Cambridge Economics

Cambridge Faculty of Economics
Alumni Newsletter

Welcome from Andrew Harvey

The fourth Alumni newsletter contains pieces on the Marshall and Stone lectures, new arrivals, conferences, distinguished alumni and visiting professors. We also have an article by Angus Deaton on his experiences in 1960s Cambridge and another set of recollections on Cambridge 30 years later, from Tavneet Suri. Last year's piece by Kenneth Arrow about his visit in the academic year, 1963-64, prompted some correspondence about the so-called `secret seminar'. In particular, Aubrey Silberston contacted me and we are delighted to include an article by him on the topic. Any other views on this or other activities in times past would be more than welcome!

Hamid Sabourian is stepping down from the Chairmanship of the Faculty, having served four years. He will shortly be escaping to Hong Kong, where he will be spending some of his well-earned sabbatical leave. Richard Smith, our Professor of Econometric Theory and Economic Statistics, will be taking over. We all wish him well in a job that has become increasingly challenging over recent years.

The big event this year was the conference held in June to mark the 75th Anniversary of the publication of Keynes' General Theory. The big event next year will be the Royal Economic Society Annual Conference, which will take place in March 2012. It has not been held in Cambridge for many years and we are delighted to have the opportunity to host it. The local organisers are Solomos Solomou and Pramila Krishnan, while Chryssi Giannitsarou is the Deputy Programme Chair. Keynote speakers will be Elhanan Helpman and Ariel Pakes of Harvard University and Nancy Stokey from Chicago. More details on

www.resconference.org.uk

There were conferences in June to mark Geoff Harcourt's 80th birthday and Hashem Pesaran's 65th. The annual garden party for staff and graduate students provided the opportunity to say farewell to William Peterson and Ken Coutts, both of whom have made a massive contribution to the running of the Faculty. They have been with us for a long time and will be sorely missed. (Having said that I have managed to persuade William to help with the Newsletter this coming year).

Finally a reminder that the Alumni Weekend will, as usual, take place in September, 23-25th to be precise. The Phillips machine will again be coaxed into action.

Profile: Clare Spottiswoode CBE The Swing of the Pendulum

Bank accounts, life insurance policies and gas bills. These seemingly mundane yet crucially important artefacts of contemporary living define much of Clare Spottiswoode's activities over the past twenty years. She is often seen as the consumers' feisty standard bearer in the face of powerful business interests. But this is an image she rejects, saying firmly that her public interest commitment and the role she plays are "to make sure the pendulum [of the market] does not swing too far in one direction or the other".

Continued overleaf

In a satisfyingly eponymous manner, as the co-education wave got underway in Cambridge, Clare was the first woman undergraduate to be admitted to Clare College (1972-75), where she read Mathematics for Part 1 of the Tripos before transferring, as she had planned, to Economics for Part 2. Both she and her soon-to-be husband, an architect, then won Mellon scholarships to Yale, where she gained an MPhil in Economics.

Until her current spell as a member of the government-appointed Independent Commission on Banking, Clare's best known role has been as Director-General of Ofgas (1993-1998), the former regulatory body for the natural gas industry in the UK. She came to this after time spent working in the economics section of the Treasury, which she followed by not only starting her own computer software business but starting her family as well.

As Head of Ofgas, which was later incorporated into a combined regulatory body for the gas and electricity markets as a whole (Ofgem), she was faced with building a framework for regulation and policy more or less from scratch during the early stages of privatisation in Britain. She needed her skills in managing the swing of the market pendulum from the first day. In sharp distinction to the Conservative government's later approach to the privatisation of electricity supply and to railways, British Gas Corporation, the former monolithic state-owned enterprise, had been transferred virtually unchanged to the private sector. Despite the regulator being charged with maintaining an even-handed approach to the industry and its customers, the screensaver on one of her senior colleagues' computer exclaimed boldly 'I hate British Gas'.

Following the lead set by Steven Littlechild, the architect of regulatory policy in Britain, a large part of Ofgas's responsibilities was to act as a surrogate for the competitive process in an industry whose inherited structure gave the dominant supplier considerable market power. The American approach of 'rate of return' regulation, by which the regulator set limits on profit margins as a proportion of revenues, was regarded as flawed, because suppliers could – and did – inflate their costs rather than reduce their prices in order to meet their efficiency targets. Instead, the British approach has been to drive efficiency up and costs down by holding regulated industries' price increases below the general rate of inflation (so-called RPI-X).

To do this effectively called on Clare and her small team to build an economic model for price regulation based on detailed knowledge of the natural gas sector, at the same time avoiding becoming overly dependent on the gas suppliers for information and advice. For this she needed all her skills in economics, which had been well sharpened during her spell at the Treasury. For most of her time there her brief was almost single-handed responsibility for 'World Economic Prospects, Europe and Developing Countries'. She reported to Denis Healey and then to Geoffrey Howe as Chancellors of the Exchequer and had her policy papers on Europe returned with annotations in Mrs Thatcher's own hand.

The next swing of the pendulum saw Clare, in a post approved by the Financial Services Authority, representing the interests of individuals with life insurance policies underwritten by Norwich Union, now Aviva. Revenues from premiums had over time exceeded payments against claims, so that the company had accumulated an 'inherited estate' of funds amounting to £6 billion. Policyholders feared that the company would retain most if not all of this for its own use. Working on their behalf, Clare negotiated a 70/30 distribution in favour of the policyholders in return for them waiving their rights to any further distributions, an outcome more than double what had been achieved in previous cases.

Last year, Clare became a member of the Independent Commission on Banking, charged with advising government on reforms to the banking system so as to promote financial stability and competition. The Commission published its interim report in April and, after consultation with customers and providers, is due to make its final recommendations in September. One of the Commission's proposals, which has already been received with approval by the Treasury, is that in diversified banking groups, the income flows and assets associated with retail banking should be ring-fenced from investment banking and other more risky activities. This is provoking robust reactions from the larger banking groups who are concerned about the implications of such a measure for their international competitiveness and for the increased cost of funds which, they say, will result from the need to hold more reserve capital.

