuncture when a decision is being made and form a decision of the right thing to do in view of the inflation target. That is paramount. I do not think that speeches made by anybody are going to be particularly influential above the work that the MPC does. The two things that I think are crucial for an MPC member are both competence as an economist and impartiality with respect to the kinds of positions being staked out and I believe on both of those the job is to look at the data on the day the decision is being made and do the best job to meet the inflation targets and that is the only thing that matters.

Q11 Mr Gauke: What do you say to those journalists who suggested that in the case of yourself and indeed before that Richard Lambert, that being a Balls' buddy may have been a factor in the appointment?
Professor Besley: As I said, I have no information that that was true and I can tell you that my impartiality in these matters is not going to be compromised in anyway by anybody.

Q12 Mr Fallon: The Committee, according to the August minutes, seemed unusually uncertain about the outlook for inflation, particularly in respect of energy prices and import prices. Do you share that uncertainty?
Professor Besley: Yes. There are a variety of uncertainties; I am not sure why you have specifically picked up on those at this juncture. You are looking back to what was said in August specifically, is that right?

Q13 Mr Fallon: I am quoting from the Inflation Report of August which presumably you have read.
Professor Besley: Yes, indeed.

Q14 Mr Fallon: It says, "In the Committee's judgment there is an unusual degree of uncertainty over the prospects for energy and import prices".
Professor Besley: Yes, and I agree with that. Of course since then, if one looks at energy, a significant amount has happened which was at that point unpredictable, namely the fall in the price of oil. So there is no question that they were unable to predict that, as were any commentators at that time. I think that is something that has happened rather unexpectedly since that point.

Q15 Mr Fallon: How reliable do you think the current data available are on inflation expectations?
Professor Besley: There is a variety of sources as you know and they do not always point in the same direction, suggesting they cannot all be equally reliable. The Bank, as you would expect, draws on all those sources and tries to make sense of any contradictions in them. There are a number of issues there, in particular whether inflation expectations are particularly about CPI or RPI and of course we are asked to target CPI which is relevant. There are numbers that come through looking at spreads, for example in bond markets between indexed and non-indexed bonds. Then there are straightforward questions that are asked of members of the public. They all contribute to an overall picture; clearly there is a wide margin of error around all of those different ways of trying to figure out what exactly people are expecting over a given period.

Q16 Mr Fallon: We are aware of all these issues, what we are trying to do this morning is try to get some of your views on them. Are you concerned about the reliability of the data?
Professor Besley: "Concerned" would suggest that I think there is a deep issue which could be remedied by some simple fix. Of course I am concerned. I would prefer any dimension relevant to monetary policy that data were more reliable. The question is, do I have a specific concern about a better method that could be brought to bear to improve the quality of the data? On that I do not have a specific suggestion.

Q17 Mr Fallon: How much spare capacity do you think there is in the UK economy at the moment?
Professor Besley: That is an issue around which there is a great deal of uncertainty. I think going forward it is definitely an issue that the MPC is concerned about.

Q18 Mr Fallon: What is your view? How much spare capacity do you think there is?
Professor Besley: I do not want to be drawn into a question of coming up with a specific number or trying to quantify the output gap or any similar measure. I believe we are in a situation where demand is strong and the output growth that we have seen in recent periods suggests that supply is also growing a little bit above trend. We are in a situation where those are relevant facts but I do not

want to be drawn on the question of a specific take on the level of spare capacity since I do not think that is the only issue at stake here.

Q19 Angela Eagle: You are mainly a micro-economist, are you not? Do you think that micro-economics in this particularly context is more important than macro? We are not making that much progress in developing new macro-economic theories; everybody appears to be a micro-economist these days.
Professor Besley: What is certainly true is that the old idea that there are two kinds of economics, macro- and micro-, is an extremely old fashioned view from where I a sit now. There are enormous efforts to try to join up, if you like, phenomena that occur in the macro-economy with the underlying decisions that people make in the economy on investment, on pricing, on whatever. My view is that there really is not a meaningful distinction any longer and what is true is that the ideas that are prevalent in micro-economics do ultimately come to influence a view of the bigger picture and the way the economy works.

Q20 Angela Eagle: Do you think that that can always be measured like some kind of mechanistic thing, if you add up all the micro-economics—taking all the assumptions that one inevitably has to make, some of which are entirely dubious—that somehow you can add it up to a big predictive picture of the whole?
Professor Besley: That would be a nice thought but I do not think we are envisaging that.

Q21 Angela Eagle: It is possible though, is it?
Professor Besley: We do our best with whatever tools we have and in different areas we may be able to do that better or worse but I think there are genuine issues here about how one does that in specific instances.

Q22 Angela Eagle: There is a paper you did called "*Peer Group Externalities and Learning Incentives: A Theory of Nerd Behaviour*". How do you think that applies to the MPC?
Professor Besley: Not at all. There is a story behind that paper and the reason it was written. There was a great deal of interest at the time in herd behaviour in financial markets.

Q23 Angela Eagle: "Herd" rather than "Nerd"?
Professor Besley: Exactly, so to come clean with you that paper deliberately had a play on words.

Q24 Angela Eagle: How would you describe your own view of economic systems? Are you a neo-classical endogenous growth theory man? Or are you a post-Keynesian man? Or a monetarist?
Professor Besley: I find it quite impossible to put myself in any specific camp. At the end of the day I am a pragmatic economist who draws on appropriate theory and data depending on the issue that I am studying. I do not think that beginning with the idea that that makes you some kind of economist is particularly relevant. I think for the vast majority of economists out there in the world they just view themselves as trying to do the best job they can with the issue concerned and I put myself in that camp of economists, whatever that is.

Q25 Angela Eagle: We have now had nearly 10 years' experience of the economic system that was set up by the current chancellor of which the MPC is an extremely important part. Would you make some observations from your own views of how you think that is going and whether there should be changes to the structure or whether you think it is about right?
Professor Besley: One has to say that if one looks at the evidence from this period it has been an enormously successful and stable period in British policy making, particularly in the area of monetary policy, so one has to begin with the view that in a broad sense it has been a period of success. I think it is also the case that it is the kind of question that is better posed to a more experienced MPC member who has had more time to reflect from the inside as to how exactly the process works.

Q26 Angela Eagle: Do you want to reflect from an outsider who has just popped inside?
Professor Besley: I certainly do not have what I would regard as strong views on the way the system should or could be reformed. While of course there may be things that on reflection I would do, I do not have anything I particularly want to bring to the table now.

Q27 Mr Love: Can I return to the issue of spare capacity in the sense of the labour market participation? You indicated in the response to the questionnaire that you felt that increased market participation was the result of older workers coming back into the workforce and, of course, migrant labour. Do you think that would significantly raise spare capacity in the economy?
Professor Besley: The way I view this is that you cannot separate the growth of supply from demand in the sense that, why are migrants arriving in the UK? Significantly because we have had a period of prolonged employment growth which means that migrants can come here and find jobs and there are certain skill shortages and bottlenecks that they can fill. Equally there is what I like to think of as an encouraged worker effect among some of the older age groups who realise now that given the relatively buoyant labour market opportunities they can move into the labour market and secure employment. I think this idea that this is entirely about a pure supply shock is not quite the right way to view the issue, but as long as we have strong employment growth in the UK it will tend to draw in workers, both those who perhaps move from inactivity to employment and those who choose to come here from, for example, accession countries—but also many other countries—because we offer economic opportunities.

Q28 Mr Love: The minutes of the September meeting of the MPC stated that the migrant labour might also affect the degree cyclicality in the labour market. Do you agree with that? And what do you think the implications are for the future?
Professor Besley: I think the exact issue there is whether or not if we did see, coming to my previous answer, a downturn in employment growth, whether we would see migrants choosing to return home or staying here in the UK, effectively unemployed here. That is the sense in which it could change the cyclicality in the labour market, whether we found we had a larger pool of domestic unemployed labourers or we would find that people really decided that they preferred to return to the kinds of social networks and social protection they would receive in their home countries. So that the sense in which I think it creates an issue looking forward as to how exactly cyclicality in the labour market will work and play through.

Q29 Mr Love: How serious a danger do you think that is? If the inward migration is being beneficial in restraining wages and of course providing skills—especially at the lower end of the skills range—if the economy was to downturn and migrant workers were to migrate again, would that cause us additional problems?
Professor Besley: If things played out like that I would expect there to be less downward pressure on wages when unemployment rises. That is the consequence. Perhaps we would observe less cyclicality in wages as a consequence if it turned out that the labour force was essentially moving in and out in line with our employment growth cycle.

Q30 Mr Love: As a consequence of those two factors—of older workers and migrant workers coming into the economy—there has been an increase in unemployment, what effect is that having on wage restraint?
Professor Besley: I wish I knew the answer to that question; it is something which has been exercising both my thinking and that of those who are concerned about this issue. The very great difficulty is that if, as appears plausible, there has been a real structural change in the UK labour market in the sense that, as you recall, if you look over recent history what we have observed is quite a significant increase in employment without uptake in inflation which I think could significantly be attributed to the increase in supply of labour, particularly migrant labour. What makes it difficult to guess how that is going to have an impact in a downturn is that you have to be sure to what extent this is a truly structural factor as opposed to just a short-term factor. However, clearly one view of the world—it is not one that I think we have sufficient evidence to say it is cut and dried—is that wages are now significantly going to be influenced by inflows and outflows of labour of a more international variety, therefore giving more stability to wages than would otherwise happen in a fully closed labour market.

Q31 Mr Todd: Sir John Gieve in a recent speech said there was a puzzle of UK business investment. Is there a puzzle?
Professor Besley: There is a puzzle in the data and that is that business investments have been very weak since the turn of the millennium. Of course now one of the interesting elements of re-balancing we are seeing in the economy at the moment is an increase in business investment coupled with, I think, a re-balancing away from consumption which is something to be welcomed. The Fed have been putting out some interesting discussion papers on the issue of intangible investment and the importance of intangible investment. A good example would be software. That would be a good example of something which is not picked up in standard investment data and could explain why, in spite of the fact that investment appeared so weak in the early part of the decade, a lot of that investment was in the form of intangible capital. In fact business investment was much less weaker than the view you might take just looking at the raw investment numbers. There is a puzzling weakness in investment which has not been properly explained. Just to give you an idea, the Fed's estimate for the US—I do not think we have comparable numbers for the UK—is around 10% of national income is actually intangible assets. It does suggest that this could be quantitatively quite important; it could ultimately be the explanation of the apparent weakness in business investment in the early part of this decade.

Q32 Mr Todd: There has been a rebalancing of past data—UK data—to reflect assumed software investment which recognised that that could be seen in capital terms. Are you suggesting that our current data remains defective in this respect?
Professor Besley: There is a serious possibility that once we begin to look at a broader range of intangible investments—it may not just be software but the kinds of things that go on which are possibly complementary or substitutes for other kinds of physical capital—we will form a different view of the extent to which there has been a lapse in business investment over that period.

Q33 Mr Todd: Do you think there might be any possible relationship to the previous topic you touched on which is the very liberal labour market in which relatively cheap labour is available which, in most people's terms, can be substituted for capital investment? Capital investment appears less attractive if labour remains cheap. Does there seem to be any linkage between that?
Professor Besley: That is an interesting idea. The only thing one would say is that one has not observed a fall in real wages over this period and so if labour were really becoming a lot cheaper you would observe labour becoming cheaper relative to capital and we have not really seen that over the relevant period. Incentives to substitute labour and capital in terms of the underlying prices of doing so do not appear to have changed very dramatically.

Q34 Mr Todd: Why do you think it is that in a period of long term stability and growth British business seems to have been so unwilling to invest in a sustained way? Or do you just think the data may be wrong?
Professor Besley: The data may be revised but also I think our view of intangible investment may be the key to that puzzle. To come back to the beginning of your question, it is widely acknowledged that there is a puzzle here for exactly the reasons you are suggesting. Ultimately I think one of the answers—I do not know how much of the answer, we would have to do a detailed study—comes from this intangible investment.

