Foreword

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As the Great Financial Crisis of 2008 spreads and deepens, the role of central bank policy in general and the Federal Reserve's policy in particular has become more important – and increasingly contentious. Once seen as maestros of prosperity and masters of their fate, struggling central bankers in the US and Europe are now caught in a tug of war between those who think their policies must be more aggressive and inventive to pull our economies out of stagnation, and those who think they are already doing far too much, risking massive inflation and financial collapse.

From this perspective, it is hard to fathom how far we have come in just a few years: in the mid-2000s, central bankers, economists and pundits were hailing the “New Consensus” on monetary policy – independent central banks armed with “inflation targeting” frameworks (light and heavy) were wielding an improbably simple tool (a short-term interest rate) – and were congratulating themselves on the “Great Moderation” of low inflation and rapid economic growth this policy had supposedly engendered.

Fast forward five years and things look rather different. The world economy is confronting the debt hangover from a decade of inequality generating, debt fuelled asset bubble inflation that, at best, central banks failed to prevent. Warren Buffet likened a financial crash to the tide coming in: it allows us to see who was swimming naked. As it turns out, the central banks and their economist engineers of the “great moderation” were also rather under-dressed.

Central banks are finally peeling themselves away from this inflation targeting obsession and are now desperately trying to confront mass unemployment and destructive stagnation. But their policies are having uncertain effects. Yet, though policies are changing, in the realm of economic analysis the same ideas that led to the mismanagement of monetary policy in the build-up to the crisis are still firmly in place. Most economists are stuck in their old ways of understanding the mechanisms of monetary policy, and therefore are ill equipped to understand the role monetary

policy played in the run up to the *Great Financial Crisis*, or how to reconstruct monetary policy as an effective tool to help generate employment and revive our economies.

It is in this context that we can see the great importance of Hasan Cömert's book, *Central Banks and Financial Markets: The Declining Effectiveness of US Monetary Policy*. Through detailed institutional, historical and econometric analysis, Hasan Cömert shows that profound changes in the financial system in the 1980s and 1990s dramatically undermined the ability of the Federal Reserve to use its simple monetary tools to control the price of credit (medium-term and long-term interest rates) or the quantity of credit (the size of financial institutions' balance sheets). Cömert calls this the dual de-coupling between monetary policy and the financial markets.

Cömert describes the key processes and changes that undermined the power of the Federal Reserve to control the monetary system, making clear that some of these wounds were actually self-inflicted. He attributes the decline in the Federal Reserve's control to four interrelated processes: rapid innovation in financial markets, deregulation in the regulatory framework, policy choices of the Fed and increasing financial integration. Clearly, the Fed's support of financial deregulation, especially under the reign of Alan Greenspan, and the adoption of a short-term interest rate focused operating framework, greatly contributed to their declining ability to effect longer term interest rates and quantities of credit.

One of Cömert's important contributions is to show econometrically that this loss of control, especially over long-term interest rates, started as far back as the late 1980s – much earlier than other studies have suggested. This finding suggests just how egregious it is that during this time, the mainstream “New Keynesian” monetary theory that came to the fore emphasized the powerful role that the short-term policy interest rate would play, even as its ability to affect other interest rates and credit aggregates were declining, as Cömert convincingly shows.

Hasan Cömert's analysis is highly relevant to the debate about: “Who Lost the Economy?” Some argue that it was the Fed, who kept interest rates too low for too long, fuelling the reckless lending and production of complex financial products and build-up of leverage that ultimately crashed the system. The upshot of Cömert's analysis is that the Federal Reserve's *monetary policy*, in and of itself, was not primarily responsible for the financial crisis. He showed that the Fed's policy was less and less effective over time in influencing the medium and longer term interest rates that generated the housing boom.

But far from absolving the Fed of blame, Cömert suggests instead that financial deregulation, allowed and sometimes promoted by the Fed, very

likely facilitated the crisis. Cömert also shows that inflows of foreign credit plausibly had an impact on keeping relevant interest rates low, thereby contributing to the housing bubble.

One of the powerful aspects of Hasan Cömert's analysis is the seamless way he moves from historical and statistical analysis to a well informed and insightful discussion of a broad range of relevant economic theory. The argument of the book is clearly more consistent with post-Keynesian analysis which emphasizes the endogeneity of money and credit than mainstream and New Keynesian theory which emphasizes the "exogenous" controllability of interest rates by the Fed. Nonetheless, Cömert's framework is also clearly an improvement over much of the post-Keynesian literature. Unlike the a-historical and excessively abstract approach of some post-Keynesian analysis, Cömert develops a rich historical and institutional analysis that describes the forces that shape the nature of the credit system and the effectiveness of monetary policy as it changes over time.

Emphasizing history and institutional evolution along with theory and econometric analysis – as Hasan Cömert does – is a much more realistic and useful approach for understanding and confronting the dangerous historical juncture in which we find ourselves. A key question we face is how central bank policy and the financial markets in which it operates can be restructured to help restore full employment and sustainable and equitable economic growth. Hasan Cömert's book is an extremely important contribution to helping us understand what did and did not go wrong with Federal Reserve policy, and how to think about reconstructing both theory and policy to help get us out of the deep morass that we are in.

NOTE

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