But alongside their concern that the banking system as a whole should have sufficient reserves of capital to allow it to absorb any future financial shocks, Clare and her colleagues are placing equal weight on the consumers' interest. They are recommending that the Financial Conduct Authority, the regulator, should have a primary duty to promote effective competition. In this way, aspects such as transparency of product pricing and ease of account switching would be improved, and service innovation and new entry encouraged. And, against the background of the overall capital safeguards, it would be possible for individual banks to fail. Now that would mark a significant swing of the pendulum.

Reflecting on her time in Cambridge in the 1970s, Clare has found the grounding in Mathematics she had in Part 1 invaluable and regrets that moving from one Tripos to another now seems to have become rather more difficult. She recalls the dominance in Economics teaching of macroeconomic analysis, interpreted mainly from a left-wing point of view, although classes and tutorials with Mervyn King provided something of an antidote. Somewhat wryly, she wonders whether her interest in, and commitment to, efficient markets and consumer sovereignty is in spite of all this – or perhaps because of it. And as she compares the Economics Faculty then and now, she notes that yet another pendulum has clearly swung.

Tony Cockerill

My Cambridge in the 60s and 70s

I came to Cambridge in the 60s intending to be a mathematician and a rugby player ("Fitzwilliam College needs good second-row forwards, Mr. Deaton".) The first ambition only briefly outlived the second (idleness and waning interest), and I changed to economics in time to take Part II of the Tripos. I was fortunate to find a dedicated and inspiring supervisor in Ken Wigley of the DAE, and quickly learned that I had fallen on my feet; I loved the weekly round of reading, thinking, writing, and discussion and I realised, after years in the mathematical wilderness, that I could write and liked to. Lectures were less important to me, and were not much emphasized by the faculty. I remember struggling with David Champernowne's econometrics course whose text was Malinvaud—even in French more approachable than the lectures. Because my undergraduate exposure to economics had been brief and involuntary, I had not seriously considered that I might do well, nor thought about academic economics as a career. But after a miserable period in the Bank of England (very different then), I managed to persuade Jack Revell to bring me back to the DAE as a research assistant. Jack very soon accepted a chair in Wales, and I was left funded but uncommitted, and began learning economics seriously, albeit in a haphazard way, talking to people, reading, and trying my hand at things that interested me.

Revell's project was an offshoot of Richard Stone's growth project (of which Ken Wigley was also a member) and Dick quickly became not only my supporter and my friend, but in his work, his writings, and his life an exemplar of what I wanted to be. Dick led by example, not by teaching; I cannot remember him ever explaining anything to me, but I avidly read his books and papers, and I was often invited to share his and Giovanna's social life in Millington Road. I got to know his friends, including James and Margaret Meade, as well as many international visitors who came to dinner – I have clear memories of Galbraith, Kantorovich, Leontief, Modigliani, and Tinbergen. I learned how to do research from my colleagues in the DAE, who were unstintingly generous once they realised just how little I knew. Ken Wigley patiently explained to me what a t–value was, and Geoff Whittington, then also in the DAE, encouraged and listened to me; he had (and still has) a rare ability to show his admiration for a younger colleague's work, and to help improve it, even in the face of overwhelming evidence of its flaws. Another friend and mentor was Gwyn Aneuryn-Evans, terribly and incomprehensibly isolated from the faculty, who lived (and soon died) in a thick cloud of tobacco smoke in a small office inside the front door on the ground floor (now the reception area). He was an inexhaustible font of econometric and statistical knowledge, who worked with me in spite of my ignorance, and in exchange only for someone who recognised his existence. At that time, the faculty had little interest in, and some hostility to the use of econometrics and formal statistical methods, and that contributed to the isolation, not only of Gwyn Evans, who had been "brought in" to teach econometrics, but also of Dick Stone, who was also marginalised at that time. David Champernowne, who became my PhD advisor, was a truly great mathematical economist and statistician, who managed to live in both camps, but somehow never built a bridge between them.

And then there was the tearoom where, in my time, Nicky Kaldor and Joan Robinson were king and queen, each surrounded by a group of courtiers, but with comments thrown from group to group. ("An international pig standard, Nicky! What are you talking about?" "You are deaf, Joan, not a pig standard, a brick standard." The brick standard was one of Kaldor's (many) pet schemes; bricks are made under constant returns from readily and widely available materials, so price stability is guaranteed, if I remember the argument.) When Frank Hahn came back to Cambridge in 1972, there was a third court, and there were many other individuals I remember, including (not-yet-a-building) Austin Robinson ("You are a grandpa again, Austin" from across the room), Phyllis Deane, Mike Farrell, Charles Feinstein, Brian Reddaway, Bob Rowthorn, Ajit Singh, and David Champernowne, as well as a cohort of closer contemporaries, Tony Atkinson, Christopher Bliss, Michael Ellman, Oliver Hart, Mervyn

King, David Livesey, David Newbery, Roger Witcomb, and for periods, Joe Stiglitz and Eric Maskin. Bob Solow, Ken Arrow, Hyman Minsky, Roy Radner and Axel Leijonhufvud were memorable visitors. Although much of the discussion flew over my head, I picked up a lot, including just how much there was to know. One notable lesson was the breadth of economics; many different positions were held in that room, often well-thought through and eloquently defended in what could be a cacophonous and even bitter debate. Joan Robinson's constant challenges to neoclassical economics have stayed with me, not the detail but the notion that something was (and to me still is) deeply wrong. I learned that economics and politics could not and should not be separated. Nicky Kaldor's intelligence, wit, eloquence, and deep knowledge of economics shone brilliantly in a group where none of those qualities were in short supply. He was the best debater I have ever heard, but his dismissals and arguments could wound, no less so for their wittiness and the merriment that they provoked. The tea-room atmosphere did not favour those with a limited taste for this sort of thing, and James Meade and Richard Stone were rarely present. That the tea-room is now the Stone room marks a welcome recognition that would not have been forthcoming 35 years ago, although it is also hard to escape the irony.