Q35 Mr Todd: Is this one of the areas of research that you would also commend to the Bank?
Professor Besley: Yes, the Bank is working on these issues in the monetary analysis department so there is no question that it is an important area. It is not an area, given my own expertise, that I will be particularly engaged in.

Q36 Mr Todd: Another area was the area that Andy touched on just a moment ago which is the effect of migrant labour not merely on labour supply but also on demand in the economy. I think you touched on that briefly in your submissions to the Committee.
Professor Besley: Yes. That is an enormously important issue. As you are aware, the difficulty in making any assessment of the demand side impact of migration is that we simply do not know how many migrants there are. Even if we took a view that migrants, say, were consuming at the rate of, say, 50% of a typical domestic worker, to scale that up to a demand effect which would affect the aggregate economy would give you an enormous range of possible estimates of the size of that demand effect simply because of the issues in the data.

Q37 Mr Newmark: I think it was Stephen King of HSBC who wrote in *The Independent* recently that like leggings and Bob Dylan monetarists' thinking is remarkably back in vogue. With that in mind, how important do you think is money supply in setting interest rates?
Professor Besley: Whether it has anything to do with Bob Dylan I have no idea, but people are now looking at monetary aggregates and trying to interpret what they are telling us. There is no question that that is an important issue; it is something I am personally thinking hard about.

Q38 Mr Newmark: When you say that you are thinking hard about it, would you view yourself more as a monetarist in the way that you think about setting these things up?
Professor Besley: No, I am not thinking about it because I am a sort of proto-monetarist; I am thinking about it in the sense of trying to understand what it implies. There are a number of competing explanations, one of which is that there is some underlying structural change. As we know certain kinds of financial institutions appear to be holding cash, so we have to take a view on whether there is going to be some underlying portfolio adjustment down the line which could lead to inflation in asset prices which then have implications through demand for monetary policy. To the extent I am worried about it, I am trying—as is everyone else I think—to take a view on how exactly we think this could play out. The recent growth in M4 could ultimately have an impact on the economy.

Q39 Mr Newmark: In your opinion what is the recent rise in import telling us about the future path of inflation? Do you think that there is something stoking up there? Do you think the fact that all these huge private equity institutions are now holding wads of cash ultimately is going to lead to asset inflation as people bid up prices of companies and so on?
Professor Besley: In my personal view I view this as an issue for concern about the future path of inflation. There is sufficient uncertainty though that I would not hold that view with a degree of confidence that says that, ahead of all other factors—

Q40 Mr Newmark: No, but there is some monetarism in your DNA.
Professor Besley: I do not view this as an issue of monetarism. I view this as an issue of trying to have a view of how

Q41 Mr Newmark: When you take into account money supply and the pressures on money supply, which you have acknowledged is an issue, particularly with M4 and how that seems like it is going through the roof, you must take that into account.
Professor Besley: Yes, but that does not make me a monetarist. I think that is the issue I am taking issue with. I think one can be concerned about these issues without being in any sense a crude monetarist. That is what I am saying.

Q42 Mr Newmark: To what extent were you surprised by the muted effect on inflation on the recent rise of oil prices?
Professor Besley: I think that like everybody I was surprised but I think I am beginning to form a view which is quite consistent on this and I think it is a view that many people are coming to that at the end of the day—this links back to your previous question—inflation is created by an excess of demand over potential supply. You can have shocks in prices that bear on that and oil prices or cheaper goods from China or wherever they might be, but at the end of the day what matters for inflation is exactly that. I think too many people were looking back to the 1970s and saying that we had this huge oil price shocks, it had a massive systemic impact throughout the economy, and I think now we have a somewhat different view of the world and it is one which means we concentrate on what really matters which is nominal demand relative to supply capacity. I think the surprise is in the fact that we

were not, when this initially hit, sufficiently influenced by what really matters. People were surprised and I would put myself in that camp.

Q43 Mr Newmark: In your answer in your questionnaire you say that despite oil prices now falling we may enjoy less relaxation in inflationary pressures than might have been hoped for. I am just curious as to why you think that.

Professor Besley: That is exactly the other side of this coin, namely that if really what is driving inflationary pressures is nominal demand versus supply capacity, a fall in the oil price shock may give some temporary respite coming through CPI directly and we are observing direct effects on CPI already through falling petrol prices. In the medium term that is not the factor that is going to drive inflation, it is going to be whether the balance of supply and demand factors in the economy is right. That is the sense in which I think that to say just because we are having a relaxation of oil prices we are going to enjoy some better medium term inflation outlook just does not follow. What follows is that we have to keep an eye on what matters.

Q44 Kerry McCarthy: You have already mentioned that you are initiating a research project on personal debt and you were asked in your questionnaire about the significance of the recent rise in personal insolvency. Given that we have very benign economic circumstances at the moment, to what do you attribute the rise in personal insolvencies?

Professor Besley: I think there is little doubt that there has been a structural change in the market for debt, particularly around—as you know and I am sure your Committee is concerned with—the sharp increase in the number of IVAs that people are taking out (Individual Voluntary Arrangements). That has gone up very significantly in part because I think they have been heavily marketed in certain quarters as you are probably also familiar with. What you are beginning to see—if you look at the recent data on unsecured debt I think this is borne out—is that the lenders in unsecured debt markets are becoming a little more cautious and we are seeing a cooling off in lending in the form of unsecured debt, albeit at a time where of course there is more secured debt perhaps on the back of the strength of the housing market. I think if it is the case that there has been, if you like, a structural change which means individuals are more inclined to re-negotiate their debts through IVAs that will have an ultimate effect on the way lenders perceive lending in this market. My own take is that there has been that change and I think we will see a market correction. Indeed, as I say, the recent evidence on unsecured debt suggests there is a market reaction to the increase in personal insolvency.

Q45 Kerry McCarthy: Since there is already a cooling off in the market, that would presumably have even more of a restrictive effect in that the supply of lending. Do you think that is a potential concern?

Professor Besley: In terms of the monetary transmission mechanism that somehow that will have less effect on the economy, I think it is unlikely partly because secured lending is quantitatively much more important that unsecured lending where I think most of this activity is concentrated.

Q46 Kerry McCarthy: Do you think that the increase in personal insolvencies is a result of increased interest rate sensitivity in the population as a whole? Or is it more linked, as you say, to firms out there marketing the idea?

Professor Besley: I think it would be hard to document persuasively that the interest rate increase has really been the principal driving factor relative to these other factors that I have already mentioned.

Q47 Chairman: Professor Besley, thank you very much for your evidence this morning. You are thinking hard about a lot of things but we have not heard many conclusions this morning so when you come before us again we are looking forward to these conclusions flowing out at your next appearance.

Professor Besley: I will be delighted when I have myself fully played in to offer more concrete conclusions on this business.

Witness: **Dr Andrew Sentance,** gave evidence.

Q48 Chairman: Good morning Dr Sentance. Can you introduce yourself to the Committee, please?

Dr Sentance: My name is Dr Andrew Sentance; I am a member of the Monetary Policy Committee.

Q49 Chairman: I will ask the same question as I asked previously, how were you appointed to your key role? When were you approached and who did you speak to?

Dr Sentance: Like Professor Besley I was first approached by the Permanent Secretary of the Treasury, Nick McPherson, during the second week of July. I then discussed with the Governor of the Bank of England but most crucially I had to discuss with my employer at the time, British Airways—with the Chief Executive of British Airways, and with my immediate boss—about whether I could be released from British Airways in the timescale that the Treasury were looking for because they wanted to make an appointment as soon as possible. We were able to conclude those negotiations successfully and so the Chancellor was able to make an announcement later that week. I did not have too much hesitation in my own mind about this; this was something I wanted to do. I think it is a very prestigious appointment for an economist in the UK to take part in the Monetary Policy Committee and contribute to its deliberations. Obviously there needed to be a process of negotiation with British Airways and that was completed quite speedily.

Q50 Chairman: You say you spoke to the Governor?
Dr Sentance: Yes, I spoke to the Governor in that process and one of the issues that we needed to resolve was to make sure that things that I was continuing to work on within British Airways were not going to conflict or get in the way of then moving onto the Monetary Policy Committee at the beginning of October.

Q51 Chairman: You were part of *The Times* Panel from January 2006 to July 2006. In that time you disagreed with the MPC twice, calling for cuts on both occasions. Why did you support a cut in interest rates in March and April of that year?
Dr Sentance: I think the situation has changed quite a lot in the UK economy over the last six to nine months, but earlier this year we were faced with a situation where a lot of the data that was coming out from 2005 was pointing to a weakening economy. Indeed, GDP growth in the UK economy in 2005 was quite a bit below trend at below 2%. We also saw at the time rising unemployment so there were a number of indicators around that time that suggested that perhaps the economy was continuing to be soft. As we went through the spring and the summer I think the evidence turned out that the growth of demand and activity has been much more robust. Also that rise in unemployment that we have seen may be a lot more to do with supply factors in the labour market than demand side factors. That evidence has come through over the last six months but at that time it was not so clear and to me it seemed the balance of risks suggested that actually the economy was in danger of remaining weak through 2006. As it happened that fortunately was not borne out.

Q52 Chairman: Can you easily swot away *The Guardian's* July assessment that you are a dove?
Dr Sentance: I do not find this hawk and dove classification very helpful. I am quite taken by a quote from John Maynard Keynes who was accused by people of changing his mind quite a bit. He said to the person who put this to him, "When the facts change, I change my mind. What do you do, sir?" I think Professor Besley's comments have indicated that it is quite possible, as evidence comes in about the state of the economy, to arrive at different conclusions as you go through time. The view that you might have taken in one set of circumstances is not necessarily a guide to the view that you will take in a different set of circumstances.

Q53 Chairman: That is what we do as politicians, but maybe not always with such a sound basis.
Dr Sentance: I am not making a virtue of changing your mind, but I think it is something you have to be prepared to do if circumstances change.

Q54 Mr Fallon: You have not really changed your mind, have you? In July you were still saying that the Bank should be cautious about raising rates at that stage. You are a serial dove, are you not?
Dr Sentance: I think you will just have to judge my performance on the Committee as it goes through. I do not think I want to be pigeon-holed into a particular camp in that way at the moment.

Q55 Mr Fallon: In his press conference Mervyn King said that there is a 50-50 chance that inflation would rise above 3% in the next six months. How would you rate those chances?
Dr Sentance: I think the chances of inflation rising above 3% have gone down slightly in the short term because of the fact that oil prices and petrol prices have fallen back. Some of the short term upward pressure on inflation is abating but I think that the Bank obviously has to focus on the medium term inflation outlook and that is obviously something that is going to be the main influence on the interest rate decisions over the next six to nine months or so.

Q56 Mr Fallon: How much risk do you think remains on the upside?
Dr Sentance: I would not want to put a percentage on it in the way that Mervyn did there, but I would say that it has receded from that 50-50 in the short term because of the evidence that has come in on oil and petrol prices.

Q57 Mr Fallon: What is your view of the degree of spare capacity in the UK economy?
Dr Sentance: I think that measuring the degree of spare capacity is quite a difficult thing but I think also that it is important to distinguish between a short term and a long term context when you are looking at that. In the mid-1990s we had unemployment at about 10% and I think if, at that time, demand had increased quite rapidly in the short term we might well have had inflationary pressures, yet through a process of good demand management and beneficial supply side changes we have actually moved to a situation where unemployment is a lot lower and we have not seen inflation coming up. I think the answer to the question depends on whether you are taking a short term or a long term view. I think in the short term we are probably close-ish to round about the sort of capacity limits of the economy. I do not think those capacity limits are set in a very tight and hard way and it is possible that over the longer term developments could take place which would allow us to get, for example, to possibly lower unemployment. We will have to see.

