Preface

The dichotomy between macroeconomics and microeconomics, despite both being branches of economics observing and studying the same economy, perplexes most students of economics, including professional researchers. It is therefore reasonable to investigate how these segregated theoretical approaches relate to each other, and to integrate them. That is the main aim of this book.

As Keynes suggested, there is an important economic element in macroeconomics that does not exist in microeconomics: money. Neoclassical microeconomics theory is concerned with describing a barter economy that does not include money. This is evident from the fact that attempts to integrate money into a neoclassical economic framework have never succeeded. A critical reason for such failures is that in a barter economy there is no serious difficulty with *double coincidence of wants*. Market participants are assumed to find their transaction counterparts without any difficulty. In such scenarios, the economy operates efficiently without money as a medium of exchange. In reality, however, there is no guarantee that the transaction counterpart, whose goods a market participant wants, also needs the goods that may be offered in exchange. Therefore, a barter economy is inefficient whenever there is the difficulty of the double coincidence of wants.

Money can be regarded as a kind of implicit social contract for overcoming such difficulties. Once money is introduced into the economy as a medium of exchange and a store of value (the distinction between these two concepts is almost meaningless because money is hoarded for the future exchange of goods), the function of goods markets or their prices differs completely from that in the barter economy. As elementary microeconomics tells us, prices are determined to equilibrate demand and supply in the barter economy. Such an adjustment towards equilibrium does not, however, work in the monetary economy. The value of money, tentatively defined as the inverse of a price index, is mainly determined by rational expectations concerning future value. This is partially because money does not have economic value in itself when hoarded for future consumption. This prominent characteristic of money implies that the price index sequence forms a nested structure. The current price index is a function of the future price index that is determined beforehand. Similarly, the future price index is affected by the price index in the immediately succeeding future period, and so on. Thus, the values of each price index sequence depend on their own future levels; they do not depend on demand and supply conditions in goods markets or on nominal money supply levels.

Accordingly, in the monetary economy, the current price level does not necessarily equilibrate goods markets even if price movements are flexible to goods market adjustments. If money is insufficiently supplied through fiscal and monetary policy mechanisms, purchasing power contracts in the economy as a whole, resulting in an excess supply of labor and involuntary unemployment. This is a peculiarity of the theory of effective demand with flexible prices, which is developed by this book, when applied to the monetary economy.

Besides incorporating the crucial role of money in the market economy, the unification of macro and microeconomic theory is a substantial contribution made by this book to economic theory as a whole. It enables the use of the most popular value judgment in economics to evaluate macroeconomic policies, the concept of *Pareto efficiency*, which addresses the efficient allocation of scarce resources. In general, however, it is difficult to infer any value judgments in the discussion of macroeconomic policies by professional economists. Such an arbitrary attitude endangers the establishment of social justice parameters in the discipline and practice of economics.

Pareto efficiency seems to be quite a narrow concept for evaluating the effects of macroeconomic policies. For example, it disengages from the problem of fairness of income distribution. However, there remain many macroeconomic problems that can be resolved by incorporating the concept of Pareto efficiency. One of these involves the problem of involuntary unemployment that is examined in this book. Involuntary unemployment is defined as the situation where workers are unemployed despite their willingness to work under prevalent wage rates. If effective demand expands such that these workers find employment, their lifetime utility will improve. Moreover, since profits will also increase together with production, the expansion of effective demand is beneficial for employers as well as for incumbent employees, and results in economic gains for every agent in the economy. Therefore, any policy that reduces involuntary unemployment improves resource allocation in a Pareto sense. This discussion implies that involuntary unemployment is a waste of scarce resources (i.e., labor), and that an expansionary fiscal-monetary policy contributes to improving socioeconomic welfare by absorbing idle resources for product activity.

To summarize, Keynesian theory is supported by two pillars. The first is the *bubble-like* property of money, where the price level is determined by its future expected value; essentially a self-fulfilling prophecy. However, it must be noted that, as opposed to the barter economy, the price level does not always clear the market in the monetary economy. The second is the strict dynamic microeconomic foundation underpinning this theory that allows for the evaluation of macroeconomic policy impacts. This is because the legitimacy of policies should be judged from the viewpoint of Pareto efficiency and exclude the irrational behavior of economic agents.

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