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# Right man, rough job

## Ben Bernanke's renomination as Fed chairman is good news. But his hardest work lies ahead

HAVING endured weeks of criticism over his plans to reform American health care, Barack Obama urgently needs some friendly headlines. That helps to explain why, on August 25th, the president nominated Ben Bernanke to a second term as chairman of the Federal Reserve, even though Mr Bernanke's first one does not expire until next January. The decision was widely hailed on Wall Street and in Washington, DC. With few exceptions, politicians and economists lined up to praise Mr Bernanke and to laud Mr Obama for keeping him.

The decision was a good one, for two important reasons. The first, on which most commentators have dwelt, is that Mr Bernanke has done a sterling job of dealing with the worst financial crisis since the 1930s. Some of the breathless praise about how this former student of the Depression saved the world from a repeat is overdone. It ignores the fact that Mr Bernanke was complicit in creating the loose monetary conditions which fuelled the financial frenzy in the first place. As a governor of the Fed earlier this decade, he was even more convinced than Alan Greenspan that central banks had no business raising interest rates to head off asset bubbles. Reappointing Mr Bernanke might thus appear akin to paying a plumber all over again for repairing pipes that he fitted after they have flooded your home. Nor, once the crisis struck, was he the only central banker to prove handy with monetary plunger and wrench. The leaders of several other rich-world central banks have also acted boldly.

Nonetheless, Mr Bernanke's academic research gave him an acute appreciation of the risks posed by dysfunctional financial markets. His willingness to experiment with unconventional monetary-policy devices allowed the Fed to counter financial collapse even as America's politicians were paralysed. And his mild, diplomatic manner brought much-needed calm amid the crisis (see article).

The second reason why the renomination makes sense has less to do with Mr Bernanke's strengths than with the dangers of ditching him. The likely alternatives were not obviously superior to the incumbent. Given the broad consensus that he has handled the crisis well, replacing him, especially with an obvious Democrat, would have whiffed of politicisation. True or not, that perception would have damaged the Fed and thus the economy. America's central bank is already in its most parlous political position in generations, under fire from the left for failing to prevent financiers' excesses and from the right for swelling its balance-sheet and overstepping its remit. It is caught up in a furious debate over financial regulation, and has little popular support. According to one poll, Americans think less of the Fed than of the Internal Revenue Service. In this environment, the merest hint of a partisan decision could have been disastrous.

Mr Bernanke's reappointment has defused that danger. But far more perilous times lie ahead. For both substantively and politically, the tasks over the next four years may be harder than handling the crisis itself. There will be no quick return to business as usual for the Fed or any other central bank (see article). The Fed's monetary stance must be loose enough for long enough to prevent the economy sinking into a deflationary quagmire, but must be tightened quickly enough to stop inflation soaring. With short-term rates close to zero, this monetary balancing-act must be performed with untested equipment—particularly the swelling and shrinking of the Fed's balance-sheet—and against a backdrop of steeply rising government debt (see article).

## A question of backbone

Politically, the difficulties will if anything be greater. Mr Bernanke must steer the debate over regulatory reform so that the Fed is not left with implausibly broad responsibilities and insufficient tools with which to carry them out. He must explain the logic behind its monetary decisions but stand firm against pressure to influence them. Given that America's economy is likely to face weak growth and high unemployment for a long time, that will not be easy. For example, the housing industry will cry out if the Fed starts to sell its mortgage-backed securities. And there will be howls from Congress, and maybe the White House too, if interest rates rise when joblessness is still high and the deficit huge.

Mr Bernanke has earned his reappointment by showing that he is a bold and creative crisis-manager. In his second term he will need just as much technical competence as he has shown in his first, and even more political backbone.

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# The very model of a modern central banker

## An academic background stood the chairman of the Federal Reserve in good stead during his first term. Political skills may be more important in his second

AS THE financial crisis gathered force in August 2007, Jim Cramer, a hyperbolic market commentator on cable television, hurled the worst epithet he could muster at the chairman of the Federal Reserve: “Bernanke is being an academic. It is no time to be an academic!” By August 25th this year, when Barack Obama nominated Ben Bernanke to a second, four-year term, what had once been an epithet had become a source of strength. “As an expert on the causes of the Great Depression, I’m sure Ben never imagined that he would be part of a team responsible for preventing another,” Mr Obama said. “But because of his background, his temperament, his courage, and his creativity, that’s exactly what he has helped to achieve.”

It is too soon to declare that the threat of depression has passed, but not to conclude that Mr Bernanke’s academic background, which seemed a liability at the start of his tenure, has proved his greatest asset. His so far successful handling of the crisis reflects not just what he learned about the Depression, but what other economists have learned from studying crises—as demonstrated by the similar strategies other central banks have taken. A political neophyte compared with his predecessor, Alan Greenspan, Mr Bernanke made that a strength when he pleaded with politicians to bail out the system. “I’m a college professor,” he told Congress as it debated the $700 billion Troubled Asset Relief Programme. “I never worked on Wall Street… My interest is solely for the strength and the recovery of the US economy.”

