

Finance

**AARP**

THE LITTLE BOOK  
*of*


**Economics**



**Greg Ip**

Digital Edition

FOREWORD BY MOHAMED EL-ERIAN  
CEO of PIMCO

THE LITTLE BOOK  
  
of  
ECONOMICS

*How the Economy Works  
in the Real World*



GREG IP

# MAKING YOUR MONEY WORK FOR YOU

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Additional Praise for  
*The Little Book of Economics*

“Greg Ip has the rare talent of making even the toughest topics easy to understand. In *The Little of Book of Economics*, he tells you what you need to know with superb clarity and memorable examples. I recommend this book to anyone who wants a clear explanation of how the forces of economics shape the world.”

—Michael J. Mauboussin, Chief Investment Strategist,  
Legg Mason Capital Management;  
Author of *Think Twice*

“The book is an excellent introduction to basic economic concepts and ideas explained in clear and thoughtful ways. A must read in economic literacy.”

—Nouriel Roubini, Professor of Economics,  
New York University; Co-founder and  
Chairman of Roubini Global Economics



THE LITTLE BOOK  
  
OF  
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THE LITTLE BOOK  
  
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ECONOMICS

*How the Economy Works in  
the Real World*

GREG IP

FOREWORD BY  
MOHAMED EL-ERIAN



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*To Natalie and Daniel*



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# Foreword



IT WAS AS A 15-year-old at school in England that I was formally introduced to the subject of economics. And I immediately fell in love with it. Here was a subject that provided me with valuable tools to think about a range of topics, to formulate answers from first principles, and to pose additional interesting questions whose answers I was also eager to know.

My love affair with economics has blossomed and continues today. And I feel privileged as economics seems to be even more relevant and topical as time passes. It facilitates our understanding of the well-being of societies; it explains many of the daily interactions between individuals, companies, and governments; and it offers a guide

to understanding the political and social trends that are shaping our world.

Simply put, economics is the key to understanding and analyzing both what is likely to happen and what should happen. Yet, as a topic, it is also horribly misunderstood and often overlooked.

Many believe that economics is too complex, too mathematical, and too arcane for them. Others question the benefits of investing their time and effort to get to know a subject that is the source of endless jokes, including presidential ones. (For example, President Harry S. Truman is said to have famously asked for a one handed economist, noting that “all my economists say, on the one hand and on the other.”)

Why am I telling you all this? Because I have come across a book that makes economics brilliantly accessible and, also, lots of fun (yes, economics can be fun!).

Forget about those heavy textbooks. Instead, read Greg Ip’s book. It is well written and highly engaging. Moreover, this book could not have been written by a more qualified person; and it could not come at a better time.

Greg first came to my attention, and that of my professional colleagues, through his reporting and analyses at the *Wall Street Journal*. We would all eagerly look forward to his columns for insights into economic developments and the outlook for policy.

Greg's work at the *Wall Street Journal*, and now *The Economist*, is based on careful, in-depth research. It uses a robust set of analytical frameworks and reflects access to top policymakers and thinkers. And it is always relevant and timely. His columns have been the catalyst for interesting discussions at PIMCO's Investment Committee as we all tried to better understand developments and detail our shared outlook for the economy and markets.

In his elegant book, Greg takes us on an informative and stimulating economic journey. We make multiple stops as we get exposed to basic topics (such as the drivers of economic growth and welfare) and delicate balances (such as the tug of war between inflation and deflation). We learn about how government actions impact the economy—be it through the familiar channel of public finances and interest rates, or the more complex web of regulations and prudential supervision.

The book offers us a wonderful mix of perspectives. We are treated to broad overview analyses that are reminiscent of looking at the landscape from a plane flying at 30,000 feet in a cloudless sky. We are also exposed to careful micro discussions, finding ourselves, as Greg puts it, “inside the sausage factory.”

As you would expect, Greg's book also includes delightful discussions of one of his favorite topics—namely, the design and operation of monetary policy. We get a

rare view into the mysterious world of the U.S. Federal Reserve where technocratic competence has to be combined with political savvy and judgment calls about the inherently uncertain balance of future risks and opportunities.

The book also provides us with numerous examples of how all this analysis applies to companies and people that are familiar to most of us. Indeed, the frequent real world snippets and text boxes are a great reminder of how economics plays out every day in the world around us.

Greg did more than produce an elegant book. He did so at a great time.

The global economy today is in a multiyear process of resetting after the 2008–2009 global financial crisis. This historical phenomenon is full of unfamiliar dynamics. It constantly questions “conventional wisdom” and it proceeds in a highly uneven and bumpy fashion.

No wonder economics features so prominently on the front pages of daily newspapers around the world. In industrial countries, there are frequent reports on the unusual level and composition of unemployment, the explosion in public debt and deficits, the volatility of exchange rates, the prospect for higher taxation, and the still fragile state of the banking system. In major emerging economies, you will find numerous articles on the sustainability of their development breakout phases, on controlling

inflation and asset bubbles, and on resisting protectionist pressures from abroad.

Greg assembles and analyzes these pressing themes in a work that is as much a guidebook for our times as an explainer of economics. His brilliant book will help you identify and understand the economic forces that are dramatically reshaping the globe today, and having a major impact on our social and political outlook. It will expose you to the key issues in an engaging and enjoyable fashion. Even seemingly old hands like me will end up learning and re-learning critical aspects of this fascinating and relevant topic.