Cambridge in the early 1970s was full of great economists, drawn from many schools, countries and traditions. It was an environment in which undergraduates, researchers, and faculty could learn and develop. If the old Keynesians were nominally in charge, almost all of the elements of modern economics were well-represented. In spite of (or perhaps because of) the chaos – little serious undergraduate teaching (Brian Reddaway used to say ironically that we academics needed to stick up for the 40-hour year), no graduate courses, haphazard supervision of PhD students and a bias against formal empirical work (wouldn't it have been great if all that scepticism had been devoted to improving econometrics, rather than dismissing it?) – it worked, certainly for me.

Angus Deaton

Ken Arrow, James Meade and the Secret Seminar

I remember well Ken Arrow's year in the Faculty in 1963-4. He was not the only distinguished visitor that year. Robert Solow was there also. They shared a room next to mine in the relatively new Faculty (now Austin Robinson) building. Their presence was a great joy to us, or to nearly all of us. Ken Arrow's main contact was of course Frank Hahn. Bob Solow however had a less happy relationship with Joan Robinson, who attacked him relentlessly at every opportunity.

Ken Arrow is quite right that James Meade's election was not universally popular, especially among the Keynesians, who had hoped that Nicky Kaldor or Joan Robinson would be elected. James's first contact with Cambridge, after his election in 1957, was certainly not a happy one. He received a phone call from Austin Robinson, Chairman of the Faculty Board, who told him that the second year theory lectures, traditionally given by the Professor of Political Economy, and thus previously by Dennis Robertson, were henceforth to be given by Joan. James long remembered this bitter welcome.

Ken Arrow is, however, wrong about the secret seminar. This took place weekly on Mondays during term in Richard Kahn's rooms in King's. It had been going for several years before James came to Cambridge. The supporters of Richard and Joan were there, together with several others – at different times, Nicky Kaldor, Richard Goodwin, Brian Reddaway, David Champernowne, Harry Johnson, Jan Graaf (quite outstanding), Robin Matthews, Luigi Pasinetti, Ruth Cohen, Michael Posner, Kenneth Berrill, myself and others. Piero Sraffa was invited but very rarely came. He confined himself to Sunday walks with Richard and Joan. Distinguished visitors to Cambridge were often invited, including, on at least one occasion, Paul Samuelson.

James Meade was invited to attend the secret seminar, and did so initially. He felt however that the atmosphere was not friendly to him, and after a time he withdrew, and started a lunch time seminar for all Faculty members. This was not a great success, and eventually James returned to the secret seminar, which could certainly be a very stimulating group. Pasinetti, in his recent book (Keynes and the Cambridge Keynesians, CUP 2007), has much of interest to say on its background and its atmosphere, together with his assessment of its achievements and failures.

As the 1960s progressed, however, the seminar began to lose its edge. Some of the principals were ageing, several issues that had preoccupied the group were losing their interest, and there were problems about which younger Faculty members to invite. Finally, around 1970, Kahn sent round a curt note. The meeting (he never called it a seminar) had served its purpose, he said, and would be wound up.

In time of course James became firmly established in the Faculty and was widely liked and admired, attracting such economists as Christopher Bliss, Geoff Heal and Tony Atkinson, to name only a few. He retired from his chair early, in 1967, saying that one reason for this early retirement was that he wanted to avoid the burden of examining. He stayed on as a fellow of Christ's, won the Nobel Prize in 1977, and remained a uniquely important figure in Cambridge economics.

Aubrey Silberston

Sir Richard Stone Annual Lecture

The third in the series of the Centre for Research in Microeconomics (CReMic) Sir Richard Stone Annual Lectures at the University of Cambridge was held on 11 November 2010.

The Lecture, entitled 'The Shape of the World: Measuring Global Development', was delivered by Angus Deaton of Princeton University (see article, page 3). The central issue addressed by Angus was entirely appropriate for the Annual Lecture being a topic very much of a concern to Richard Stone. His subject was that of measurement in the global context. Angus highlighted the intrinsic difficulties associated with attempts to construct measures of cost-of-living and income for different countries that are internationally comparable. In particular, different patterns of demand and relative prices across countries create an immediate problem for the construction of relevant international purchasing power parity based measures. As exemplified by the International Comparison Program for 1993 and 2005, an improved basis for their construction can induce dramatic changes in the poverty line with consequent policy implications. Ideally when attempting to construct internationally comparable price indices, goods should be comparable across countries and locally common and representative, objectives that are likely to be incompatible. Even if quality-matching is successful, the respective weighting of goods in the consumption basket may be quite inappropriate domestically. All is not lost, however. Angus emphasised that alternative approaches based on global surveys such as the Gallup World Poll could offer a solution that provides reliable and internationally comparable measures.

Richard Smith

Profile of a Pitt Professor: Gary D. Libecap

Water, land, forests and fisheries – the circumstances under which property rights to natural and environmental resources can be defined and enforced to address the problems of open access, and how or when markets might be developed as options for more effective resource management and allocation, are some of the most important and policy-relevant questions for our planet today. Gary D. Libecap, currently the 2010-2011 Pitt Professor of American History and Institutions at the University of Cambridge, and Professorial Fellow of St. Catharine's College, focuses on these vital questions. Gary examines the bargaining and transaction costs involved in collective action to establish property institutions and markets. His work encompasses economics and law, economic history, natural resource economics, and economic geography. His latest books reflect his varied interests: *Owens Valley Revisited: A Reassessment of the West's First Great Water Transfer*, (Stanford University Press, 2007) and *The Economics of Climate Change: Adaptations Past and Present*, co-edited with Richard Steckel (University of Chicago Press and NBER, 2011).

