FREE LUNCH

EASILY DIGESTIBLE ECONOMICS

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Appetizer

This is a book about economics. I used to say that as a half-apology, knowing that economics had to work quite hard to compete with other subjects, not to mention most other things in the bookshop. Things are different now, thanks to the global financial crisis that began in the summer of 2007 and was far from over in the run-up to its fifth anniversary as this was being written. The crisis came like a whirlwind, damaging everything in its wake but also shaking up perceptions, including those about economics. Everybody has a view on the crisis, and most people have something to be angry about, about bankers, regulators, politicians and even economists. Apart from the fact that the repercussions of the crisis will live in the memory for decades, its effects are real. Would we have had severe cuts in public spending and tax hikes in the absence of the crisis? Would, to take a simple example, the coalition government in Britain have been emboldened enough to introduce big increases in university tuition fees? Would there have been a coalition government at all, a rarity in Britain, in the absence of the crisis? The crisis drew into sharp focus questions about how modern economies operate. It marked a shift from the easy, credit-driven growth of the 1990s and 2000s into something very different. Banks were safe, staid institutions, were they not? No, and in the autumn of 2008, the western banking system came very close to collapse. This was the time when at a practical level the cash machines almost did not get refilled, the supermarket shelves almost were not restocked, the wages not paid. It was very close to a full state of economic emergency, in Britain and in other countries.

So, without wishing that kind of crisis on anybody, it seems to me that it taught us that everybody should take an interest in economics, and not just at times of great turbulence. The crisis, you will find, makes appearances throughout this book but it does not dominate it. For this is a book about economics. And it is a book about economics quite unlike any other. There are no tricky diagrams of the kind that leave you wondering whether the page has been printed the right way up. There are no complicated mathematical equations. Unless something can be easily explained, it has no place in this book. Above all, at a time when we all need to know some economics, it is intensely practical. This book will not necessarily make you a millionaire – I always say that the only economists you see driving Rolls-Royces are wearing chauffeurs' caps – but it will tell you about the process by which we become, mainly, better off, apart from when those crises hit. It is also, I hope, good fun.

The aim of this book is to fill a gap, just like a good lunch. For years, at the *Sunday Times* and elsewhere, readers had been asking me to recommend an easily digestible book on economics, either for non-economists or for those whose grasp of it is a little rusty. Until now I have found it difficult to do so. There are some excellent textbooks on economics, some of which I shall recommend later, but they are intended for formal courses of study, with teachers offering a guiding hand. This is different. I hope that many students will read and profit from *Free Lunch* but in a way that complements formal study rather than replaces it. There are, too, some excellent works describing recent economic history but these can be difficult, if not impossible, in the absence of the building blocks. An account of, say, Alan Greenspan or Ben Bernanke's time as Chairman of the Federal Reserve Board in Washington needs the context of knowing something about monetary policy and how central banks are supposed to operate it. Similarly, trying to judge whether an assessment of the success of the government's management of the economy is fair or unfair requires a few basic tools.

Why have I called it *Free Lunch*? It is not, whatever you might think, a sneaky attempt to increase sales by passing off a work on economics as an addition to the ever-popular and expanding catalogue of cookbooks, although that would not be a bad idea. Rather, it is because the one snappy phrase from economics most people will have heard of, even if they are unaware it has anything to do with the subject, is: 'There's no such thing as a free lunch.' You never, in other words, get something for nothing. As I am a journalist often required to lunch, not always enjoyably, it has always been close to my heart. It is such a famous phrase but its origins are unclear. While it is often attributed to the American economist Milton Friedman, of whom more later in the book, the *Oxford Dictionary of Quotations* lists its authorship as Anonymous, first coming into circulation in American university economic departments in the 1960s but making it into print, not in a textbook or learned article, but in *The Moon is a Harsh Mistress*, a 1966 novel by the science-fiction writer Robert Heinlein. It is likely, however, that the phrase was in use much earlier than this. The *San Francisco News* used it in a 1949 editorial, itself reputed to be a reprint of one written in 1938, while the legendary New York mayor Fiorello La Guardia said it in 1934, albeit in Latin. As for the origin of the idea, bars in the west of America commonly offered free lunch to patrons buying a certain amount of alcohol, notably during the gold rush. Those who stayed sober soon worked out that they were paying for their lunch with what they were being charged for beer or whisky.

