While economics is famous for its complex terminology and hard-to-fathom equations, it is in fact the study of our everyday lives. One of the UK’s most famous economists, Alfred Marshall, described it as “the ordinary business of life”.

The word itself comes from two ancient Greek words: oikos meaning house and nomos meaning rule or law; economics can be seen as the study of household management. Of course in today’s globalised world it also looks at how these rules work at national and international levels.

**Why it matters**

Economics is all around us, all of the time. A rise in your bus fare, the closure of a factory where your uncle works, or the reason you are going on holiday in Cornwall rather than the Costa del Sol this year can all be explained by using core principles of economics.

It also gives us an understanding of concepts featured in the news on a daily basis, such as the national debt, inflation, real interest rates, and balance of payments. Understanding how these work can help people personally. For example, someone who does not understand the difference between ‘real’ and ‘nominal’ interest rates will probably make poorer financial decisions (real interest rates have been adjusted to remove the effects of inflation).

On a larger scale, everyone from politicians to protest groups and bankers to business leaders use economics to try to predict how our commercial markets and financial systems will behave in the future and as a theoretical basis for them to make decisions. Economics helps us to understand the ways in which people behave and how society develops and changes over time.

**Resources, choices and costs**

A key concept in economics is the shortage of resources. If land, labour, raw material, time and brainpower were available without limit, there would be no need for a science of economics. But the fact that all these things – which economists call inputs of production – have a limited supply, means we need a system to decide how to divide them up.

Economics is therefore the science of how those choices are made and the impact they have. Every time someone makes a choice, for instance over whether to spend £10 on a book or film ticket or save the money in the bank, they have to give up the other opportunities. The same applies to a government deciding on building a new £10-billion airport or using the same money to offer people a tax cut.

The value of the option that you sacrifice is known as the opportunity cost. By looking at what would be lost by making a choice, it helps ensure that it really is the best option and that resources are indeed used most efficiently.
Little and large
One of the first distinctions someone embarking on the study of economics will come across is between micro- and macroeconomics. These two terms again come from Greek: ‘mikros’ means small and ‘makros’ means big. A more modern way of looking at the split is between the ‘big picture’ of how a national economy works and the ‘narrow focus’ on how markets made up of many individuals operate.

Microeconomics looks at how individual players in the economy, such as households and firms, interact. These interactions match what one party wants (demand) and what the other gives in exchange (supply). Each time you buy a chocolate bar from a newsagent or undertake the morning paper round, you are taking part in that process of supply and demand.

The collective weight of all the decisions on demand and supply made by millions of people sets the price for goods, services, assets and labour. Demand and supply therefore form the main principle that underlies all microeconomics. At a microeconomic level a focus on efficiency helps businesses succeed, creating jobs and delivering high quality products and services at the lowest possible cost to households.

“Microeconomics is what most professional economists do,” says Paul Johnson, director of the Institute for Fiscal Studies. “It is all about understanding how people, companies and governments make decisions and how and why they change their behaviour.

Macroeconomics, on the other hand, examines the whole economy – the total amount of activity by firms, households and the government. It also looks at how different countries interact with each other through trade and investment.

At the heart of macroeconomics is the flow of money around the economy. Households receive wages from businesses who receive the money spent by households. Businesses and households both pay taxes to the government, which in turn makes benefit payments to households and pays businesses for goods and services. In an open economy, businesses buy and sell to firms in other countries.

Added together, these payments make up economic activity, which is often measured as gross domestic product (GDP). Macroeconomists are interested in how fast GDP is growing (growth), how fast prices are rising (inflation), and whether jobs are being created or lost (unemployment).

“Macro-economics is all about how all the decisions made by millions of people over what to spend and save add up to the big picture of unemployment, inflation and growth,” says Professor John Van Reenen, director of the ESRC-funded Centre for Economic Performance at the London School of Economics.

At the macroeconomic level, poor countries that have applied sound economic policies have been able to reduce poverty. Developing new policies that can lessen or even eliminate poverty is one of the most urgent economic challenges.
Economics in action
There is a clear relationship between micro- and macroeconomics. The total level of output is the result of millions of choices made by individual households and firms. The ability of businesses and consumers to spend will depend on how well the economy is running. Economics can also make a vital contribution towards increasing people’s welfare and wellbeing.

“How should you design the tax system or the pension system?” asks Paul Johnson. “These are economic questions because how they are designed has a huge effect on how much people work and save, as well as on how much money they have. Getting the design wrong can be hugely costly.”

It’s a question of balance, according to Professor John Van Reenen. “Sometimes what is a good decision for an individual at the micro level may not be good for society as a whole at the macro level. For example, in a recession everyone starts cutting spending. But when everyone is demanding less, firms cannot sell their goods and services so they will cut back jobs forcing households to spend even less. This can become a vicious circle.”

The challenge governments face is to deliver strong and stable growth, keep inflation under control, ensure the economy creates jobs for its citizens and that households’ living standards rise over time. Economists constantly debate how to achieve these goals. The main tools are known as fiscal policy, which is the role the government can play by increasing or cutting taxes and public spending, and monetary policy, where the central bank seeks to control the money supply.