Gary is based in sunny Santa Barbara where he is the Distinguished Professor of Corporate Environmental Management, Bren School of Environmental Science and Management and Department of Economics, University of California, Santa Barbara. He is also a Research Associate at the National Bureau of Economic Research and a Sherm and Marge Telleen Research Fellow at the Hoover Institution, Stanford University.

During his stay at Cambridge, Gary started two new book projects, *A New View of Environmental Regulation: A Public Choice Economic History*, Resources for the Future and *Environmental Markets: A Property Rights Approach*, with Terry L Anderson, under contract with Cambridge University Press. He travelled to Chile in late March as part of a National Science Foundation sponsored team to begin analysis of the management of aquifers in the Atacama Desert – the driest part of the planet, but also the source of one-third of the world's copper, where mines use processes that are water -intensive.

Gary Libecap is a native of Montana, is married to Ann Libecap and has two children. While in the UK, he and his wife have explored the British Isles - often on foot - and in the US, he spends his free time fly fishing near his family cabin in Montana - in an environmentally sustainable way of course!

Profile: Giancarlo Corsetti

Policy-relevant research and teaching in macroeconomics – once the hallmark of Cambridge economics – is set to regain its international profile with the arrival in the Faculty last year of Professor Giancarlo Corsetti. Since the early-1990s, he has been at the forefront of the development of New Open Economy Macroeconomics (NOEM), whose Keynesian antecedents he readily acknowledges. As economists know well, both the strength and the weakness of Keynes' original framework of analysis is that it refers largely to a closed economy – one without a foreign sector. Mundell and Fleming incorporated a demand-side driven foreign sector into the model so that, with well-functioning goods and assets markets, and with interest rates exogenously determined by global forces, the economy could reach a new general equilibrium. This is the model of the small open economy, the equilibrium outcome being influenced by the behaviour of prices (assumed to be sticky) and by policy towards the exchange rate (usually assumed to be fixed-rate).

NOEM has been motivated by the need to go beyond the Mundell-Fleming (M-F) model in a globalising world in which the functioning of international asset markets and exchange rate movements clearly have profound effects on output, employment, prices and investment in all sizes of economy. In the NOEM models, general equilibrium is reached in markets that are characterised by imperfect competition and incomplete global integration, and by frictions that reduce the speed of adjustment to shocks, from either the demand or the supply side. An important feature of these models is the presence in equilibrium of output and employment gaps, implying welfare detriment as compared with the outcome under the assumption of competitive markets. There are clearly interesting and important challenges for monetary and fiscal policies, and for their international co-ordination, in improving and stabilising macroeconomic activity.

Giancarlo Corsetti, Stephen Morris and Kiyohiko Nishimura at the Keynes Conference

In the wake of the global financial crisis, Corsetti lists three key questions that need to be addressed in the next stage of NOEM research:

- Why did conventional models and policies for supplying liquidity to the banking system fail in the face of unprecedented uncertainty shocks that sharply increased risk premia and destabilised international financial markets?
- How do financial shocks impact on credit markets, giving rise to 'toxic' assets and resulting in problems of global illiquidity and solvency?
- How did relative asset prices – he cites residential real estate prices in particular – get so out of line as to seriously misallocate resources, becoming associated with persistent global savings and investment imbalances and generating an unsustainable boom?

Part of his current research is into the role of 'over-borrowing' in contributing to global imbalances. In the NOEM framework, excessive borrowing comes about because of the effect on wealth that occurs when a country's real exchange rate appreciates, for example because of a positive global demand shock that improves its terms of trade (the export-import price ratio). In the M-F model, the rise in the exchange rate stabilises the economy – export competitiveness is reduced, output is directed to the home market and demand-side overheating is contained.

In Corsetti's model, by contrast, there is a second-round event with feedback effects which is de-stabilising – precisely the opposite outcome from M-F. This is because the increase in demand against constrained production capacity will boost corporate profits and personal incomes – the wealth effect. As global financial markets are more or less impaired because they are not completely integrated, this increase in wealth cannot be invested in a fully-diversified global portfolio of financial assets; that is, there is limited risk-sharing opportunity.

The additional wealth will encourage an increase in current period consumption on the part of the country's residents. They can leverage this by (over-) borrowing from abroad. The capital inflow is then by definition the counterpart of the deficit on the current account of the balance of payments. The upward movement of the exchange rate has resulted in a misalignment of prices in both the goods and the assets markets. This leads to a non-optimal allocation of resources, giving the potential for an aggravated economic cycle that is associated with endemic global imbalances, culminating in turbulent 'boom and bust' adjustments. In these circumstances, conventional international coordination efforts by bodies such as the IMF will be of little use.

But, with an impish grin, Corsetti notes there may be a 'second best' outcome to all this. If limited risk-sharing because of impaired global financial markets restricts credit and results in sub-optimal capital asset investment, an 'irrational' financial bubble may help to overcome this under-investment – for a time at least.

Giancarlo Corsetti has come to Cambridge from the European University Institute in Florence, where he worked primarily on international monetary and fiscal transmission mechanisms and their effects on macroeconomic interdependence. Among several professional affiliations, he is a Fellow of the Centre for Economic Policy Research (CEPR) in the UK. His doctorate is from Yale. Together with his Faculty colleagues and the doctoral candidates in macroeconomics, he is looking forward to building a strong research group in Cambridge.