Q58 Mr Love: Can I turn to this conundrum of business investment? Perhaps you could give us your view as to why, with conditions being so benign over recent years, we have not seen until recently an upturn in business investment.
Dr Sentance: Looking at this from a business standpoint where a lot of my experience has been, I think in the early phases of a recovery from a period of weakness in the economy—which we did see in 2001-2002 certainly in a number of businesses—companies wait to take up some of the slack before they then begin to think of significant new investment. That is probably one of the elements but I do not think there

is any single, complete explanation of this. I think there is some data uncertainty; Professor Besley alluded to some of the factors there. I think, however, that people have observed that the investment to output ratio in the UK has tended to be relatively low compared with other European countries for quite a prolonged period of time. I think there may be structural features of our economy compared with other economies which contribute to that. The fact that we do have more flexible labour markets than other European economies may help in ensuring that investment can be used more efficiently. It may also encourage—I think there was some reference to this in the earlier discussion—some substitution of labour for capital at the margin which means that structurally we would tend to have a lower investment rate than other countries, but that is not necessarily a bad thing. I think, however, that it is an area where there is no absolutely concrete and complete explanation so in that sense there is still a bit of a puzzle. There are a number of different hypotheses around.

Q59 Mr Love: We talk a great deal in this Committee and in general about globalisation and competition internationally. Since the capital stock per worker is much higher in equivalent economies that supposedly we are competing with, why have we not seen Britain catching up? You have given some of the explanation, but surely there should be more competitive pressure on the UK to increase its capital stock per worker.
Dr Sentance: I think the way in which companies respond to those globalisation pushes depends on the circumstances of the company. In some circumstances increased investment may be the right thing to do, but it is not necessarily the case for all companies. I think it is also worth observing about the investment picture that investment has been much weaker in manufacturing activities than in non-manufacturing. That could reflect another side of the point that you are pointing to, that international companies are choosing to invest in lower cost labour locations where they are building up production facilities and may not be investing as much in the UK as before this globalisation issue became a much more significant factor. I can see globalisation operating in two directions on investment. Yes, as you say, it should perhaps be encouraging companies to innovate and invest in new technology more quickly, but on the other hand they may be putting more of their investment overseas.

Q60 Mr Love: One of the interesting factors is that foreign companies investing in Britain seem to do a better job in terms of capital investment than our own indigenous companies, but let us not go into that now. Can we sustain the increase that there has been recently? Is that sustainable?
Dr Sentance: The increase in business investment?

Q61 Mr Love: Yes, business investment.
Dr Sentance: Investment, on the latest figures, is growing at about just under 5% per annum. Giving that investment is more volatile than other components of demand in a time when demand and output are growing reasonably healthily, I think that is the sort of rate of growth we might expect. It is faster than GDP growth because when we have seen a downturn investment is then normally weaker than GDP growth.

Q62 Mr Love: Finally, I was interested to see in a recent CBI survey they suggested that 40% of their respondents with defined-benefit pension schemes said that pension deficit was a real factor in their overall business investment. The EEF survey—a similar survey—suggested that it was hardly a factor at all. What role do you think that the pension deficits of companies has played in the lack of business investment overall?
Dr Sentance: I think that is a very difficult issue to gauge. I agree it is a factor that we should be considering. The Bank has done its own survey and it is slightly more in line with the EEF conclusion than the CBI's conclusion, but I would not want to dismiss it as a factor at all. I have worked in a company where they have significant pension issues—British Airways—and it is clearly a factor affecting management decisions, but the way in which that comes about obviously will depend on the circumstances of the company. I suppose my observation would be that if companies are able successfully to deal with pension deficits then it should not be too much of a barrier to investment. I think the key factor will be how successfully companies are able to feel that they have got on top of this deficit issue and then can move on and continue to invest as they normally would.

Q63 Mr Gauke: It is noticeable looking through your comments from your period on *The Times* MPC that you consistently raised the issue of the international economy when explaining your analysis. Given your background with BA that is not altogether surprising. Do you think that as a member of the MPC you will focus perhaps more on the international economy and the influence that has on international businesses than perhaps the MPC as a whole has done up to now?
Dr Sentance: It is certainly a very important factor for me because so many UK businesses do deal internationally. We are a relatively open economy to international trade. Our biggest exposure is to the European market but we are also exposed to US and Asian markets. It is a bit early for me to say whether I am going to put more emphasis on that than other members; I have only participated in one round of meetings. What I have observed in that is that the Committee as a whole places quite a bit of weight on international development. I think the area that I would like to put emphasis on—I indicated this in my written responses to you—is that how those international factors are driving structural change in the UK economy I think is a very important issue. Structural change is obviously a continual factor of business life and I have come from an industry where there have been an awful lot of changes in the structure of the industry driven by competitive pressures and other short term factors. I think

something that will help the Committee to understand better as it goes through its deliberations is how shifts in the structure of business are taking place.

Q64 Mr Gauke: Do you think over the last few months the fact is that you have been—to use the terminology—dove-ish compared to the MPC is because you have placed greater weight on what you perceive as the weaknesses in the international economy than the MPC has done?
Dr Sentance: No, I do not think it is because of that. If you go back to those instances earlier this year it was because we had seen quite a slow down in the UK economy during 2005 and it was uncertain at that stage whether the economy was going to rebound. That was my main concern. That had been driven quite a lot by consumer factors. I do not want to underplay the importance of international economy generally; I think it is a very important influence because international trade and investment is so much an important feature of the UK.

Q65 Mr Todd: Your business background is appealing. Previous economists with a strong business background have tended to be dove-ish in my experience; indeed I think the one who came from BA right at the start of the process had that gravitation. Is there any linkage between practical business experience and a wish to see the economy grow faster but take some risks with it?
Dr Sentance: First of all I think it is very useful for the Committee to have access to people with business experience and the way in which that should impinge on judgment is through a greater depth of understanding about how businesses which ultimately make up the economy respond to developments. I would not want that to be caricatured into a view about whether interest rates should be lower or higher. I think that understanding could lead in a number of different directions. I think the important thing for the Committee is that they have access to that knowledge and expertise of how businesses actually work.

Q66 Mr Todd: Certainly business representative groups tend to favour rate cuts earlier than the MPC has actually made them and be more resistant to rate rises when they happen.
Dr Sentance: Yes, but I would like to distance myself as an independent member of the MPC from the views of business representative groups.

Q67 Mr Todd: Does your business experience bring you any uncomfortable baggage? I noticed that you had responsibility for environmental policy in your airline which some might think pose some rather challenging choices?
Dr Sentance: I do not regard that as uncomfortable baggage in the sense that climate change is going to be a very major business issue looking over the next 10 to twenty years. Indeed, it is an issue that I would want to keep an interest in.

Q68 Mr Todd: It would have a profound effect on the economy at large if some of the steps that are being proposed to us were actually put in place.
Dr Sentance: Quite possibly over the longer term, but I would want to make clear to this Committee that by leaving British Airways I am putting myself in a different position from the one that I was in when I was employed by British Airways and contributing on their behalf to some of these discussions.

Q69 Mr Todd: So we should not scrutinise too carefully articles on aviation growth and emissions, for example.
Dr Sentance: I actually think there are a lot of very good things in those articles. What I would like to make clear to the Committee is that in anything I do in this area in the future I will not be acting as a representative of British Airways.

Q70 Mr Todd: Do you think we know enough about the impact of labour market growth from immigration into our economy? I think you listened to the questioning of Professor Besley on this where there is huge uncertainty. Do you agree?
Dr Sentance: I do not think we know as much as we ought to about this. It is a very difficult area in terms of developing statistical measures and so on. I think one of the strengths that the Bank has in this area is through its network of agents who are in contact with businesses around the country. I was actually with other members of the Bank of England down in Southampton yesterday to look at businesses in that area. It is clearly a very major factor in that local economy; a lot of workers from Eastern Europe have come into that part of the local economy. Hopefully we are in a good position to try to improve the understanding, but I think it is something that we do not yet properly understand.

Q71 Mr Todd: Is there enough active commissioned research in this field? Looking at the comments of the MPC and in questioning the MPC in this Committee before, it has become clear that their knowledge is very, very limited indeed. Is there a lot of value in actually actively commissioning this amongst economists?
Dr Sentance: The Bank has a lot of economic resources and some of them already do this but I think there is scope for other parties to contribute, such as the Government and the private sector.

Q72 Kerry McCarthy: You were fairly dismissive in your response to the questionnaire about the significance of personal insolvencies in terms of assessing household finances. You said there were other factors that were actually more important or that we ought to be paying more attention to. Can you elaborate on that?
Dr Sentance: First of all I am sorry if I came across as dismissive; I did not want to dismiss something which obviously has some great significance to the individuals concerned. The point I was trying to get across is that the area that the MPC would be interested in from this data is what is it telling us

about consumer spending and household finances more generally. I think there is a lot of other evidence that we have from retail sales figures, from measures of consumer spending and consumer confidence data, from direct measures of household income that are relevant to a much greater proportion of the households in the UK and should probably be given more weight than this insolvency data.

Q73 Kerry McCarthy: So you would not see the rise in personal insolvencies as the tip of the iceberg?
Dr Sentance: I would want to look at it alongside all the other data that we have. I would want to look at whether it suggests that it is consistent with other data that is suggesting quite a significant change in the trend of consumer spending. I think that is one of the key issues that we would want to understand on the Monetary Policy Committee. I would want to look at it alongside data of retail sales, consumer spending, consumer confidence, household finances and so on. I think taking it in isolation it could lead us to some slightly misleading conclusions.

Q74 Kerry McCarthy: To what extent do you think that banks are responsible?
Dr Sentance: Commercial banks?

Q75 Kerry McCarthy: Yes.
Dr Sentance: I find it very difficult to comment on that. It is not something that I have done any particular analysis on. I feel I cannot really comment. I think the figures, even though they have come up, are probably lower than they have been at some other times, for example in the early 1990s I know this was quite an important issue.

Q76 Mr Newmark: The August Inflation Report noted that in response to rising energy prices companies have squeezed other costs such as wages. Using your experience at British Airways, is this how firms have been reacting?
Dr Sentance: Certainly observing the way in which BA has responded as the energy prices have risen they have had to look at other costs. I would say that they would look across the board; they would look at other supply costs as well as employment costs. In terms of looking at employment costs they would look at the numbers employed as well as the wages that are paid. Indeed, it is my observation that businesses perhaps have slightly more flexibility in the short term in varying the numbers that they employ either by stopping hiring or by allowing employment to reduce through natural wastage for example, than they have in changing wages. Wages change subject to annual or sometimes even less frequent negotiations.

Q77 Mr Newmark: I guess where I was leading to is that if oil prices then drop will there be tendency to fill that gap by some sort of wage increase which would then put added inflationary pressures. Do you see that happening as oil prices drive because from what you have said they have managed to cut costs by natural wastage and putting pressure on their suppliers?
Dr Sentance: I think that whilst companies have sought to try to offset the fuel cost rise I am sure they have not been able to do it totally through other mechanisms.

Q78 Mr Newmark: I am trying to look forward now. Looking forward, is there a threat of inflation through any wage inflation?
Dr Sentance: The logical consequence of that probably means that companies have had a higher increase in costs than they would like and would be very happy to see the reduction in oil price feeding through to lower costs without feeling the need to increase costs in other areas. I do, however, think there is a more general issue which is that it is quite clear that even though the increase in inflation has been muted there has been an increase in inflation from higher petrol and oil prices and energy prices more generally. I think we do need to safeguard against that feeding through into higher wage settlements because that was the sort of mechanism and influence that set off the wage price spirals which were so damaging in the 1970s and early 1980s.

