

UNIT 1

1.2 The economy as a whole

Economics is the study of how we interact with each other and with nature in producing our livelihoods. It is a system of interacting parts, a bit like the human body, but on a larger scale. Figure 1.2 is a map—or simplified model—that introduces the main actors and the flows of goods and services among them.

Firms. Most of the production and distribution of goods and services is undertaken by firms. Owners of firms hire workers, and make decisions about what they are going to produce and the technology, machinery, software, and raw materials they will use to produce it. Hiring workers takes place in what is called the *labour market*—a market where people offer their time and skills and employers pay to hire them. The buying and selling of goods and services takes place in *product markets*. Firms also buy goods and services from other firms, for example the machinery, software, and other things needed to carry on their production.

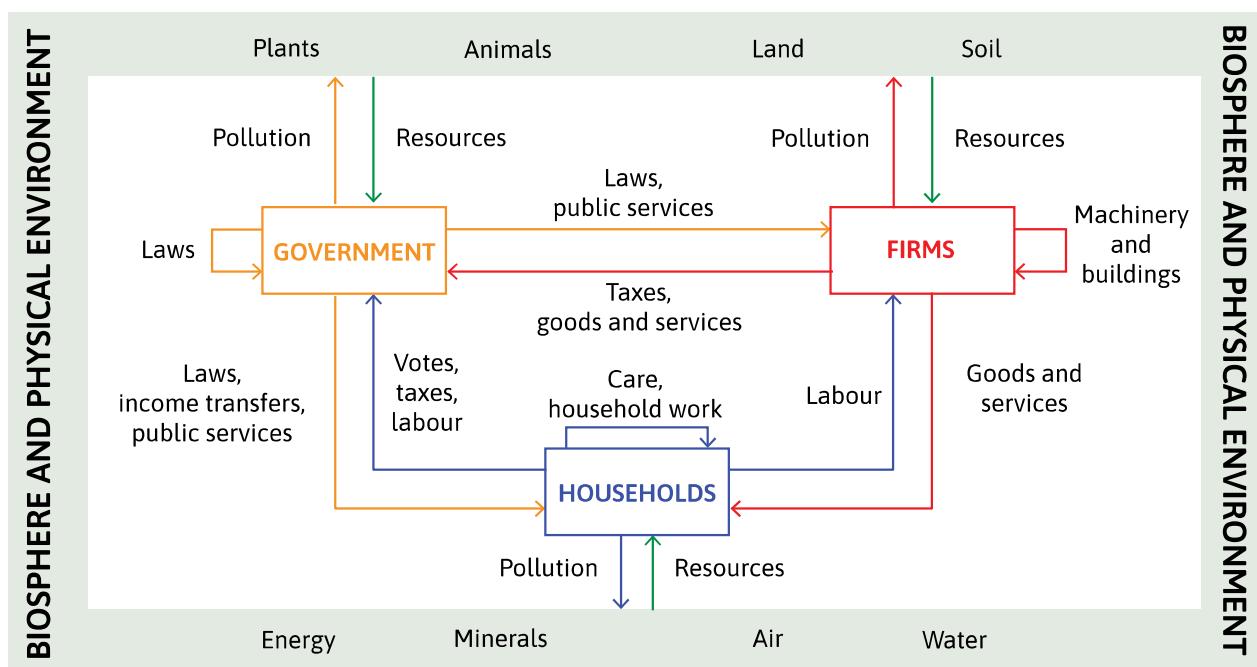


Figure 1.2 A model of the economy.

[FULLSCREEN](#)

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Individuals in the households shown in the figure, work for governments and firms as well as caring for others and doing work in the household. The model does not show everything—for example, some individuals work for themselves.

Governments use the taxes paid by owners of firms and households to employ people and purchase the goods and services needed to provide public services, such as schooling and public security. Governments also implement laws and policies that regulate how all of the actors (including the government itself) interact. Not shown in the figure are the transfers made by the government to households in the form of pensions and unemployment insurance, or the different levels of government from city to national.

Like any map, this one is a simplification. It represents the economy of a single country, which we will call the ‘home country’. A more complete picture would include firms, households, and governments in other countries, and also financial markets. In the household section, it would distinguish between men and women and people of different ages or ethnic communities, and include organizations other than firms, such as trade unions, churches, and community groups. Some households would be very wealthy and others poor.

The economy is a huge and complex system involving billions of interactions between millions of different actors. Economists build simplified models to focus on the particular features of the economy that help us to answer particular questions about how it works.

Building block

For an introduction to economic modelling, read [Section 2.8 of the microeconomics volume](#).

The relationships among the actors—shown by the arrows—differ. The goods and services that firms sell to each other and to households are exchanged by individuals choosing what they would like to buy or sell in markets. The work that households do in firms is directed by managers and owners. The taxes and the other government policies are implemented by law by governments, which in a democracy are elected by the votes of household members.

Together, the labour and product markets make up the **supply side** of the economy. It is called the supply side because it is concerned with all the activities that are required to supply the goods and services available for purchase. It is illustrated by the flows of labour from households to firms and of goods and services from firms to households in the diagram.

The particular way that labour and product markets function in different countries has important implications for how much can be produced and the quality of goods and services that can be made available. Understanding the supply side of the economy also helps us understand why people earn what they do and how many people have a job, relative to the number of people who want to be working. The key outcomes we focus on in this unit are

therefore real wages and employment (these terms are defined more precisely in the next two sections).

There is also a **demand side** of the economy, which has to do with the amount of overall expenditure on all the goods and services produced—the economy's output. In [Figure 1.2](#), three of the key sources of demand for the economy's output are shown: firms, households, and government. There will also be expenditure by customers abroad (on the home country's exports) and some of the home country's demand will be met through production that takes place abroad (the home country's imports). We focus on the supply side of the economy in Units 1 and 2, and introduce the demand side in Unit 3 and subsequent units.