Tony Cockerill

Faculty Conferences

75th Anniversary of the General Theory

The Faculty, together with Cambridge Finance, held a conference in June to mark the 75th Anniversary of Keynes' General Theory. The aim was to provide a forum for a forward-looking discussion of a broad range of themes, from economic policy models to the theory of finance, reflecting the different dimensions of Keynes' contributions. The global crisis that has erupted in recent years means that many of the themes addressed by Keynes in the 1930s are still relevant today. The new Chair of Macroeconomics, Giancarlo Corsetti, played a prominent role in organising the event.

The conference featured many of the leading names in macroeconomics and finance, including Markus Brunnermeier (Princeton), Barry Eichengreen (Berkeley), John Geanakoplos (Yale), Charles Goodhart (LSE), Guido Lorenzoni (MIT), Albert Marcet (LSE), Stephen Morris (Princeton), Kiyohiko Nishimura (Bank of Japan), Jose Scheinkman (Princeton), Frank Smets (European Central Bank) and Michael Woodford (Columbia University). Hamid Sabourian and Hashem Pesaran of the Faculty of Economics also featured on the programme. The plenary lecture, 'Mr Keynes and the Moderns', was delivered by Paul Krugman of Princeton University. Various papers and videos are available on the conference website

www.econ.cam.ac.uk/keynes-conf-2011/papers.html

CIMF/IESEG Conference

On 1st and 2nd September 2011 The Centre for International Macroeconomics and Finance in the Faculty of Economics in conjunction with the IESEG-School of Management at Lille Catholic University organised a conference on issues related to recent developments in the links between macroeconomics and financial markets, with special emphasis on the yield curve. One of the aims of this two-day conference was to offer the opportunity to exchange views between experts about the implications of the recent financial crisis for research in macro-finance. The conference was sponsored by the European Central Bank. Keynote speakers were Paul Fisher from the Bank of England, Glenn Rudebusch from the Federal Reserve Bank of San Francisco, Frank Smets from the European Central Bank and Philip Turner from the Bank for International Settlements. A selection of papers will be published by Cambridge University as part of the series on Modern Macroeconomic Policy Making edited by Jagjit Chadha and Sean Holly.

Conference in Honour of M Hashem Pesaran

On 1st and 2nd July 2011 the Faculty held a Conference to mark the 65th birthday of Professor Hashem Pesaran and his contribution to the Faculty and Econometrics worldwide. Those who came were world leaders in the field of econometrics and included many of Hashem Pesaran's current and former students as well as numerous co-authors. Financial support was provided by the Bank of England, the European Central Bank, John Wiley and the Cambridge Endowment for Research in Finance.

Hashem Pesaran and Vanessa Smith

Staff Comings and Goings

We are pleased to welcome the following people to the Faculty from the Michaelmas Term 2011:

Oliver Linton (PhD Berkeley, 1991) from the London School of Economics will be Professor of Political Economy. His research interests are in nonparametric methods in Financial Econometrics.

Our new University Lecturers are **Jane Cooley Fruehwirth** (PhD Duke, 2006) from the University of Wisconsin-Madison; **Pontus Rendahl** (PhD European University Institute, 2007) from the University of California, Davis; **Björn Wallace** (PhD Stockholm School of Economics, 2011) from the Stockholm School of Economics; **Sorawoot Srisuma** (PhD LSE, 2010) from the London School of Economics.

Ken Coutts and **William Peterson** are retiring from the Faculty. We thank them for their outstanding contributions to the Faculty's teaching, administration and research. They will be sorely missed.

Christoph Vanberg, **Mauricio Prado** and **Jayant Ganguli** will be leaving the Faculty in Michaelmas Term.

The Marshall Lectures 2010–11: James J Heckman University of Chicago

This year's Marshall Lectures on 'The Economics and Psychology of Human Development and Inequality' were given by James Heckman, who has conducted numerous studies of the impact of education and training on earnings, health, labour supply and household production. His analyses measure differences between socio-economic groups in the economic benefits of education, including public and private costs.

The conventional measure of skill of a person is the number of years of full-time study undertaken ('schooling'). A standard problem in examining the link between schooling and earnings is unravelling the interaction between the amount of education and a person's abilities in producing earnings. While the amount of schooling can be directly observed, abilities often cannot. Furthermore, the contribution of abilities to a person's employment and earnings may be largely independent of schooling. Job performance and earnings may depend mainly on abilities, with amounts of schooling and associated formal qualifications such as degrees and diplomas doing little more than signalling to employers a person's suitability for employment, rather than significantly improving their stock of human capital.

Heckman's current work, on which the lectures were based, investigates the link between differences in abilities and inequalities in incomes and life opportunities, with particular reference to the socially disadvantaged. He also addressed the origin of abilities. At the outset he quotes Marshall: " I have devoted myself for the last twenty-five years to the problem of poverty, and very little of my work has been devoted to any inquiry which does not bear on that. "(*Report to the Royal Commission on the Aged Poor, 1893*). Heckman distinguishes between cognitive abilities and non-cognitive abilities, such as persistence and commitment. Both cognitive and non-cognitive abilities are in part innate and in part amenable to change through schooling, parenting and interventions through other social institutions. To better understand the nature and influence of non-cognitive abilities, he draws on personality theory and evidence from psychology. He develops a production function framework familiar to economists, but less so to psychologists, in which the input of scarce resources (education, training, parenting and other interventions) is optimised to achieve greater productivity and lower inequality.

Non-cognitive abilities are personality characteristics, or traits. Heckman uses the well known acronym OCEAN to summarise the dimensions of personality that are widely used by psychologists:

Openness
Conscientiousness
Extraversion
Agreeableness
Neuroticism

Of these, conscientiousness has been found to be the most predictive of a variety of life outcomes, including educational attainment, wages and health. A crucial issue that arises is whether personality traits and intelligence are innate – that is, fixed by a person's biology at birth – or whether they are malleable – that is, capable of being changed over the course of a lifetime by experience (social conditioning), which may include the intermediation of schooling, parenting and other influences. The ability (or inability) to change the traits that govern individual behaviour is at the heart of the well-known 'nature versus nurture' debate.