Q79 Mr Newmark: Attention has recently been paid to the rise of money supply in the UK. How important in your thinking is money supply when setting interest rates?
Dr Sentance: I would be interested in money supply because there is some concern that over some period of time it might feed through into higher money demand and therefore that could contribute to inflation. My observation is that linkages are quite indirect and variable and so I would be looking at money supply data alongside other data—and perhaps giving more weight to other data—in the short term with the more direct measures of money demand. Actually what we have seen is that nominal domestic demand—the amount of directly measured spending in the UK economy—has picked up over the last six to nine months and is currently running at 6% as the Governor mentioned in his recent speech. If we have other data that is showing demand is picking up then I think we should give some weight to money supply data which is in a sense confirming that. On the other hand you may have a situation where the money supply data is pointing in a rather different direction from the other data and therefore you would perhaps put less weight on it.

Q80 Mr Newmark: Just focussing on M4, in your opinion what is the recent rise in M4 telling us about the future path of inflation?
Dr Sentance: It is telling us that there has been an accumulation of money in the economy that could feed into spending in the future. This accumulation has taken place in these other financial institutions and there is a bit of uncertainty—

Q81 Mr Newmark: They will feed in because private equity firms, for example, or even a pension fund, has to put that money to work at some stage.

Dr Sentance: We saw in the late 1980s quite high money supply growth and perhaps did not put enough weight on it in that time, so we should try to learn the lessons from that. On the hand, there were situations in the early 1980s when money supply growth was quite strong and yet other indicators that real economy was pointing in the opposite direction. All I was trying to do was counsel about putting too much weight on one indicator and rather to look at it alongside other, more direct measures of the rate of growth of demand.

Q82 Mr Newmark: Do you see the growth in M4 raising a red flag at least with respect to inflation down the road?
Dr Sentance: I think it is a risk. I think it is raising an amber light but I would want to see other confirmatory data before putting a lot of weight on it.

Q83 Angela Eagle: Obviously Mr Newmark is trying to kick the monetarist corpse alive and you seem to be saying that you are not really a theoretical monetarist, you are more of a pragmatic man when it comes to looking at economic data.
Dr Sentance: I think I would agree with that broad assessment. I am not a theoretical monetarist certainly, but I think that any pragmatic person would also look back at some of the instances we have had before when we perhaps did not put enough weight on money data, for example in the late 1980s. Your pragmatism can point you in different directions depending on what the evidence is.

Q84 Angela Eagle: Can you bear to look at all the evidence rather than cling to one particular theory, however outmoded or outdated it might be?
Dr Sentance: Yes, I think the difference schools of thought and different frameworks for analysing the economy does tend to be a bit exaggerated, particularly at the moment. There has been quite a bit of convergence in thinking, a sort of synthesis—

Q85 Angela Eagle: A post neo-classical synthesis.
Dr Sentance: I am not sure about that, but what I have observed is when you talk with other economists people are generally using a common framework and I think that is very helpful for an organisation like the MPC where we come together and bring our different judgments. At least there are no large theoretical differences underpinning our discussions; that has certainly been my experience.

Q86 Angela Eagle: Could you just share with us the sorts of things that would keep you awake at night? What are the major downside worries or risks on the downside that you think, looking at the current position that we are in, that would worry you, that you would be watching for?
Dr Sentance: I think the thing that has to keep you awake at night if you are a member of the Monetary Policy Committee is not keeping inflation close to its target level and allowing it to deviate significantly either in one direction or another.

Q87 Angela Eagle: That is the job direction, but what do you see looking out there?
Dr Sentance: In any particular circumstance there will be different things causing me to worry. Your question is probably directing me to the things I am worried about at the moment. I think on the upside in terms of inflation there is the risk that if we have continuing inflation running above the target level that does begin to be factored into wage increase and I think that is a significant worry that we need to reassure ourselves on. The data so far has been relatively reassuring; the earnings data has been relatively steady but we need to keep a watch on that. On the downside I think probably the US economy is probably the major worry at the moment. On the forecasts that we currently have the US economy is going to have a slowdown and we are seeing stronger growth in other areas, so based on the evidence we have at the moment it does not seem a massive risk. However, sometimes when weaker indicators start coming through they get followed by even weaker ones, so on the downside I think that is probably the biggest concern at the moment.

Q88 Chairman: It has been pointed out that one of your big interests is politics. Are you intending to jump the desk at any time?
Dr Sentance: I have tried to stay out of party politics in the various things that I have done. I am very interested in the political process and policy and the real world application of economics to policy question, but I do not have any party political interests.

Q89 Chairman: In terms of research projects, do you have any?
Dr Sentance: It is early stages but I have mentioned a couple of things that interest me at present. One is the way in which survey data can be used based on my experience in the CBI in helping to understand the short term trends of the economy. The second is this whole issue of structural change, particularly driven by globalisation and international practice.

Q90 Chairman: As Andy mentioned, we are interested in globalisation in this Committee.
Dr Sentance: I would be happy to discuss those with you in the future.

Q91 Chairman: Dr Sentance, thank you very much for your evidence to us this morning. Best wishes in your MPC work in the future.
Dr Sentance: Thank you very much for the opportunity to talk with you.

Written evidence

Questionnaire in advance of Treasury Committee hearing for Professor Tim Besley

A. Personal and professional background

1. *Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC? Are there any relevant personal or other factors of which the Treasury Committee should be aware in considering your appointment?*

None

2. *Do you intend to serve out the full term for which you are appointed?*

Yes

3. *Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC? In particular, what areas of the MPC's work do you believe you will make a particular contribution to, and which will you have to undertake additional research on on your arrival?*

I have been a professional economist for nearly 20 years. Throughout that period my main interest has been in applied policy analysis. This has involved developing appropriate economic theory and empirical analysis of specific policy issues. My work has ranged across a variety of policy spheres and types of economy—developing and developed. For example, I have studied economies as diverse as those of India and the United States. Latterly, the main theme of my research has been to understand how institutions shape economic performance taking both economic and political factors into account.

My research involves making sense of economic data as well as refining the analytical tools that are used by economists for studying such data. Most of my work could be classified as applied micro-economics. However, I have looked at determinants of macro-economic performance and its link to policy. I have a long-standing interest in the factors that shape patterns of regional development.

Modern macro-economics uses approaches that emphasise the need for rigorous micro-economic foundations. This means paying careful attention to such issues as wage and price setting, the behaviour of consumers and firms, and the workings of financial markets. These are all areas where I have made academic contributions.

4. *To what extent will membership of the MPC require a different approach from that required in academic research, with regard to the discharge of the duties and responsibilities involved?*

My academic research is about identifying and analysing specific issues. This problem-driven focus equates well with what is needed on the MPC. However, in academic research, it is sometimes possible to shelve important issues for later thinking and even to pick the "low hanging" fruit in a research program. The time frame for research is also often months, if not years. In my MPC work, I am excited by the challenge of responding more to current exigencies and facing the challenges set by responding to immediate events. Being a member of the MPC also provides an opportunity to communicate economic ideas to a wider audience.

5. *Which of your publications or papers are of most relevance to your future work on the MPC?*

Of particular relevance is my work on pricing in imperfectly competitive economies. This was mainly applied to trying to understand how tax changes affect prices. However, it is of much wider applicability and is a useful starting point for thinking about how prices respond to any kind of cost shock. In work on the United States, we found evidence of effects that underlined the need to take models of imperfect competition seriously in explaining links between costs and prices. This is now an important theme in most macro-economic models. It is also highly relevant in thinking through the impact of cost shocks—such as increases in oil prices.

B. ACCOUNTABILITY

6. *How important do you think it is for MPC members to be subject to ex post parliamentary accountability? What are the strongest and weakest parts of the current procedures in the UK?*

Ex post accountability is an essential part of a successful monetary policy regime. I regard the fact that the MPC is accountable to Parliament rather than only to the Executive as a key strength of the system. This increases the chances that monetary policy is assessed and debated on a non-partisan basis. I strongly support the requirement of MPC members to appear before the Treasury Select Committee as part of the appointment procedure and for discussion of interest rate policy decisions. I have yet to observe any weaknesses in the system.

7. *If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?*

I would hope that my voting record and inflation outcomes during my tenure would show that I have played a role in keeping inflation close to target. In addition, I would wish to be judged on how effectively I have communicated my views and explained the rationale behind MPC decisions.

8. *Do you believe there is merit in having an individual paragraph in the minutes of MPC decisions in which to explain your most recent vote?*

The views of dissenters are already carefully reflected in the minutes. There are also many opportunities for explanations of decisions through speeches, interviews and appearances before the Treasury Select Committee. It is too early for me to judge whether this constitutes adequate opportunity for MPC members to express their views.

C. OTHER PROFESSIONAL ACTIVITIES

9. *What other professional activities do you expect to undertake in addition to your position on the MPC and how do you intend reconciling these activities with your position as a MPC member?*

I will hold an ESRC professorial fellowship for the other two days per week. This fellowship runs for three years alongside my term on the MPC. I was awarded this fellowship to undertake a body of research in political economy which is broadly focused on understanding the institutional foundations of market economies. I will remain Professor of Economics and Political Science at the LSE under the terms of this fellowship. There is no conflict between fulfilling this research programme and my duties as an MPC member. Indeed, I imagine that my experience on MPC will provide insights into the issues dealt with in that research programme.

I also have a modest commitment of time as a lead editor of the Mirrlees Review recently launched by the *Institute for Fiscal Studies* to look at the future of the UK tax system. In the near term, I am chairing the DFID-ESRC joint funding program committee and will see that commitment through in the next year. I also have a short-term commitment to the review that Sir Hayden Phillips is conducting into the funding of political parties to which I am giving some advice. During my tenure on the MPC, I may occasionally take on small projects for the World Bank, IMF or other bodies, but only where these bear directly on issues which are relevant to my research expertise and the time commitment is modest.

Along side these commitments, I shall be involved in a limited number of "everyday" academic duties—such as writing reviews, supervising PhD students, being a member of professional bodies and networks, and attending conferences in the UK and abroad.

10. *Outside of MPC meetings, what activities do you intend undertaking in order to add to the public's understanding of the role and decisions of the MPC?*

I will undertake a number of agency visits—I have two arranged already. These will be accompanied by briefings and question-and-answer sessions. I also plan to make speeches and give interviews to explain my thinking on relevant issues as well as that of the MPC.

D. MONETARY AND ECONOMIC POLICY

11. *How might the system of control over monetary policy in the UK, in place since 1998, be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy?*

I have a lot of faith in the current system. We have a regime with many attractive features—a clearly defined policy objective, independent MPC members and careful communication of the rationale for decisions through publication of the minutes and the inflation report. Although it has not yet been used, the open letter that would accompany any movement of inflation more than one percent away from the target would also be important in explaining the MPC's thinking in such circumstances. Also important is the dedicated work of the Bank of England staff which provides skilled and careful analysis of relevant data.

The explicit symmetrical inflation target has clearly served to anchor inflation expectations limiting second round responses in wages and prices to shocks, such as the rise in oil prices.

The system is both transparent and accountable. The stability that has been enjoyed in the UK economy since 1998 is, in large measure, due the features that I have outlined. At this early stage in my position as an MPC member, I see no direction for improvement.

12. *How great is the risk to UK growth and inflation posed by high nominal oil prices? How should monetary policy react to higher inflation caused by increased oil prices?*

As I write, this risk appears to have subsided somewhat. But the recent rise in oil prices has clearly presented enormous challenges for the MPC and for central banks the world over. As I noted above, the commitment to keep inflation close to target has helped to limit second round effects in wages and prices. This explains, in part why the inflationary effect has been more muted than might have been predicted *ex ante*. But it is still important to keep a careful eye on possible second round effects. When oil prices were rising steeply, there is also some evidence that domestically generated inflation was weaker as firms decided to bear down on other costs. If correct, this has been good news for meeting the inflation target. However, it may also suggest that we will enjoy less relaxation in inflationary pressures than might have been hoped for as oil prices fall back.

13. *What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?*

It is best not to think of either the exchange rate or asset prices as *affecting* monetary policy. The key issue is to analyze the forces that lie behind exchange rate and asset price movements in order to establish the underlying drivers. Monetary policy should then respond appropriately to these drivers in so far as they have implications for inflation. But there is no simple formulaic rule—each situation needs to be analyzed on its own merits.