Does 'There's no such thing as a free lunch' work as a piece of economics? Most of us can think of cases where we have apparently got something for nothing. That bus fare you did not pay, or that £10 note you picked up on the street, for example. But think about it. The free fare has a cost, not just in the risk of prosecution but also in that fare-dodgers mean, in the long run, higher fares for all, including you. As for that windfall £10, I would not pretend that there is some higher economic authority guaranteeing that everybody's lucky gains and losses even out exactly over time but it is likely that something approximating to that is close to most people's experience. Any gambler will tell you how hard it is, over time, to stay ahead of the bookmaker; any stock market investor that it is difficult to beat the index consistently.

Let me give you another example of the 'free lunch' idea at work. If you have just bought this book, thanks, and you have proved that there is, indeed, no such thing as a free lunch. If you have borrowed it from a friend, you are obliged to them, and your payment will probably be to have to lend them something of yours. If it is from a library, you are paying for it in taxes, or will eventually do so. And if you have stolen it then shame on you, but you are paying for it with a guilty conscience and you might get caught. My contract with you is that, in return for obtaining this book, by the time you've read it, you will know as much economics as you will probably ever need and more than the vast majority of the population. Except, of course, in the unlikely event that everybody else reads it too. That would put me in a monopoly position, although not for long, because economics tells us that we would then see a flood of entrants into the market of similar works. Economics could become the new cookery.

At one level the book is an aid to reading newspapers, particularly the financial pages, and understanding (and being able to see through) the economic claims and counter-claims of politicians. Why are we interested in inflation, the level of interest rates, the balance of payments and the budget deficit, and what do they really mean? Why are we interested in some of these things more than others, and at certain times rather than others? No longer when you see economic stories on the financial pages (and increasingly the front pages) should your reaction be to turn over. The only newspaper or magazine economic reports that should be hard to understand are those that are badly written. When you hear a politician saying that this year his or her government is spending a record amount on the health service you will be able to scream at the TV, as I do: 'But that's been the case virtually every year since the National Health Service was created!' – or at least it was. Every voter should know some economics.

There is, however, more to *Free Lunch* than that. When I urge school or college audiences to study economics, it is not just because some such knowledge is essential for modern living. Rather, it is because the way that economists think about and analyse problems in a logical way is useful in so many areas. Watching economists at work is not always a pretty sight and the jokes about their indecisiveness are legion. President Harry Truman yearned for a one-handed economist because every one that he knew said: 'On the one hand this, on the other hand that.' You could, according to the hoary saying, lay every economist in the world end to end and never reach a conclusion. This is unfair, confusing the invaluable ability of economists to be able to see the other side of the argument with an apparent inability to reach decisions. Thinking like an economist means approaching problems in a logical manner, replacing assertion with analysis. This book will not turn you into a professional economist overnight but it will encourage you to think differently about things.

Free Lunch, like all good meals, comes in several courses. It can be digested at a single sitting, taken a course at a time or, if you like, dipped into from time to time by snackers. This second edition is rich enough to risk, towards the end, a nasty bout of indigestion. Even so, I hope very much that you enjoy it.

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Starters

Many books on economics begin by saying something like: 'Economics is about the allocation of scarce resources between competing demands.' Or, according to a very good and widely used textbook: 'Economics is the study of how society decides what, how and for whom to produce.' These are splendid definitions and undoubtedly correct as far as they go but they suffer from two important drawbacks. The first is that it is not until you have studied quite a lot of economics that you really understand what they mean. The second is that they are, for me, just too limited. Economics dominates and shapes our daily lives, even when we are not aware of it. It is all encompassing. This does not mean that we exist only as economic men and women, or are obsessed by money. It does mean that there is no getting away from economics. We refer, after all, to countries as 'economies'. I like the definition used by the great English economist Alfred Marshall (1842–1924) who said economics was the study of people 'in the ordinary business of life'.