Heckman's analysis enquires into the conditions that give rise to the long-term economic and social disadvantages suffered by particular individuals and groups that are linked in turn to inequalities in skills and outcomes that may be propagated across generations. As is well known, an important element in social conditioning is family background, in particular the set of household characteristics that include marital status, parenting, employment and family size. Recent research shows how disadvantage literally gets under the skin and affects the biology of the poor, and the children of the poor, and their children's children. Heckman presented epigenetic evidence suggesting that factors influencing social conditioning may also have an enduring biological impact by affecting the expression of a person's genes. Gene expression is heritable through RNA (ribonucleic acid), not DNA. Characteristics associated with physical and social disadvantages are inherited and in turn affect gene expression and hence opportunities available to the next generation.

Interventions to enhance cognitive and non-cognitive skills such as those designed to relieve poverty, reduce discrimination in the workplace, and improve access to schooling can compensate *in part* for economic and social disadvantage, but the process can be a lengthy one. Interventions are most effective early in a person's life.

In this context, he stresses the importance of early child development, focusing on early childhood parenting and surrogate parenting programmes. For example, Heckman argues, as Marshall himself once did, that building 'character' is important and can be influenced by the role of one's mother. Cognitive skills and personality are both important causal determinants of children's achievement.

His analysis is built in part on the 'technology of skill formation' that shows the great malleability of young children's cognitive skills, but not the cognitive skills of adolescents. This explains the greater productivity of early investment compared to later investment in cognitive skills. Non-cognitive skills are more malleable at later ages. Interventions for disadvantaged adolescents are most successful if they target non-cognitive skills. Heckman shows that the highest rates of return to human capital for the disadvantaged are obtained when interventions are targeted to the early years rather than to on-the-job training much later in the life-cycle. The valuable lesson he draws is that over the life cycle, investing in the early years of child development is of fundamental importance to reducing inequality in society, and, at the same time, to boosting productivity. Heckman formalises his analysis in terms of an augmented production function in which productivity (the output term) is determined *inter alia* by investment in both cognitive and non-cognitive abilities. Drawing on psychological evidence, these two factors interact in the production function, indicating that interventions to improve productivity and hence to raise the relative earning capacity of the disadvantaged are most effective if done at an early stage in life. Compensating for impaired cognitive abilities becomes more difficult with age. This is less true for compensating for impaired non-cognitive skills.

In his model, parents are assumed to invest in enhancing their children's skills and life opportunities for altruistic reasons. The optimal social rate of investment, and its timing, will be impaired if financial market failures make it difficult to borrow against the (uncertain) expected future income of the child to support his education and training. This is obviously a major factor in prolonging disadvantage.

In concluding a fascinating and accessible set of Marshall Lectures, Heckman eloquently reinforces his findings that inequality in skills contributes to multiple inequalities in society, and not only those that are measured by income differences. Family life plays an important part in shaping skills. Because of this, his formal dynamic models to explain skill formation, and hence productivity and earnings, have a strong psychological and biological foundation.

James Heckman is a Nobel Laureate and the Henry Schultz Distinguished Service Professor of Economics at the University of Chicago. He did his doctoral work at Princeton University and taught first at Columbia University before moving to Chicago. His research led to work on the statistics of selection bias, in which he created the celebrated 'Heckman correction for self-selection', which is a cornerstone of empirical research in economics today. His contributions to the statistical analysis of economic data, identification and heterogeneity are very much at the heart of contemporary research in applied econometrics and social policy evaluation.

Talking after the lectures, Heckman outlined two policy prescriptions that resonate with the current education and training debate in Britain. One is about the value of formal vocational training. Earlier work of Heckman and others has found that at low levels of skill the rate of return on investment in training as it is currently configured can be negative. It is better, therefore, for young people to make the most of their endowment of abilities by getting a job, their development being encouraged by workplace-based incentives and practical workplace skills. Workplace-based training fosters non-cognitive skills through learning-by-doing and mentoring. But such efforts require there to be an active and accessible labour market in which employers hire on the basis of evidence of abilities rather than of prior formal qualifications.

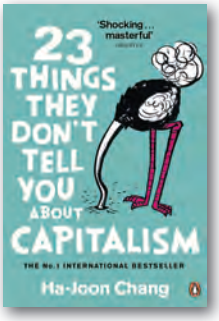
The other prescription concerns the challenge of raising college attainment levels among disadvantaged groups. In the US, it is a persistent feature that, in spite of free schooling for the disadvantaged, attainment levels vary across socio-economic groups and disadvantage persists. The main reason for this, in Heckman's view, is their lower abilities, which are a consequence, in part, of their adverse early environments. The abilities that matter can be shaped. Supplementary parenting can reduce deficits in abilities.

While Heckman is reluctant to draw cross-country comparisons, the signals for educational policy in Britain are clear.

Tony Cockerill and Sriya Iyer

New Books

Professor Sheilagh Ogilvie's latest book, *Institutions and European Trade: Merchant Guilds, 1000-1800* was recently published by Cambridge University Press. A magisterial new history of commercial institutions, this book shows how the study of merchant guilds can help us understand which types of institution made trade grow, why institutions exist, and how corporate privileges affect economic efficiency and human well-being.



Ha-Joon Chang's new book, *23 Things They Don't Tell You About Capitalism*, was recently published by Allen Lane (Penguin). The book questions some of the most widely accepted policy propositions and empirical 'facts' in economics in a serious but entertaining way. It has been extensively reviewed in the media, and has so far been translated into six languages with thirteen more to follow.