There is much popular discussion of bubbles in asset markets. On the whole, it is difficult to identify the difference between bubbles as distinct from "normal" fluctuations. I am sceptical about the ability of the MPC to use monetary policy as a means of better aligning asset prices with fundamentals.

14. *To what degree do you consider the recent rise in personal insolvencies to be of significance when considering the vulnerability of UK household balance sheets? What impact will this have, in your opinion, on setting interest rates?*

Insolvency is clearly very difficult for those concerned and nobody welcomes an increase in the rate of personal insolvency. To some degree, this may reflect a poor appreciation of the consequences of indebtedness among some groups of borrowers. However, given the sophistication of most lenders, it is difficult to believe that lenders are unaware of these risks when deciding how much to lend. Any move towards policy interventions would need to acknowledge the important role that access to credit plays particularly in allowing individuals to open small businesses and in becoming home owners. Either way, policy making in this area is well beyond the scope of the MPC's remit.

As far as monetary policy is concerned, the rate of personal insolvency could affect the transmission mechanism of interest rate changes in so far as it affects aggregate consumption. To that extent, the prospects for personal insolvency rates of interest rates should be taken into account in analyzing interest rate policy decisions. However, it is only one aspect among many that is likely to matter.

15. *How would you describe the state of the UK labour market at present? In particular, how has net migration impacted on growth and inflation in the UK?*

The labour market is generating a great deal of discussion at the current juncture. How one reads the recent upturn in unemployment is a key issue for monetary policy as it has implications for wage pressures going forward. There is evidence that increases in participation (particularly by older workers) is an important factor in driving this. Moreover, employment growth still seems quite strong. Hence, I am inclined against interpreting recent increase in unemployment as a standard cyclical weakness in the economy. Doing so would tend to contradict the evidence coming through in consumption, investment and output data.

It is likely that wage pressures have been eased by an increased supply of migrant labour in recent years and this may continue to be the case in future. But this will depend in part on whether the migration that we are seeing is temporary or permanent and whether the UK remains an attractive destination for migrants.

Little is yet understood about the consumption patterns of migrants to the UK. For example, we need to understand better whether migrants save more than non-migrants in anticipation of returning to their country of origin or the extent to which they chose to remit their income to relatives abroad. More generally, it is important to look at ways in which migrants are creating pressures on the consumption side of the economy, such as in housing markets.

16. *To what extent should fiscal policy play a demand management role alongside monetary policy in the short run?*

Fiscal policy should be determined by the need for investment in public goods and services such as transport infrastructure, education, health, social protection etc. Ideally, such investments should reflect the social costs and benefits that public spending brings to the economy taking a long-run view. There are good reasons to smooth the costs of providing public services by issuing public debt to finance long-run investments, to smooth temporary fluctuations in tax revenues and to smooth payment of sudden unanticipated spending needs (such as the foot and mouth outbreak). However, I favour pursuing a debt policy that is broadly neutral over the economic cycle. This view of fiscal policy gives no role to demand management *per se*.

September 2006

Professor Timothy J Besley's Curriculum Vitae

PRINCIPAL CURRENT POSITIONS:

Professor of Economics and Political Science, London School of Economics (ESRC Professorial Research Fellow, 2006–09).

Member (part-time), Monetary Policy Committee, Bank of England 2006–09.

EDUCATION:

1972–79: Aylesbury Grammar School, Aylesbury, Buckinghamshire.

1983: BA (MA, 1987) Philosophy, Politics and Economics (1st Class), Keble College, Oxford University.

1985: MPhil, Economics, Oxford University.

1987: DPhil, Economics, Oxford University.

PAST EMPLOYMENT:

Assistant Professor of Economics and International Affairs, Princeton University, 1989–95.

Visiting Assistant Professor of Public and International Affairs, Woodrow Wilson School, Princeton University, 1988–89.

Prize Fellow, All Souls College, Oxford, 1984–89.

HONOURS/AWARDS:

Yrjö Jahnsson Award (joint-winner 2005).

Fellow of the Econometric Society (2000).

Fellow of the British Academy (2001).

Fellow of the European Economics Association (2005).

Richard Musgrave Prize (inaugural winner) for paper "Sales Taxes and Prices: An Empirical Analysis," (with Harvey Rosen), 2000.

Duncan Black Prize for paper "On the Public Choice Critique of Welfare Economics", (with Stephen Coate), 2003.

Prize Fellow, All Souls College, Oxford, 1984–91.

Cyril E Black Preceptorship in the Woodrow Wilson School, Princeton University, 1993–96.

Alfred P Sloan Research Fellowship (1994–95).

George Webb-Medley Junior Prize, Oxford University (1982).

George Webb-Medley Senior Prize, Oxford University (1983).

George Webb-Medley MPhil Exam Prize, Oxford University (1985).

OTHER PROFESSIONAL ACTIVITIES—CURRENT:

Director, Suntory-Toyota International Centres for Economics and Related Disciplines (STICERD) at the LSE.

President, Bureau for Research on the Economic Analysis of Development (BREAD), 2004–07 (Board member since 2002).

Program Member, CIAR Program on Institutions, Organizations and Growth, 2003–.

Research Fellow, Institute for Fiscal Studies, London, 1995–.

Research Fellow, CEPR, 2002–.

Co-founder and Organizing Committee Member, Public Economics UK.

Member of editorial team: Mirrlees Review on "Reforming the Tax System for the 21st Century".

Associate Editor, *Quarterly Journal of Economics*, 2006–

Editorial Board, *World Bank Economic Review,* 2000–.

Associate Editor, *Journal of Development Economics* 1995–.

Associate Editor, *International Tax and Public Finance* 1995–.

Associate Editor, *Review of Development Economics,* 1997–.

Associate Editor, *European Journal of Political Economy*, 2004–.

Council Member (elected), Royal Economics Society, 2000–05. (Member of the Executive 2003–07).

Council Member (elected, re-elected 2006), Econometric Society, 2003–.

Editorial Advisor, *The Journal of Developing Areas* 2001–

Editorial Advisor, *Developing Economies* 2003–

OTHER PROFESSIONAL ACTIVITIES—PAST:

Co-editor, *American Economic Review*, 1999–2005

Program Director, CEPR, Program in Public Policy 1998–2002.

Council Member (elected), European Economics Association, 2001–05.

Deputy Chairman, STICERD, 1997–2000.

Managing Editor, *Economic Journal* 1996–99.

Associate Editor, *Economics and Politics* 1993–99.

Editorial Board, *Oxford Economic Papers* 1988–98.

Editorial Board, *Review of Economic Studies,* 1995–2005.

Faculty Research Fellow, National Bureau of Economic Research, Cambridge, MA, 1991–98.

Fellow, All Souls College, Oxford, 1995–2000.

Junior Research Fellow, Institute for Policy Reform, 1994.

Econometric Society Program Committee, 1994 (Washington), 1997 (New Orleans) North American Winter Meetings, 2000 World Congress (Seattle), 2003 (Stockholm).

Professeur Associé, Université d 'Auvergne, Clermont-Ferrand, France, 1991–95.

PRINCIPAL INVITED LECTURES:

Review of Economic Studies Lecture, Royal Economic Society, 1998.

Lindahl Lectures, Uppsalla University, 2002.

Joseph Schumpeter Lecture, European Economics Association, 2003.

Keynes Lecture, British Academy, 2004.

Walras-Bowley Lecture, Econometric Society World Congress, 2005.

Kuznets Lectures, Yale University, 2006.

PUBLICATIONS—BOOKS:

Principled Agents? The Political Economy of Good Government, The Lindahl Lectures, Oxford: Oxford University Press, 2006.

Development Challenges of the 1990s: Leading Policy Makers Speak from Experience, edited with Roberto Zagha, Oxford University Press for the World Bank, 2005.

PUBLICATIONS—ARTICLES:

"Tied-in Credit with a Monopoly Product Market," *Economics Letters,* 28, March 1988, 105–108.

"Invariance and the Axiomatics of Income Tax Progression: A Comment" (with Ian Preston). *Bulletin of Economic Research,* April 1988, 159–163.

"A Simple Model for Merit Good Arguments," *Journal of Public Economics,* 35, May 1988, 371–383.

"Rationing, Income Effects and Supply Response: A Theoretical Note," *Oxford Economic Papers,* 40, June 1988, 378–389.

"Food Subsidies and Poverty Alleviation," (with Ravi Kanbur). *Economic Journal,* 98, September 1988, 701–720.

"Optimal Reimbursement Health Insurance and the Theory of Ramsey Taxation," *Journal of Health Economics,* 7, December 1988, 321–336.

"Ex Ante Evaluation of Health States and the Provision for Ill-Health," *Economic Journal,* March 1989, 132–146.

"Publicly Provided Disaster Insurance for Health and the Control of Moral Hazard," *Journal of Public Economics,* 39, June 1989, 141–156.

"A Definition of Luxury and Necessity for Cardinal Utility Functions," *Economic Journal,* September 1989, 844–849.

"The Demand for Health Care and Health Insurance," *Oxford Review of Economic Policy* 5. (Winter 1989): 21–33. (Reprinted in A McGuire, P Fenn and K Mayhew, eds, *Providing Health Care: The Economics of Alternative Systems of Finance and Delivery*, Oxford: Oxford University Press. (1991): 46–64.)

"General Equilibrium with Parallel Markets for Goods and Foreign Exchange: Theory and Application to Ghana," (with Jean-Paul Azam). *World Development,* 17, December 1989, 1921–30.

"Commodity Taxation and Imperfect Competition: A Note on the Effects of Entry," *Journal of Public Economics,* 40, December 1989, 359–367.

"Moral Hazard, Limited Liability and Taxation: A Principal Agent Model," (with Anindya Banerjee). *Oxford Economic Papers,* 42, January 1990, 46–60. (Special issue on Public Economics edited by P Sinclair and M Slater.)

"Means Testing versus Universal Provision in Poverty Alleviation Programs," *Economica,* 57, February 1990, 119–129.

"Optimal Reimbursement Health Insurance: An Application of Profit Functions and Frischian Demands," *Journal of Economic Theory,* 51(2), August 1990, 403–422.

"Optimal Uniform Taxation and the Structure of Consumer Preferences," (with Ian Jewitt). In G D Myles, ed, *Measurement and Modelling in Economics*. North-Holland. (1990): 131–156.

"Import Compression and Trade Policy," (with Paul Collier). In J Frimpong-Ansah, S M Ravi Kanbur and P Svedberg, eds, *Trade and Development in Sub-Saharan Africa*, Manchester University Press. (1990): 203–230.

"Peasant Supply Response under Rationing: the Role of the Food Market," (with Jean-Paul Azam). *European Journal of Political Economy,* 7, 1991, 331–343.

"Public Provision of Private Goods and the Redistribution of Income," (with Stephen Coate). *American Economic Review,* 81, September 1991, 979–984.

"Decentralizing Public Good Supply," (with Ian Jewitt), *Econometrica,* 59(6), November 1991, 1769–1777.

"Welfare Improving User Charges for Publicly Provided Private Goods," *Scandinavian Journal of Economics,* 93(4), 1991, 495–510.

"Workfare versus Welfare: Incentive Arguments for Work Requirements in Poverty Alleviation Programs," (with Stephen Coate). *American Economic Review,* 82(1), March 1992, 249–261.

"Taxation and Welfare in an Oligopoly with Strategic Commitment," (with Kotaro Suzumura). *International Economic Review,* 33(2), May 1992, 413–431.

"Understanding Welfare Stigma: Taxpayer Resentment and Statistical Discrimination," (with Stephen Coate). *Journal of Public Economics* 48, July 1992, 165–183.

"Modelling Technology Adoption Decisions in Developing Countries," (with Anne Case). *American Economic Review*, *Papers and Proceedings*. (May 1993): 396–402.