Much of it also comes back to food, which is why I like the title of this book. Anne Sibert, professor of economics at Birkbeck College, London and, at time of writing, a member of the Icelandic central bank's monetary policy committee, once used a restaurant analogy to explain how speculative frenzies – financial bubbles – build up in the stock market. There are two restaurants in a town, the Ritz and the Savoy. Albert does not much mind which one he goes to but chooses the Ritz. Ben, coming next, is leaning slightly towards the Savoy but, seeing that Albert is at the Ritz, decides that it must be better. Catherine is also persuaded by Albert and Ben's choice that the Ritz must be the place, and so is David. By the time we get halfway through the alphabet, to Mary, everybody has chosen the Ritz and nobody the Savoy. But then Neville, who is next, has a very strong preference for the Savoy, partly because the Ritz is by now very crowded. Olivia, seeing Neville's choice, follows him, so does Peter, and so do the rest, right through to Zak. And then something strange happens. Halfway through their meal, all those who chose the Ritz hear that everybody else is going to the Savoy. They leave, in a rush, to go from one to the other, to the Ritz's chagrin. Think of all those who initially chose the Ritz as people who invested in dot.com shares during the late 1990s, or the rush by banks and other institutions into dodgy mortgage-backed securities in the 2000s, and then think of the rush to get out as they realised they had invested in worthless companies or securities, and you have a pretty good analogy for how bubbles build up and are burst.

Anyway, this is holding things up. The waiter is hovering and the meal is about to start. What shall we talk about? According to journalistic folklore, the only thing the middle classes talk about when gathered together at dinner parties is the level of house prices. Bubbles also come into any discussion of house prices too. The global financial crisis that began in the summer of 2007 had its roots in America's housing market and led to a sharp fall in house prices in Britain. So let us take the housing market as our starting point.

Houses versus potatoes

Most conversations about the housing market will include several elements. One person will assert that house prices have risen too much and are about to fall, while somebody else will claim that they have a lot further to rise. There is bound to be an argument over whether it is better to put your money into housing or stocks and shares. Everybody will count their good fortune to be already several rungs up the housing ladder, and not a first-time buyer struggling to scrape together a deposit for a home. These conversations change. Prior to 2007, people might also have commented on how easy it was to get a mortgage, with few questions asked. After that it became much harder, with many more questions asked. Home ownership was one of the great economic developments of the twentieth century. From a tiny minority of owner-occupied homes a hundred years earlier, the share of owner-occupied properties in England – people either owning their home outright or buying it with the help of a mortgage – peaked at 71 per cent in 2003, before slipping back to 67.5 per cent by 2010. Canada, the

United States and Australia have similar proportions at just below 70 per cent. In Spain it is a little higher, almost 80 per cent, while in Germany it is much lower, only just over 40 per cent, with home-buying usually occurring at a later age. One issue that emerged during the global financial crisis was whether some governments, notably the US government, had pushed home ownership too far.

Housing will always be an obsession, particularly in countries where home ownership rates are high. Unfortunately, as markets go, the one for housing is quite complicated. Imagine for a moment that the middle-class obsession was with the price of potatoes, which had risen to a very high level. Both the economist and the non-economist – the former after long years of study, the latter instinctively – would know how to analyse this. If the price of potatoes is very high, many people will decide they are spending too much of their income on them and switch to alternatives, such as rice and pasta, reducing potato demand. High prices discourage people from buying, while low prices encourage them. The effect on potato suppliers is, however, the opposite. High prices are an encouragement to supply more, while low prices act as a disincentive. Of course, it may not be possible to conjure up extra supplies instantly, although these days the supermarket chains operate very long storage times for so-called fresh foods. One reason why the prices of fresh produce traditionally varied so much from season to season was because supply varied between glut and shortage, depending on weather conditions and the extent to which farmers had responded to price signals (for example, planting more in response to this year's high prices).