I hope that you enjoy this book as much as I did. It's a must-read for all those wishing to understand what today's world holds in store for them, for their children, and for their grandchildren.

—Mohamed El-Erian



# Introduction



IN THE SUMMER of 2009 the cover of *The Economist* portrayed an economics textbook melting into a puddle. “Of all the economic bubbles that have been pricked, few have burst more spectacularly than the reputation of economics itself,” it said.

That same summer, Paul Krugman, the Nobel prize-winning economist, surveyed the wreckage of the global economy and declared that most macroeconomics—the study of the broad economy—of the last 30 years was “spectacularly useless at best, and positively harmful at worst.”

For those of us whose job is to watch the economy, the last few years have been a trial by fire. Just a few years

ago, we supposedly had it all figured out. Steady growth and low inflation were here to stay and nasty recessions were a thing of the past. Like the bathroom plumbing, the broad economy was something people didn't think about because it worked fine. Who could blame the folks who watch over our economy, like central bankers, for being a bit smug?

We've now seen the worst crisis and the deepest recession since the 1930s, and unprecedented government firepower unleashed in response. It's been a Galapagos Islands of economic exotica: central banks out of interest-rate bullets reaching for their monetary bayonets, debt crises stalking rich and poor countries, fear of inflation side by side with fear of deflation. The smiles have been wiped off the experts' faces. The public's indifference to the economy has been replaced by rapt attention and, let's face it, a lot of fear.

With such a turbulent and uneasy global economy, clear explanations of what's going on are vital. Yet, most people find economics shrouded in jargon and dry numbers. *The Little Book of Economics* provides the solution.

Telling the story of our economy has been my stock in trade for 20 years now. At newspapers in Canada, then at the *Wall Street Journal*, and now *The Economist*, I've followed markets, talked to workers, visited businesses, and got to know central bankers. Then I've explained to readers



and listeners in plain, simple terms, what's going on in the economy, why, and how it affects them.

I was introduced to economics as a child. My mother, a practicing economist, now retired, delighted in trying to apply what she knew about the dismal science to her four children's upbringing. We must have been the only kids in town whose weekly allowance was indexed to inflation. I took economics in college, though not intending to write about it; I just wanted a fallback in case journalism didn't work out. Right out of college, I joined a metropolitan daily newspaper that put me on the night shift covering local politics, crime, and the like, a lot of which never made it into the paper. The business section, however, had lots of space in it and regular hours, so I got a transfer. Soon, I was writing about the economy and the markets, and loving it.

In the process, I discovered a chasm between the economics taught in college and the real world. Textbooks go on about the money supply but it turns out central banks ignore it. Simple questions like "how big is the national debt?" have complicated answers. I learned about fiscal policy but not about debt crises.

So I wrote this book with those lessons in mind. This is not a book for PhD economists, but for the citizen and investor on Main Street. I've explained the essential concepts with real life examples and analogies, and shown

the forces behind the news and events of the last two years. I've left out the dense and unappealing jargon. If only the world would do the same! But of course, in the world of economics you will run into jargon, so I've prepared you by putting a section called "Into the Weeds" in most chapters. By the phrase "into the weeds," I mean the internal guts of the economy: the data, the people, the lingo. Don't be frightened by these sections; they are perfect primers for anyone who wants to follow the markets and the economy in detail. Finally, I've boiled down everything in each chapter into "The Bottom Line." If you read nothing else in the chapter, read this: it will tell you the essentials in a few short sentences.

There's much more to economics than what I could put into *The Little Book of Economics* so please visit my web site, [www.gregip.com](http://www.gregip.com), where you'll find a more complete list of sources used in this book, suggestions for further reading, more of my own articles, and answers to questions about things this book discusses.

We've been through a lot of economic trauma in the last few years, but economics still offers essential tools for understanding it. This book will put those tools in your hands.

## Chapter One



# The Secrets of Success



*How People, Capital, and Ideas  
Make Countries Rich*

POP QUIZ: The year is 1990. Which of the following countries has the brighter future?

The first country leads all major economies in growth. Its companies have taken commanding market shares in electronics, cars, and steel, and are set to dominate banking. Its government and business leaders are paragons of long-term strategic thinking. Budget and trade surpluses have left the country rich with cash.

The second country is on the brink of recession, its companies are deeply in debt or being acquired. Its managers are obsessed with short-term profits while its politicians seem incapable of mustering a coherent industrial strategy.

You've probably figured out that the first country is Japan and the second is the United States. And if the evidence before you persuaded you to put your money on Japan, you would have been in great company. "Japan has created a kind of automatic wealth machine, perhaps the first since King Midas," Clyde Prestowitz, a prominent pundit, wrote in 1989, while the United States was a "colony-in-the-making." Kenneth Curtis, one of the foremost experts on Japan's economy, predicted that in a decade's time it would approach the U.S. economy's size in dollar terms. Investors were just as bullish; at the start of the decade Japan's stock market was worth 50 percent more than that of the United States.

Persuasive though it was, the bullish case for Japan, as fate would have it, turned out completely wrong. The next decade turned expectations upside down. Japan's economic growth screeched to a halt, averaging just 1 percent from 1991 to 2000. Meanwhile, the United States shook off its early 1990s lethargy and its economy was