"Targeting Taxes and Transfers: Administrative Costs and Policy Design in Developing Countries," In K Hoff, A Braverman, and J Stiglitz, eds, *The Economics of Rural Organization: Theory, Practice, and Policy*. Oxford University Press for the World Bank, 1993.

"Taxes and Bribery: The Role of Wage Incentives" (with John McLaren). *Economic Journal* 103(1), January 1993, 119–141. (Reprinted in Gianluca Fiorentini and Stefano Zamagni (eds) *The Economics of Corruption and Illegal Markets*, in *The International Library of Critical Writings in Economics—Series Editor: Mark Blaug*)

"The Economics of Rotating Savings and Credit Associations" (with Stephen Coate and Glenn Loury). *American Economic Review,* 83(4), September 1993, 792–810. (Reprinted in Dilip Mookherjee and Debraj Ray (eds), *Readings in the Theory of Development Economics*, Basil Blackwell, 2001.)

"The Principles of Targeting" (with Ravi Kanbur). In V N Balasubramanyam and Sanjaya Lall, eds, *Current Issues in Development Economics*, Macmillan Education Ltd. (1991): 69–90. (Reprinted in Michael Lipton and Jacques van der Gaag, eds, *Including the Poor*, Washington, DC: The World Bank. (1993): 67–90 and in Nicholas Barr (ed) *Readings on the Welfare State*, Edward Elgar Publications).

"How Do Market Failures Justify Interventions in Rural Credit Markets?" *World Bank Research Observer,* 9(1), January 1994, 27–47. (Reprinted in Carl K Eicher and John M Staatz (eds) *International Agricultural Development*, 3rd Edition, Baltimore: Johns Hopkins University Press, 1997.)

"Thy Neighbor's Keeper: The Design of a Credit Cooperative with Theory and a Test" (with Abhijit Banerjee and Timothy Guinnane). *Quarterly Journal of Economics,* May 1994, 491–515. (Reprinted in *International Journal of Development Banking*, 14(2), July 1996, 29–44, and in Pranab Bardhan and Christopher Udry, *Readings in Development Economics*, MIT Press (2000))

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"Three Approaches to Public Economics," *International Tax and Public Finance,* 1, October 1994, 197–204.

"Rotating Savings and Credit Associations, Credit Markets and Efficiency," (with Stephen Coate and Glenn Loury). *Review of Economic Studies,* 61(4), October 1994, 701–719.

"Savings, Credit and Insurance," Chapter 36 in Jere Behrman and T N Srinivasan, eds, *Handbook of Development Economics*, Vol IIIa. Amsterdam: North-Holland, 1995.

"Uniform Taxation and Consumer Preferences" (with Ian Jewitt), *Journal of Public Economics,* 58, 1995, 73–84.

"Group Lending, Repayment Incentives and Social Collateral" (with Stephen Coate), *Journal of Development Economics*, 46 (1), February 1995, 1–18.

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"The Design of Income Maintenance Programs" (with Stephen Coate), *Review of Economic Studies* 62 (2), April 1995, 187–221.

"Non-Market Institutions for Credit and Risk-Sharing in Low-Income Countries" *Journal of Economic Perspectives*, Symposium on Consumption Smoothing in the Third World, (Summer 1995).

"Does Electoral Accountability Affect Economic Policy Choices? Evidence from Gubernatorial Term Limits" (with Anne Case). *Quarterly Journal of Economics,* 110 (3), August 1995, 769–798. (Reprinted in *The Economics of Budget Deficits* in *The International Library of Critical Writings in Economics,* Series Editor Mark Blaug, Edward Elgar Publishing 2002.)

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"James Mirrlees' Contributions to the Theory of Information and Incentives" (with Avinash Dixit), *Scandinavian Journal of Economics*, 99(2), 1997, 207–235.

"An Economic Model of Representative Democracy" (with Stephen Coate), *Quarterly Journal of Economics*, 112(1), February 1997, 85–114. (Reprinted in Kaushik Basu (ed), Readings in Political Economy, Basil Blackwell (2002)).

"Monopsony and Time-Consistency: Sustainable Pricing Policy for Perennial Crops." *Review of Development Economics*, 1(1), 1997, 57–70.

"Fiscal Anarchy in the UK: Modelling Poll Tax Non-compliance" (with Ian Preston and Michael Ridge), *Journal of Public Economics*, 64, 1997, 137–152.

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"Sources of Inefficiency in a Representative Democracy: A Dynamic Analysis" (with Stephen Coate), *American Economic Review*, 88(1), 139–156, 1998.

"Vertical Externalities in Tax Setting: Evidence from Gasoline and Cigarettes," (with Harvey Rosen), *Journal of Public Economics*, 70, 383–398, 1998.

"The Effects and Policy Implications of State Aids to Industry" (with Paul Seabright). *Economic Policy,* 28, April 1999.

"The Demand for Private Health Insurance: Do Waiting Lists Matter?" (with John Hall and Ian Preston), *Journal of Public Economics*, 72(2), May 1999.

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"Sales Taxes and Prices: An Empirical Analysis" (with Harvey Rosen), *National Tax Journal*, 52(2), 1999. (Winner of the inaugural Richard Musgrave Prize.)

"Political Institutions and Policy Competition", in Gudrun Kochendorfer-Lucius and Boris Pleskovic (eds),*The Institutional Foundations of a Market Economy*, Villa Borsig Workshop Series 2000, The World Bank ,102–109, April 2001.

"From Micro to Macro: Public Policies and Aggregate Economic Performance" in *Economic Growth and Government Policy*, papers presented at a HM Treasury Seminar at 11 Downing Street on 12 October 2000, London: HM Treasury, 15–21, April 2001, (also published in *Fiscal Studies,* Volume 22(3), 357–374, September 2001.)

"Land Reform, Poverty Reduction and Growth: Evidence from India", (with Robin Burgess), *Quarterly Journal of Economics,* 115(2), May 2000, 389–430.

"Unnatural Experiments? Estimating the Incidence of Endogenous Policies" (with Anne Case). *Economic Journal (Features)*, 110, November 2000, F672–F694.

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"Mass Media and Political Accountability." (with Robin Burgess and Andrea Prat) in *The Right to Tell: Institutions and the Media*, (edited by Roumeen Islam), for the World Bank. 2002.

"The Political Economy of Government Responsiveness: Theory and Evidence from India," (with Robin Burgess), *Quarterly Journal of Economics,* November 2002, 117(4), 1415–1452.

"On the Public Choice Critique of Welfare Economics," (with Stephen Coate), *Public Choice*, 114(3), 2003, 253–273. (Winner of the Duncan Black Prize for best paper published in *Public Choice* in 2003).

"Understanding the Workhouse Test: Information and Poor Relief in Nineteenth-Century England" (with Stephen Coate and Timothy Guinnane) in *History Matters: Essays in Honour of Paul David*, (edited by Timothy Guinnane, William Sundstrom and Warren Whatley), Stanford University Press. 2003.

"Political Institutions and Policy Outcomes: Evidence from the United States" (with Anne Case), *Journal of Economic Literature,* 41(1), March 2003, 7–73.

"Incentives, Choice and Accountability in the Provision of Public Services," (with Maitreesh Ghatak), *Oxford Review of Economic Policy*, Summer 2003, 19(2), 235–249.

"Halving Global Poverty", (with Robin Burgess), *Journal of Economic Perspectives*, Summer 2003, 17(3), 3–22.

"Elected versus Appointed Regulators," (with Stephen Coate), *Journal of the European Economics Association*, 1(5), 1176–1206. September 2003.

"Welfare Economics and Public Choice" and "Elected versus Appointed Regulators" in *The Encyclopaedia of Public Choice*, (edited by Charles Rowley) Kluwer Academic Publishers, 2003.

"Central versus Local Provision of Public Goods: A Political Economy Analysis" (with Stephen Coate) *Journal of Public Economics*. 87(4), 2611–2637. December 2003.

"Can Labor Regulation Hinder Economic Performance? Evidence from India." (with Robin Burgess), *Quarterly Journal of Economics*, 19(1), 91–134. February 2004.

"Paying Politicians: Theory and Evidence", Joseph Schumpeter Lecture, *Journal of the European Economics Association*, April 2004. 2 (2–3) 193–215.

"The Politics of Public Good Provision: Evidence from Indian Local Governments," (with Rohini Pande, Lupinh Rahman and Vijayendra Rao) *Journal of the European Economics Association*, Vol 2, April 2004, 416–426.

"Credible Pensions" (with Andrea Prat), *Fiscal Studies*, 26(1), 119–135, March 2005.

"Introduction", in *Development Challenges of the 1990s: Leading Policy Makers Speak from Experience*, Timothy Besley and Roberto Zagha (eds), Oxford University Press for the World Bank, 2005.

"Political Selection," *Journal of Economic Perspectives*, 19(3), 43–60, 2005.

"Competition and Incentives with Motivated Agents," (with Maitreesh Ghatak), *American Economic Review*, 95(3), 616–636, 2005.

"The New Political Economy" Keynes Lecture, *Proceedings of the British Academy,* 2005.

"Public Goods and Economic Development" (with Maitreesh Ghatak), chapter 19 in Abhijit Banerjee, Roland Benabou and Dilip Mookherjee (eds), *Understanding Poverty*, Oxford: Oxford University Press, 2006.

"Participatory Democracy in Action: Survey Evidence from South India," (with Rohini Pande and Vijayendra Rao) *Journal of the European Economics Association*, 2005.

"Handcuffs for the Grabbing Hand? Media Capture and Government Accountability" (with Andrea Prat) forthcoming in the *American Economic Review*, 2006.

"Sorting with Motivated Agents: Implications for School Competition and Teacher Incentives," (with Maitreesh Ghatak) *Journal of the European Economics Association*, 2006."Health and Democracy" with Masa Kudamatsu, *American Economic Review*, Papers and Proceeedings, 2006.

PUBLICATIONS—DISCUSSION PAPERS:

"Peer Group Externalities and Learning Incentives: A Theory of Nerd Behavior" (with Abhijit Banerjee). Woodrow Wilson School, John M. Olin Program Discussion Paper No 68, (October 1990).

"Monitoring and Wage Incentives: Capitulation versus Efficiency Wages" (with John McLaren). Woodrow Wilson School, John M. Olin Program Discussion Paper, (October 1990).

"Diffusion as a Learning Process: Evidence from HYV Cotton" (with Anne Case). Woodrow Wilson School, Research Program in Development Studies Discussion Paper No 174, (May 1994)

"Read My Lips: The Political Economy of Information Transmission", (with Rohini Pande), STICERD Economic Theory Discussion Paper No 98/355, July 1998.

"Issue Unbundling via Citizens' Initiatives," (with Stephen Coate) CEPR Discussion Paper No 2857 2001, revise and resubmit *Quarterly Journal of Economics.*

"Does Tax Competition Raise Voter Welfare," (with Michael Smart) CEPR Discussion Paper No 2857 2001.

"Political Competition and Economic Performance: Evidence from the United States" (with Torsten Persson and Daniel Sturm), NBER Discussion Paper No 11484, 2005.

"Political Selection and the Quality of Government", (with Rohini Pande and Biju Rao), Development Economics Discussion Paper, STICERD, LSE, No DEDPS44.

PUBLICATIONS—RESEARCH REPORTS

"The Supply of Manufactured Goods and Agricultural Development: The Case of Ghana" (with Jean-Paul Azam). *OECD Development Centre Papers*. (1989): 13–65.

"Private Health Insurance and the State of the NHS", (with John Hall and Ian Preston), Institute of Fiscal Studies, Commentary, No 52, 1996.

"Tax-Based Savings Incentives," (with Costas Meghir) for World Bank Project on Savings, 1997.

"Participation and Poverty Reduction," (with Michelle Adato, John Hoddinott and Lawrence Haddad), background paper for 2000 World Development Report on Poverty, 2000.

"Institutional Evolution in Rural Financial Markets," (with Sanjay Jain), for 2001 World Development Report on Institutions for a Market Economy, 2000.

