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Banking in macroeconomic theory and policy

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ABSTRACT

This special issue, "Banking in Macroeconomic Theory and Policy," explores a problem that has occupied to varying degrees several recent generations of economists: identifying and integrating the appropriate role of a banking sector within a policy-relevant analytical framework of macroeconomic analysis. This introductory article tries to provide a context for the fascinating contributions to this issue. It reviews efforts to apply developments in bank modeling to augmenting macroeconomic models during the 1960s through 1980s, theoretical and empirical elements that led to diminished emphasis on incorporating banking into analytical macroeconomic frameworks between the 1990s and the 2007–2009 financial crisis, and recently renewed work to integrate banking sectors into modern macroeconomic models. The paper concludes by reviewing briefly the contributions contained in this special issue.

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1. Introduction

The degree to which the field of macroeconomics has sought to consider explicitly the role of banks and other financial intermediation within theoretical models and policy-oriented applications has exhibited ebbs and flows during past decades. Interest in the topic surged between the early 1960s and 1980s and then plummeted between the early 1990s and the global financial meltdown of 2007–2009 and the sharp recession that followed. During the decade since, interest has resurged, financial frictions play an important role in a broad range of recent macroeconomic models, and several frameworks incorporate some relevant features of banking intermediation.

The editors of this special issue of the Journal of Macroeconomics wished to put together a number of different contributions to the field, to provide a comprehensive view of the state of the art. The articles in this special issue of the *Journal of Macroeconomics* have been solicited with a call for papers that has reached a broad and diverse audience, and we have received a substantial number of submissions. All responses to the Call for Papers underwent the same reviewing procedures as any other submissions to the journal, and all papers went through our usual rigorous referee process. The articles in this special issue join the wave of renewed contributions to efforts to incorporate banking in macroeconomic theory and policy, and they take a step forward in our understanding of these complicated interactions.

In this introduction to the special issue, we seek to provide context for consideration of the contributions of the issue's authors by overviewing how researchers have sought to integrate considerations of the role of a banking sector within

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macroeconomic theory and policy analysis. We organize this overview around three periods. In the following section, we discuss the interval that extended roughly between the early 1960s and late 1980s, during which a gradually improved understanding of how to apply economic theory to banking firms enabled researchers to begin augmenting the then-prevailing macroeconomic frameworks with model banking sectors. In Section 3, we examine the period from around the early 1990s to the 2007–2009 financial crisis, when widespread rethinking of macroeconomic theory coupled with apparent changes in real-world interactions among financial firms and markets led many researchers to de-emphasize special macroeconomic roles for banks. In Section 4, we review developments during the post-crisis period, in which a new generation of researchers has begun to re-explore how to incorporate banking in macroeconomic theory and policy analysis. Section 5 concludes by introducing briefly the interesting contributions that follow in this "Banking in Macroeconomic Theory and Policy" issue of the *Journal of Macroeconomics*.

2. The high tide of banking in macroeconomics

Several factors accounted for an increased fascination with the macroeconomic role of banking between the 1960s and 1980s. One factor was that then-new theoretical and empirical approaches for analyzing optimal portfolio management, the demand for money and other financial assets by individuals and firms, and general-equilibrium interactions among these agents were readily applicable to the topic. In addition, an intellectual tug-of-war between adherents to Keynesian- versus Monetarist-based approaches to the monetary transmission mechanism spurred efforts to sort out the precise nature of this mechanism. Moves by governments to relax a number of post-Great Depression regulations that had been imposed on the financial sector further stimulated interest in the task, as policymakers sought to understand the macroeconomic consequences of that wave of financial deregulation.

The consequence was a voluminous literature within what came to be known by the 1980s as the "money-macro" field. By that time, a full range of training for a newly minted macroeconomist often included coursework ranging from portfolio analysis and the economics and management of financial institutions to analysis of theoretical macroeconomic theories incorporating these elements. Early work tended to reflect the Keynesian-Monetarist split of the times. Adherents to the former approach, including Gurley and Shaw (1960), Brainard (1964), and Tobin and Brainard (1963) utilized analytical frameworks emphasizing asset substitutability and interdependence among markets for monetary and other financial assets and liabilities, including securities and loans held by and deposit liabilities issued by banks. These models determined an array of rates of return on alternative assets that influenced the aggregate distribution of asset holdings. By extension, also determined were equilibrium values of monetary aggregates that included "inside money" within the banking system, which, as discussed by Benjamin Friedman (1976), in turn potentially might serve as indicators or targets of monetary policy. Depending on the exact specification, such channels together influenced total expenditures and, consequently, aggregate demand. Proponents of the Monetarist approach, such as Friedman and Schwartz (1963), Brunner and Meltzer (1963, 1981), and Saving (1977, 1979), also sought to take into account rates of return on relevant assets. These researchers, however, focused attention more directly on how such rates of return affected banks' balance sheet allocations within the money supply process. That hypothesized process, in turn, linked the monetary base, via money multipliers, to monetary aggregates deemed to influence aggregate demand.

Application of the theory of the firm to the banking industry by Klein (1971), Monti (1971), and Sealey and Lindley (1977) provided the foundation for microeconomic banking modeling that has followed. Models of bank profit maximization subject to the fundamental balance sheet constraint and potentially other regulatory constraints, such as capital- or liquidity-requirement constraints, typically yield solutions for a bank's balance sheet choices once elements of risk and asymmetric information, considerations of resource costs, or contemplation of imperfectly competitive market structures have been incorporated. Naturally, such models have continued to be utilized within the profession to evaluate various microeconomic and regulatory issues. Nevertheless, at the time it was developed, this literature sought to pave the way for more thorough-going integration of banking theory within macroeconomic models. Indeed, Baltensperger's (1980) review of the progress of the microeconomic banking literature developed by the end of the 1970s emphasized the view, prevalent among authors of the period, that "a satisfactory theory of banking behavior appears as an indispensable prerequisite for a clear understanding of the workings of the financial sector of the economy in general and of the money supply mechanism in particular" (Baltensperger, 1980, p. 1). Indeed, during the 1980s, various researchers, such as Benavie and Froyen (1982, 1983) and Santomero and Siegel (1981, 1982), worked to integrate the banking sector into the "LM" side of prevailing macroeconomic models of the time.

During the 1980s, recognition of the fundamental importance of two banking issues—portfolio separation versus independence and the nature of balance sheet dynamics—received considerable attention from researchers who sought to continue the integration of banking and macroeconomic theory. Sealey (1985) identified the fundamental conditions required to yield portfolio separation, a banking environment in which banks adjust the asset and liability sides of their balance sheets independently in response to variations in a key wholesale market rate. These conditions include unanimity of risk-averse shareholders regarding portfolio decisions, separability of the resource cost functions for the assets and liabilities of the intermediaries, and banks' access to a market for wholesale funding with equal ex post lending and borrowing rates, such as possibly a wholesale-interbank-market rate. Absent these conditions, banks' portfolios are fully interdependent, which considerably widens theoretically the range of potential interactions among banks' balance sheet choices and thereby complicates the channels through which the banking sector might affect macroeconomic outcomes.

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