International Prizes

Two of our Faculty have won prestigious international awards. **Professor Sir Partha Dasgupta** has been awarded the Zayed International Prize for Scientific and Technological Achievements in Environment for his contributions to the scientific search and eco-friendly technologies that push environmental efforts towards success.

The Association for Evolutionary Economics (AFEE) has honoured **Geoff Harcourt** with its highest academic honour – the Veblen-Commons Award. This award is presented annually to a scholar, or in a few instances, scholars, who in the view of AFEE have substantially advanced our understanding of how economies actually work, in addition to insights that advance economic theory.

Obituaries

Raymond Burton (1917–2011)

Raymond Burton, who passed away at the age of 93 earlier this year, continued a family tradition of generosity towards the Economics Faculty. A substantial endowment he made in 2000 has provided precious support for the Faculty's research students that will continue in perpetuity. In his later life, Raymond was always appreciative of the letters he received regularly from our students who benefited from the Raymond Burton Fund. They would tell him of their very varied international backgrounds, their economic research work, and their plans for the future. He himself had come up to Trinity College in the 1930s, with his twin brother, to study law. But he switched to economics and then went on to Harvard to prepare himself better for working in the family's massively successful tailoring firm of Montague Burton. After war service as an artilleryman in India, he returned to run Burton's newly acquired women's fashion chain. He went on to be Deputy Chair of what was to become the Burton Group (later Arcadia) and to engage with the younger fashion market by setting up Topshop. A devoted Yorkshireman, Raymond was a philanthropist for many local cultural and environmental causes, as well as York University and the Jewish Museum.

Raymond once told me how conscious his family were of the very different background of their father, Meshe Osinsky. He had arrived in Hull in 1900 at the age of 15, a refugee from the horrors of pogroms in Kovno, in what was later to become Lithuania. After starting as a door-to-door bootlace salesman, by 19 he had established a small shop in Chesterfield selling mainly shirts and caps. By his mid 20s he had changed his name, established a factory in Leeds, and was building a chain of retail outlets across the North and Midlands. His success lay in pioneering mass production of made-to-measure suits affordable by working men. He was the Henry Ford of British men's tailoring. Well placed to respond to wartime demand for military uniforms and demob suits, by the 1930s there were over 500 high street outlets and a dozen factories, of which the Leeds one was said to have the largest number of employees, around 10,000, on one site in Europe. Montague Burton was a far-sighted employer, pioneering innovative personnel management and worker welfare. Never forgetting the circumstances of his childhood, he was also a leading supporter of the League of Nations and, after it, the United Nations Association. When knighted in 1931, the citation was for "furthering industrial relations and world peace".

An autodidact himself, he was a passionate believer in the importance of education in promoting peace. Starting in 1929, he endowed several chairs and lectureships of international relations at British universities. He also endowed chairs of industrial relations in Cardiff and Leeds and, in 1930, in the Cambridge Faculty of Economics and Politics. The story was that, when he approached Cambridge with the proposal to donate a professorship in 'industrial peace', Keynes objected, reportedly on the grounds that Marxist colleagues like Maurice Dobb might thereby be excluded. Characteristically however, Keynes suggested the solution, which was that Beatrice Webb's term 'industrial relations' should be used. This was adopted, and the phrase became commonplace.

Shortly to retire as the fourth holder of the Montague Burton Professorship of Industrial Relations, perhaps I can end on a personal note. As a child I could glimpse the distant mass of Burton's Hudson Road factory from the back bedroom of the house in Leeds that I grew up in. Raymond's older brother Stanley was a generous supporter of the University of Leeds, where my father taught for over thirty years. After I took up the Cambridge job in 1985, I was fortunate to benefit from the interest and kindness of both these admirably modest businessmen. I may not be quite 'the full Monty', but I am very conscious of how much their family has contributed. The glory days of British clothing manufacture are long gone and the capital endowment is considerably diminished. But, in replacing me, the Economics Faculty will be proud to honour Sir Montague's intention that the Professorship should improve employment relations through a better understanding of the economics of labour.

William Brown

Brian M Deakin (1922–2010)

Brian Deakin, who died in December last year at the age of 88, was until his retirement in 1989 a Senior Research Officer in the former Department of Applied Economics, a research institute within the Faculty of Economics. He became Assistant Director of the DAE and was a Fellow of Magdalene College and Director of Studies in Economics.

Brian came to the DAE in 1964 from the Economist Intelligence Unit where he had been Head of the Industrial Research Department and then Research Director. Before this and after war service, he read PPE at Oxford and then worked as an economist for an international insurance company. The unifying theme of his research in Cambridge was estimation of the production function and the impact of market failure on productivity, broadly interpreted.

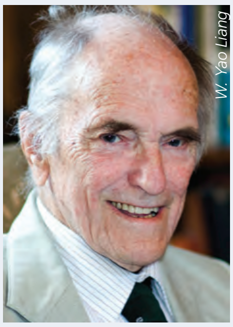
Productivity in Transport (1969) is an analysis of the production function in six British transport sectors: railways, road passenger transport, road haulage contracting, sea transport, port and inland water transport, and air transport. The work is path-breaking, chiefly because of the difficulties in measuring the output of transport services. The research finds conclusively that technical change is the single most important force in explaining productivity growth in the transport industries. This was followed by a large-scale investigation into the economic practices and effects of freight shipping cartels - *Shipping Conferences* (1973). The focus of the study is on how the conferences developed and how they operated, particularly in setting prices. Its outstanding features are the richness of detail in a hitherto largely opaque area of business activity, the careful specification of the problem to be studied, and the painstaking process of analysis. The findings are that, while co-ordination among the cartel members gave operating efficiencies, there were significant welfare losses from price discrimination.