OTHER UNPUBLISHED WORK AND WORK IN PROGRESS:

"Reputation as a Public Good" (with Michihiro Kandori). May 1992.

"Redistributive Politics and Efficient Investment" (with Stephen Coate), June 1997.

"Women in Politics: Finding Instruments for Incidence Analysis," (with Anne Case), November 1997.

"The Economics of Corporate Social Responsibility," (with Maitreesh Ghatak), November 2004.

"The Effect of the Military on Policy" (with James Robinson), October 2005.

"Political Competition and Economic Performance in India" (with Robin Burgess), October 2005.

"The de Soto Effect: Property Rights, Social Networks and Gains from Trade," (with Maitreesh Ghatak) July 2006

"Public Organizations" (with Maitreesh Ghatak) July 2006.

PERSONAL:

British Citizen: Married to Gillian Paull: Two sons: Thomas (born 1995) and Oliver (born 1997).

Questionnaire in advance of Treasury Committee hearing for Dr Andrew Sentance

A. PERSONAL AND PROFESSIONAL BACKGROUND

1. *Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC? Are there any relevant personal or other factors of which the Treasury Committee should be aware in considering your appointment?*

I have resigned from my current employment at British Airways (BA) with effect from 30 September 2006. When I take up my position on the MPC, therefore, I will have no business or financial connections, or other commitments which might give rise to a conflict of interest.

Aside from my economic expertise and business experience, I am not aware of relevant personal or other factors which are relevant to my appointment to the MPC.

2. *Do you intend to serve out the full term for which you are appointed?*

Yes.

3. *Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC? In particular, what areas of the MPC's work do you believe you will make a particular contribution to, and which will you have to undertake additional research on on your arrival?*

As my CV (attached) shows, I have worked for most of my career as a senior professional economist in a business or business-related environment—at the Confederation of British Industry (CBI), London Business School (LBS) and, most recently, with British Airways (BA). This has provided me with a wide range of experience relevant to the work of the MPC. This experience will help me to carry out my role as an MPC member in three key ways.

First, I am an experienced analyst of the UK and global economies, and I have observed at first hand the way in which the UK has made the transition to a low inflation economy over the last two decades. I have written numerous articles on UK and global economic developments while at the CBI and the LBS. At BA, a key part of my role has been to provide internal advice on economic developments to all levels of management and to the Board.

Second, I have first hand experience of working in and around the world of business, and I hope this experience will be helpful in judging how business will respond to changes in the economic climate. The last five years at BA has been a very good place to observe how a business reacts and responds in the face of big shifts in market conditions. However, my business experience is not limited to the airline industry, as I interacted with a wide range of businesses at the CBI and the LBS.

Third, I have experience in communicating economic issues to non-specialist audiences, both through the media and directly. I believe this experience will be valuable as a member of the MPC, in helping business, the public and opinion-formers to understand the issues we face and in explaining the decisions we have taken.

In the light of this experience, the areas I will be focussing on within the MPC will include he analysis of business trends through the use of survey information, and how the structure of the economy is changing in response to shifts in technology and global competition. I will also be active in supporting the two-way communication which the MPC has with the business community and the public through regional visits, speeches, interviews and articles.

4. *To what extent will membership of the MPC require a different approach from that required in your previous positions, with regard to the discharge of the duties and responsibilities involved?*

In terms of subject matter, I see a lot of common ground between the MPC and my previous roles. I also think the approach needed will be similar. My experience in the world of business is that success is generally based on good teamwork. I see the MPC as a team charged with a key responsibility for maintaining low inflation in the UK economy, through setting interest rates. The individuals on the team each make a distinctive contribution based on their different areas of expertise, experience and knowledge. However, we need work together effectively if we are to deliver success.

The working environment of the MPC will clearly be different to BA. However, through my career, I have adapted successfully to changes in working environment and I am confident this will also happen when I join the MPC.

B. Accountability

5. *How important do you think it is for MPC members to be subject to ex post parliamentary accountability? What are the strongest and weakest parts of the current procedures in the UK?*

The government sets the inflation target and it is clearly important that the MPC is able to account to Parliament how it is proceeding in delivering that target. The operational independence of the MPC is a key element in the current UK monetary policy framework.

I believe the UK procedures for monetary policy currently work well, and while that remains the case, I would not advocate any change in these arrangements.

6. *If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?*

I see the MPC as a team which has been delegated responsibility for maintaining monetary stability in the UK. So the key measure of individual success is how far each member has helped the "MPC team" to meet its objective—the inflation target. The voting record of individuals inevitably attracts a lot of attention, but just as important is how far MPC members have contributed to the debate within the committee, and therefore influenced its collective judgements. Also, MPC members have an important role in communicating to the public the issues under consideration and the rationale for the decisions taken.

I would therefore expect to be judged not only by my individual voting record and by our collective success in meeting the inflation target, but also by my contribution to the debate within the committee and by the way I have helped with communication—through speeches, articles, interviews and regional visits.

7. *Do you believe there is merit in having an individual paragraph in the minutes of MPC decisions in which to explain your most recent vote?*

The key issue is to ensure that the MPC minutes properly reflect the discussion within the committee, and the reasons for the decision taken. The views of dissenters are also minuted, and there are opportunities for individual MPC members to express their views in speeches, interviews and articles. This looks to be a reasonable set of arrangements, and I would want to have more experience of working on the MPC before expressing any opinions on the need for change.

C. Other professional activities

8. *What other professional activities do you expect to undertake in addition to your position on the MPC and how do you intend reconciling these activities with your position as a MPC member?*

I have been appointed to the MPC on the understanding that this will be my main occupation and that I will avoid actual or apparent conflicts of interest in other activities. However, the MPC is a three day a week appointment—and remunerated as such. Therefore, I plan to develop other activities which will take up the other 40% of my normal working week, subject to the rules laid down for MPC members.

I am currently a member of the Commission for Integrated Transport, a government advisory body on transport policy. This is expected to take around two days a month. I am also a visiting professor at Cranfield University, linked to their Air Transport Group. I would like to use this connection to keep in touch with the aviation sector, though currently my commitment to Cranfield involves delivering one to two lectures each year.

I therefore have room for another part-time commitment, as long as this does not conflict with my MPC role. My current thinking is to secure a part-time academic appointment. I will seek permission for any further appointments from the Chancellor of the Exchequer and the Bank Governor, in line with the rules laid down for MPC members.

9. *Outside of MPC meetings, what activities do you intend undertaking in order to add to the public's understanding of the role and decisions of the MPC?*

I envisage giving regular speeches and interviews, and making visits to local businesses facilitated by the Bank's regional agents around the country. I am keen to develop these aspects of my role as a MPC member, and have a fairly full programme of regional activities already planned for my first year on the MPC.

In terms of major public speeches and interviews, these will probably not get underway until the New Year. I would like to spend time familiarising myself with the MPC processes and thinking before making major public statements in my new capacity.

D. Monetary and Economic Policy

10. *How might the system of control over monetary policy in the UK, in place since 1998, be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy?*

I believe the system of controlling monetary policy in place since 1998 has worked well. It has kept inflation close to the target set by the government and has been associated with a period of steady and sustained economic growth. Broader international conditions have been helpful, with low inflation worldwide and global competition helping to contain price rises of tradable goods and services. However, the structure and processes of the Monetary Policy Committee have also proved effective and resilient. As a result, I have no specific changes to propose to the framework.

The existence of an explicit symmetrical inflation target has been a key element contributing to the success of policy. An explicit target is helpful in providing clarity about the policy framework and in providing a guide for inflation expectations. Given the importance of expectations in the inflation process, this should reduce the output cost of containing inflation if it does move away from the target. We have seen in the case of Japan that deflation can be damaging as well as inflation, so this provides a basis for a symmetrical target. I can see no case, therefore, for moving away from the current approach.

11. *How great is the risk to UK growth and inflation posed by high nominal oil prices? How should monetary policy react to higher inflation caused by increased oil prices?*

A significant rise in oil prices—such as that seen over the last three years—does pose a threat to growth and inflation. In the mid-1970s and the early-1980s, a sharp rise in the oil price was one of the factors which led to accelerating inflation and recession in the UK. However, there are important differences between the situation now and then.

First, the economy is now less dependent on oil—both because of improvements in energy efficiency and a diversification towards other energy sources (especially natural gas).

Second, inflation expectations are more securely grounded—because of the experience of low inflation and the monetary policy framework currently in place. This reduces the risk that a temporary rise in inflation due to higher oil prices feeds through into a wage-price spiral. Low world inflation and competitive pressures in the global economy help to reinforce these expectations.

Third, we have a better monetary policy framework now than in those earlier episodes which helps to reduce the risk of policy mistakes. There were significant policy mistakes in the mid-1970s and around the time of the second oil price shock. In the mid-1970s, policy was initially too relaxed in response to the inflationary shock and this significantly increased the output costs of getting inflation under control—which was not properly achieved until the early 1980s.

There is no hard and fast rule about how policy should react to an oil price shock. The judgement will depend very much on the broader economic background against which the price change takes place. In the mid-1970s, the rise in oil prices occurred against a background of very strong domestic demand and the subsequent policy relaxation poured fuel on the fire. The economic background is now much more stable. The key issue for policy-makers is to ensure that the first round—or initial impact—effects on inflation, eg through higher petrol prices, do not feed through into a more sustained rise in inflation, by affecting price expectations and wage increases.

12. *What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?*

The exchange rate and asset prices are all part of the mix of economic factors which the Monetary Policy Committee must take into account in its interest rate judgement. However, it would be wrong to treat either of them as the sole factor, or even the dominant influence, on monetary policy.

For very small open economies, the exchange rate is a key factor driving inflation whereas for a large economy where trade is a much smaller proportion of GDP—such as the US—it will be a relatively minor factor. The UK lies somewhere between these two extremes. The exchange rate is important, but its impact can be offset by other factors. How the economy responds to an exchange rate change also depends on the factors which are causing that change.

Asset bubbles provide a significant challenge for policy-makers. The first problem is identifying them—often a "bubble", such as the dot.com boom in the United States, is not apparent until it has burst. The second challenge is understanding the impact they are having on demand—and hence on inflation. Within the framework operated in the UK, the appropriate response depends on how inflation is likely to be affected.

13. *To what degree do you consider the recent rise in personal insolvencies to be of significance when considering the vulnerability of UK household balance sheets? What impact will this have, in your opinion, on setting interest rates?*

A rise in personal insolvencies is clearly unwelcome, not least because of the difficult personal circumstances for the individuals and families affected. However, while it is one of the factors which the MPC should take into account in assessing household finances and consumer behaviour, it is not the most important factor. Even at current levels, personal insolvencies affect around 0.1% of households in the UK. There is much more direct evidence available on consumer spending and household finances, relevant to a much wider cross-section of the population, to which the MPC should give greater weight in its decisions.

14. *How would you describe the state of the UK labour market at present? In particular, how has net migration impacted on growth and inflation in the UK?*

The UK labour market is clearly functioning a lot better now than it was in the 1970s, 1980s and the early 1990s. Then, it was not possible to achieve a low and stable rate of wage increases without a high level of unemployment, sustained for many years. In recent years, the UK economy has been able to operate with unemployment of around 5% on the Labour Force Survey (LFS) measure, and around 3%, on the claimant count measure, without inflationary wage pressures developing.

This improvement over the last decade or so partly reflects the fact that the labour market has not had to absorb the type of shocks we saw in those earlier decades, with more stable economic growth and better economic management. It also reflects the beneficial impact of labour market policies pursued from the mid-1980s onwards—including better training and support for those out of work, and changes to the benefit structure to incentivise employment.

Over the last year, the unemployment rate has risen—on both the LFS and claimant count measures. The slowdown in the economy in the second half of last year may have contributed to this shift—as employment trends often lag economic growth. However, we should now expect the demand for labour to pick up in response to the stronger performance of the real economy in the first half of this year—moderating the rise in unemployment. The most recent data available—showing that the claimant count measure of unemployment has stabilised over the summer months—supports this view.

