The Little Book of Economics: How the Economy Works in the Real World

by Greg Ip (2010)

A Review by Olivia Husbands*

The work of Greg Ip in “The Little Book of Economics” has been praised and applauded by many since its 2010 publication. USA Today deemed it “…a must read in economic literacy” whereas magazines such as The Economist noted it as “A guide to understanding the dismal science”. Ip, an award winning journalist, skillfully avoids the academic jargon, complex equations and charts that usually find themselves in the economics literature. Instead, he presents fifteen chapters of anecdotes and analogies, thereby providing a clear understanding of how economic theories relate to real-world events. Although it is primarily focused on the United States (US), “The Little Book of Economics” gives meaningful explanations on the basic operations of an economy.

In the opening chapter, Ip reveals “The Secret of Success”, that is, what drives economic growth and productivity. He explains that economic growth depends on the productive potential of the economy, which in turn relies on three main elements: population, capital, and ideas. Every economy needs workers in order to expand, and the productivity of workers is based on capital but more importantly, ideas. Ip believes that the reason for the success in the US is that it is “idea rich”, and within the long run, investing in ideas is what ensures the economic well-being of a country.

Ip then proceeds to discuss growth cycles (Chapter 2), the difficulty in forecasting brought about by cyclicality (Chapter 3), and how fluctuations in growth can lead to volatility in the labour market (Chapter 4). He contends that in the long-run, the economy grows, but in the short-run, it is characterized by alternating periods of expansions and recessions brought about by disparities between future expectations and reality. With alternating periods of booms and busts, forecasting the economy becomes difficult. Cyclicality also leads to labour pains, since in the short-run jobs fluctuate with the economic cycle.

In “Fire and Ice”, Ip speaks to the issues of high inflation and deflation in detail. In a nutshell, he opines that “high inflation is destabilizing and corrosive; deflation can be destructive. The best inflation is not too high or too low; from 1 percent to 3 percent seems about right” (p.83). Given the consequences of inflation and deflation, the next logical question becomes, what causes either? Generally, there are two competing schools of thought on inflation: Monetarism, which blames price increases on too much money chasing too few goods; and output gaps (that is, disequilibrium between the demand and supply of goods and services). An interesting point made by Ip (p.82) is that “gold and

* Olivia Husbands is a Statistical Officer in the Research and Economic Analysis Department.
commodity prices are much better measures of the fear of inflation than predictors of inflation", partly because so many other things affect them. Of course, these dictums may be more applicable to the US, rather than the Caribbean, particularly when consideration is given to the high marginal propensity to import to the latter region, which means that the largest component of inflation is imported, rather than domestically driven.

Chapters 6 and 7 concentrate on globalization – which is defined by Ip as the increased flow of goods, services, people, ideas and capital across borders. Economies are becoming more interdependent, evident from the drastic rise in global trade since the 1950s. The ability to buy from and sell to the entire world has enabled most countries to achieve exceptional levels of wealth. Though there have been falling trade barriers, free trade is still politically unpopular, and every economy routinely engages in protectionist measures. There has also been a tremendous expansion in the movement of capital across borders. Ip notes that “unlike imports and exports markets, several financial and capital markets are not severely governed by shared rules of the road...capital markets rapidly transmits one country's problems to another” (p 105)

The focus of chapters 8 to 12 is on intervention, specifically, the role of the central bank and government in the economy. The central bank has two powerful roles. First, it is the lender of last resort. This implies that if a bank runs out of money to repay its creditors, it can borrow from the central bank. The second is carrying out monetary policy, which usually involves manipulating interest rates, reserve requirements or the money supply. The government, on the other hand, “giveth and taketh away” (p 175) It spends to offer services the private sector can’t or won’t provide at an acceptable price. It also supplies money to the unlucky elderly and sick people of the society. However, its expenditures are largely funded from the taxes it collects. Contrary to popular belief, neither politicians nor the central bank controls the economy, but this is not due to a lack of trying. Policy makers have a myriad of tools (such changes in taxes, government expenditure, interest rates etc) for shifting the behavior of the economy, however, they can never keep the country at their preferred pace for extensive periods of time.

Chapter 13 looks at debt traps and calamities, and how government borrowing can save or destroy the economy. In several cases, the expenditures of a government exceed its revenues, and so the government has to borrow to fund its deficit. Ip contends that debt is not bad. For instance, there is nothing wrong with a government borrowing to finance investment, which pays off in the future. But, one must bear in mind that debt does its damages gradually, slowly suffocating private investment and nibbling away at the country’s foundations. The breaking point comes, when debt is so high, that investors suspect that the government will default and they in turn suddenly stop investing in Government activities. This leads to a debt crisis.

Following on from chapter 13, Ip zeroes in on the “love-hate relationship” individuals have with financiers. A popular view, according to Ip, is that financiers “don’t make anything, they just get rich rearranging the fruits of others’ labor” (p 212). But, the financial system is important to growth as it is the main conduit through which savers are matched with those who need capital.
In the final chapter, "A species of Neuralgia" Ip gets down to the heart of the matter: why do financial and economic crisis transpire? He explains that each and every crisis is unique but they all share similar characteristics such as when or how the crisis will occur.

Economics is often thought of as dry, boring and difficult to comprehend. But, Ip shows that it can be applied to the conventional business, which many would find interesting and useful. Ip clear and concise writing, coupled with his ability to engage the reader, makes the Little Book of Economics an excellent read for the inquisitive "laymen", who wants a general understanding of how the economy works, while avoiding all the jargon usually associated with economic texts. It naturally follows that experienced economists, or even those who have studied economics at an undergraduate level, would not be inspired by this text. Also, the book is written largely in the context of the US, and so, it is not fully applicable to microstates, such as those of the Caribbean. Notwithstanding this, it is an excellent read for non-economists.