After this, Brian's research interest moved to the functioning of the UK labour market. His two major studies published in this field are into short-term measures to support employment in the face of severe recession (*Effects of the Temporary Employment Subsidy*, 1982) and, later, into the effectiveness of the Youth Training Scheme (YTS), an initiative intended to improve vocational skills and job opportunities among young people (*The Youth Labour Market in Britain*, 1996). The setting for both studies was the steady rise in unemployment in the UK during the second half of the 1970s as the long period of post-war full employment came to an end.

The Temporary Employment Subsidy scheme did support jobs and output at a time of recession and was good value for money overall when account was taken of savings on welfare benefits and increased taxation receipts. But YTS was associated with significant amounts of 'deadweight' spending on training that would have taken place in any case, and with courses that were very low in the quality of their content, delivery and assessment.

Tony Cockerill

Iain Macpherson (1924–2011)



Born in 1924, William John (Iain) Macpherson was brought up and educated in Scotland and then served as a Captain in the Queen's Own Cameron Highlanders and 6th Gurkha Rifles. Like many men of his generation, his studies were disrupted by the war but he graduated with an MA from Aberdeen in 1950 and went from there to Peterhouse, graduating with a PhD in 1955. He married Aileen in 1956 and they had two children – Donald and Catriona, and two grandchildren – James and Claire. He was appointed to a University Lectureship in Economics and admitted into the Caius Fellowship in 1959. He published *The Economic Development of Japan c. 1868-1941* in 1987, described by reviewers as a "finely crafted text" that "opens windows onto a fascinating and important subject".

In his teaching Dr Macpherson filled the room with his personality and his students loved him for it, in later years bestowing upon him the ultimate student accolade – his own Facebook group: The Macpherson Appreciation Society "for all those who love Dr W. J. Macpherson … expert in Indian and Japanese Development, a fine economic history supervisor and repeat offender of copyright infringement laws". He was an unforgettable lecturer and supervisor; his wit, energy and humanity brought economic history to life. Dr Victoria Bateman, now a fellow at Caius, recalls that supervisions on interwar unemployment were coloured by stories of the Jarrow March and General Strike. His wartime experiences guided gripping accounts of Indian famine. He drew evocative pictures of Keynes, looking from his King's College study and asking himself if the grinding poverty and unemployment that he saw could really be the product of individual choice. Academic life and work were lifted by Iain Macpherson's spark, enthusiasm and incisive Scottish humour. Geoff Harcourt, a contemporary from the Faculty, describes him as an old-fashioned liberal, astute, well-respected, very kind and with a dry wit matched by enormous integrity. He lightened the mood of many lengthy, sometimes fractious, fellowship meetings with a pithy joke. He had an uncanny ability to remember a diverse and large number of people and he did not align himself with college or faculty, instead giving his sage advice generously and equitably. He will be deeply missed but memories of his wisdom, humanity and collegiality will live on through the very many people whom he inspired and supported.

Michelle Baddeley

My Graduate Experience at Cambridge and Beyond

I am a development economist, with a focus on microeconomic issues in Sub-Saharan Africa. I read Economics at the University of Cambridge and Trinity College in the late 1990's, matriculating in 1996. After Cambridge, I went on to do an MA in International Development Economics at Yale University, followed by my PhD in Economics at Yale. My time in the PhD program at Yale really cemented that I wanted to be an academic and that is how I ended up as an Assistant Professor at MIT at their Sloan School of Management.

1996 was the year James Mirrlees won the Nobel Prize, which in fact was announced right around my matriculation dinner. Shortly after, Amartya Sen joined Trinity College as its Master, taught in the Tripos and was also awarded the Nobel Prize in Economics. Cambridge was an incredibly vibrant place to be studying economics, so I consider myself extremely lucky in that dimension. Personally, I met some of my best friends while there. Professionally, thanks to some amazing supervisors, I was pushed very hard intellectually and really learned to appreciate the power of economics and the power of economic theory in understanding the world. Given my background (I was born and raised in Nairobi), I think I was always interested in development, but aside from taking Partha Dasgupta's regular class, I never took the development options. I always knew as an undergraduate that I would go on to further study in economics and so thought the math options would serve me better in the longer run. That turned out to be completely true! But this inherent interest in development is what took me to the program at Yale... and then there was no turning back.

Let me speak a little about my work. I am an applied microeconomist at a time when the field is split amongst folks who do structural work and those who do reduced form work (and experiments), though that is beginning to change, of course. I have always felt that both approaches have important contributions to make to the field of development. My dissertation work would be described by many as structural while some of the work I am doing now is experimental. I feel like my work blends a lot of aspects of applied economics and I like being in that part of the field. I even have an applied theory paper! My research focuses on the use of technologies in various Sub-Saharan economies (my home of Kenya as well as Rwanda and Sierra Leone, the last two being post conflict societies). Most of my work tries to understand the successes and failures (and why) of technology adoption across various sectors: agricultural and financial. On the agriculture side, let me quickly mention two very exciting experiments that are currently in the field: the first is with coffee farmers in Rwanda studying the diffusion of the technology through social networks; the second is with staple rice farmers in Sierra Leone studying whether short term subsidies can encourage experimentation with new technologies and hence broader adoption. On the finance side, I have been studying the rapid and massive adoption of mobile money in Kenya and the large impacts this has had on the ability of households to smooth risk across space and within their social networks. This work on mobile money is not experimental but has involved designing and collecting many rounds of panel data in the field.

These are, of course, only a few things I have been working on - the most exciting ones - with hopefully, many more to come. I do feel like my time at Trinity and the Faculty of Economics was really responsible for how I think about economics, for building in me an appreciation of the importance of economic theory in understanding decisions, even in Sub-Saharan Africa. As you can probably tell, I absolutely love what I do. Much as I think I always knew I would go on to further study, I would never have imagined I would end up being an academic. If you had told me this while I was an undergraduate, I would have laughed hysterically, nothing could have seemed farther from the truth then. Now, I cannot imagine doing anything else with my life!

Tavneet Suri

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