Labour supply developments also appear to have played a part in the recent rise in unemployment. In a well-functioning labour market, employment should rise to absorb an increase in labour supply—boosting economic activity. But the process of adjustment may take some time, so unemployment could be pushed up temporarily by a rise in the labour force. Net migration is one of a number of factors which could be helping to raise the labour supply at present. In the medium term, a larger labour force should have a positive impact on economic growth, by boosting employment without raising the rate of inflation. In the short-term, unemployment could rise while the labour market finds ways of absorbing the increased supply of workers.

15. *How would you describe, and account for, the recent performance of business investment growth in the UK?*

The latest official figures show reasonably healthy growth in business investment in both volume and value terms—up by 4.5% on a year ago in value terms and by 4.2% in volume terms. In my experience, it helps to look at both volume and value data because of the difficulties in measuring the prices of some investment goods (eg information technology). Recent data can also be subject to significant revisions. I would not be surprised to see some upward revision in future estimates.

Of more interest is the composition of investment, with the growth being driven mainly by construction and the service sector. Manufacturing investment is more subdued, reflecting the weak growth in manufacturing production over many years. This may also reflect the shift in some sectors of manufacturing to lower cost production facilities in Asia and Eastern Europe. Manufacturing investment now accounts for about 12% of total business investment, so the non-manufacturing element is much more important in terms of its impact on demand.

There is a certain level of business investment which will take place for replacement purposes and to embody new technology, which will be relatively unaffected by economic factors. The two main economic factors affecting business investment are demand prospects and the health of company finances. I would see both factors as reasonably supportive of business investment growth at present.

Business investment is one of the more volatile elements of demand—and a sharp downturn in investment intentions can often be an early warning indicator of a broader economic downturn. Investment intentions should therefore be watched closely by the MPC.

16. *To what extent should fiscal policy play a demand management role alongside monetary policy in the short run?*

Fiscal policy clearly affects demand and must be taken into account in the setting of monetary policy. With government spending and taxation both accounting for around 40% of GDP, movements in both, and the balance between them, have significant impacts on demand—and hence inflation.

There is a self-correcting element to fiscal policy—the so-called "automatic stabilisers" that should help to stabilise the economy and the growth of demand. It is generally sensible to allow these stabilisers to operate and to focus on maintaining a sound medium term fiscal position. Fiscal policy can support monetary policy by ensuring that it does not generate large destabilising swings in demand. But trying to fine tune the economy through the use of fiscal policy has not generally proved successful in the UK.

September 2006

Dr Andrew Sentance's Curriculum Vitae

Qualifications

PhD in Economics (London School of Economics, 1983–86)—Thesis title: "The Government as employer: a macroeconomic analysis".

MSc in Economics (London School of Economics, 1981–82).

BA (Hons, 2.1) and MA in Economics (Clare College, Cambridge, 1977–80).

A Levels in Economics, Mathematics and History (Eltham College, London SE9).

Employment

Bank of England

Member of Monetary Policy Committee (from October 2006).

— Appointed by Chancellor of the Exchequer, July 2006.

British Airways plc:

Chief Economist (January 1998–February 2003); Chief Economist and Head of Environmental Affairs (February 2003–September 2006):

— Heading a team responsible for economic and industry analysis, regulatory advice and corporate environmental policy.
— Contributing to development of corporate strategy.
— Influencing government and regulators on airline competition, airport policy and environmental issues.

— Playing a key role in developing an aviation industry position on emissions trading and climate change.
— Trustee and Chairman of Investment Committee for BA Pension Funds (APS and NAPS).

Key achievements at BA:

— Member of senior management team ("Gang of 5") appointed by Rod Eddington to lead "Future Size and Shape" strategic review after 9/11 attacks.
— Playing a key role in developing economic and environmental case for 3rd Heathrow runway, leading to government support in 2003 Aviation White Paper.
— Helping to secure BA, industry and government support for emissions trading as response to global warming contribution of aviation. BA joined UK Emissions Trading Scheme in 2001.
— Raising the profile of BA's environmental stance, both within the company and externally.
— Leading BA's input to two CAA reviews of airport regulation and charges, leading to rejection of "dual till" approach to regulation and separate regulation of London airports.
— Developing a more robust framework for BA revenue forecasts, producing more reliable projections, including in the aftermath of 9/11attacks.
— Analysing impact of increased competition and globalisation on industry demand and revenue trends, supporting BA fleet restructuring and changes to network strategy.
— Developing and presenting BA case to the Competition Commission CityFlyer Express enquiry (1999), resulting in regulatory approval for acquisition.

London Business School (1994–97)

Director, Centre for Economic Forecasting (August 1995—December 1997); Senior Research Fellow (January 1994–July 1995):

— Providing intellectual and managerial leadership for the Centre.
— Projecting analysis of the UK and international economy to the media, business executives and policy-makers.
— Teaching and research as a member of LBS Economics faculty.

Key achievements at LBS

— Published around 40 reports, substantial journal articles and book chapters on a wide range of topical economic and business issues.
— Edited London Business School *Economic Outlook*.
— Strengthened business interest in and support for Centre by more effective targeting of research and launch of LBS Economic Policy Forum for business executives.
— Helped to secure renewal of core funding from ESRC and generate additional funding from public bodies and research trusts.
— Member of a number of inquiries and commissions on major public policy issues, including the "Dahrendorf Commission" on Wealth Creation and Social Cohesion (1994–95) and NAPF Retirement Income Inquiry (1995–96).
— Regular contributor to the media on economic issues.
— Consultant to a number of business organisations, including acting as Chief Economic Adviser to the British Retail Consortium, 1995–97.

Confederation of British Industry (1986–93)

Director, Economic Affairs (October 1989–December 1993); Associate Director, Economic Affairs (December 1988–October 1989):

— Developing CBI economic policy and analysis of UK and international economies.
— Managing CBI Economic Affairs Directorate, including tax department.
— Lobbying government on economic matters in support of CBI policy.
— Acting as senior CBI media spokesman on economic issues.

Head, Economic Trends and Policy Group (Mar–December 1988):

- — Overseeing business surveys and economic analysis.
- — Developing CBI proposals on fiscal and monetary policy, including the Budget.
- — Editor of CBI Economic Situation Report.
- — Promoting CBI assessment of economic issues in the media.

Head of Economic Policy (September 1986–March 1988):

- — Developing CBI proposals for Autumn Statement and Budget.
- — Developing CBI policy on interest rates, exchange rate and ERM.
- — Working to support CBI City/Industry Task Force.

Key achievements at CBI

- — Strengthened quality of CBI economic analysis and policy recommendations, raising its profile and influence at a critical period for UK economic management.
- — Lead author of influential CBI reports—eg City/Industry relations (1987), European Monetary Union (1989), UK inflation (1991) and UK manufacturing performance (1992).
- — Extended CBI surveys to cover financial services and provide regional results.
- — Pioneered UK business thinking on problem of lack of "competitiveness" in European economies, leading to major UNICE initiative in mid-1990s.
- — Became a leading media commentator on UK and European economic issues.
- — Appointed as one of the original members of the Treasury Panel of Economic Forecasters (the "seven wise men").
- — Provided advice to government on statistical issues, serving on RPI and CSO (later ONS) advisory committees.

PROFESSIONAL AND ADVISORY

Member, Commission for Integrated Transport (2006–present).

Member of United Nations International Civil Aviation Organisation Emissions Trading Task Force (2005–06) and Market-Based Instruments Working Group (1999–2004).

Advisory Board, Air Transport Action Group (2000–06).

Visiting Professor, Royal Holloway, University of London (1998–present).

Visiting Professor, University of Cranfield (2001–present).

Trustee, Anglo-German Foundation (2001–present).

Fellow, Royal Aeronautical Society (2004–present).

Society of Business Economists—Chairman (1995–2000), Deputy Chairman (2000–03), Council member (1991–2003), Fellow (2001–present).

Department of Trade and Industry Corporate Responsibility Skills Steering Group (2003–04).

Treasury Panel of Independent Forecasters (the "seven wise men"), 1992–93.

Office for National Statistics (formerly Central Statistics Office) Advisory Committee,1992–98.

Retail Prices Index Advisory Committee, 1989–90 and 1992–94.

Dahrendorf Commission on Wealth Creation and Social Cohesion, 1994–95.

National Association of Pension Funds (NAPF) Retirement Income Inquiry, 1995–96.

Hundred Group of Finance Directors, EMU Working Group, 1996–97.

PUBLICATIONS

Author of around 80 articles and reports on economic and business issues, as well as numerous other contributions to newspapers, magazines and broadcast media, including:

The United Kingdom's inflation performance, CBI, September 1990 (with D McWilliams), reprinted in P Foley (ed), *Why Inflation?*, Lloyds Bank Annual Review Vol 5, 1992.

"Exploding the myth of low UK profitability" *CBI Economic Situation Report*, January 1992 (with Duncan McKenzie).

"Is Europe losing its competitive edge?" *CBI Economic Situation Report*, February 1992.

"Can Europe compete post-1992?" *Economic Affairs*, September 1992.

"Inflation prospects outside the ERM" *CBI Economic Situation Report*, October 1992 (with James Walsh).

"Rebalancing the British economy" *The Business Economist,* Vol 24, No 1, Winter 1992.

"Manufacturing capacity and investment: Is there a constraint?" *Foundation for Manufacturing and Industry Research Paper*, August 1995 (with Rebecca Emerson).

"Are we entering a new golden age of economic growth?" *Economic Outlook*, November 1995 (translated into French and republished in *Problèmes economiques*, May 1996).

"Innovation, imitation and growth in a changing world economy" *Economic Outlook*, May 1996 (with Michael Chui, Paul Levine and Joe Pearlman).

"Europe's economic malaise: A problem of competitiveness?" *Business Strategy Review*, Summer 1996.

"The rise of Asia and structural change in the world economy." *Economic Outlook*, August 1996.

"The contribution of design to the UK economy" *Design Council Research Paper*, February 1997 (with James Clarke).

"The strength of the pound and UK manufacturing performance" *Foundation for Manufacturing and Industry Research Paper*, September 1997 (with Paul Robson).

"Monetary Union—a successful venture for Europe?" *Business Strategy Review*, Vol 8, No 4, pp 7–12, Winter 1997.

"Modelling and forecasting UK public finances", *Fiscal Studies*, Vol 19, No 1, February 1998 (with Stephen Hall and John O'Sullivan).

"Interpreting UK business surveys", *The Business Economist,* Vol 29, No 1, Spring 1998.

"Macroeconomic policy and UK economic performance" , Chapter 2 of *Britain's Economic Performance*, T Buxton, P Chapman and P Temple (eds), Routledge, 1998.

"Time to start planning for slower growth" IATA Airline Economic Results and Prospects, 1999–2000.

"Aviation and the environment: Can we achieve sustainable growth?" *Avitas Global Outlook for Air Transport,* 2001.

"Profiting from slower growth", *Airline Business,* July 2001.

"Airport capacity and the future of European hub networks" Air transport Research Society Conference, Seattle, July 2002.

"Airport slot auctions: desirable or feasible?" *Journal of Utilities Policy*, vol 11/1, February 2003.

"Sustainable growth of UK airport capacity" Chapter 12 of *Air Transport and Infrastructure: The Challenges Ahead*, Dieter Helm and Derek Holt (eds), OXERA Publications, 2003.

"Aviation and climate change—can emissions trading deliver a solution" Chapter 22 of *The Finance of Climate Change*, Kenny Tang (ed), Risk Books, 2005.

"Aviation growth and emissions in a carbon-constrained world", *The Business Economist*, Vol 36, No 3, Autumn 2005.

PERSONAL

Age 48, married with two children.

Trustee, Harvest Help (a development charity active in Zambia and Malawi).

Other interests include:

- playing piano, organ and guitar;
- music: listening, composing, performing and recording; and
- politics, history and current affairs.

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