Difficult as Mr Bernanke’s first term was, his next will be more politically treacherous. The recovery now under way will be feeble: deflation will remain a bigger threat than inflation for at least a year. Yet early signs of growth will generate pressure to tighten monetary policy which Mr Bernanke must beat back without seeming soft on inflation.


Once the recovery is entrenched and unemployment is falling, he will have to raise interest rates and shrink the Fed's balance-sheet, inviting attack from Congress and perhaps Mr Obama. He will also have to create a new monetary regime to replace the single-minded focus on low inflation, says David Blanchflower, who recently quit the Bank of England's monetary policy committee. The Fed may have to intervene in markets more to prevent new bubbles. But that, like tightening monetary policy, is unpopular and the Fed is already in bad odour with the public (see chart).

Still, Mr Bernanke is probably up to these challenges. Mr Obama has strengthened him immensely, by nominating the 55-year-old Republican long before his term expires rather than leaving him dangling or replacing him with a Democrat. More important, Mr Bernanke has shown he can adapt academic theory to the political reality in which the Fed operates.

This was not a foregone conclusion. Mr Bernanke was appointed to the Fed in 2006 largely on his academic credentials. As a professor at Princeton University, then a Fed governor under Mr Greenspan and briefly an adviser to George Bush, he helped build the edifice of macroeconomic orthodoxy that has proven so badly flawed. He argued that central banks performed best by concentrating solely on inflation, preferably with a target. To an even greater degree than Mr Greenspan, he was sure that using monetary policy to try to stop asset-price bubbles would do more harm than good.

To a great extent this reflected his and most macroeconomists' assumption that markets were, most of the time, rational and efficient. In September 2005, he declared: "Recent house price increases are attributable mainly to economic fundamentals." Jeremy Grantham, a fund manager, has said Mr Bernanke's faith in efficient markets was so strong that he could not see a once-in-a-century bubble in home prices because such a bubble wasn't supposed to be possible. Mr Greenspan is blamed for planting the seeds of the crisis by holding interest rates low after the 2001 recession, but Mr Bernanke provided ample intellectual cover for the strategy. As late as August 7th 2007, days before the crisis erupted, the Fed said it was more worried about inflation than about a weakening economy.

But once the gravity of the crisis became clear, Mr Bernanke knew what he had to do. Financial institutions, unsure who was fatally exposed to toxic securities, began to hoard liquidity (cash and super-safe government debt) and withhold credit from each other. As liquidity dried up, some institutions failed and others reduced their lending to businesses and households, starving the broader economy. When everyone wants liquidity, only the central bank can supply more. Over the next 20 months, Mr Bernanke employed ever more creative means to inject liquidity into the financial markets. He also used conventional monetary policy, eventually cutting short-term interest rates close to zero and attempting to lower long-term interest rates by purchasing bonds. But the Fed needed a functioning financial system to transmit the benefits of such actions to the broader economy.

He was not the only central banker to come to this realisation, or even the first. When the crisis first broke in August 2007, the European Central Bank (ECB) was more aggressive in its initial response, providing at first unlimited cash to euro-zone banks. Similarly, the Fed's decision to throw its weight behind Bear Stearns, American International Group and Citigroup, had its analogues abroad: the Bank of England provided a lifeline for Northern Rock and the Swiss National Bank later backstopped UBS. All central bankers, not just those who are authorities on the Depression, know that in a crisis, the failure of a single financial firm can trigger contagion and the collapse of its counterparties, endangering the entire financial system and economy.

But Mr Bernanke not only acted more quickly and forcefully, he faced unique constraints. Almost by accident the ECB ended up with a modern toolkit: it can lend to far more counterparties against far more types of collateral than the Fed. Europe's economy remains bank-dominated. America's once was, too, and the Fed's tools reflect that: it can ordinarily lend only to banks from its discount window. But America's economy is now dominated by a shadow banking system of investment banks, financial firms and investment funds. Mr Bernanke's staff devoted much of their creativity to overcoming the legal and technical barriers of the Fed's 20th-century charter and, when they hit the limit, convincing Congress and the administration to pick up the baton.

Professional economists have applauded Mr Bernanke's actions, but the public has not. The Fed's approval rating stands at just 30%, lower than any other federal agency and down from 53% in 2003, according to Gallup. Partly this is because the economy has faced a devastating recession that the Fed was meant to prevent. But it also reflects discomfort with the Fed's meddling in private markets.

Central bankers expect to be unpopular, but the Fed is uniquely vulnerable now. A bill in Congress would subject its most sensitive decisions to legislators' scrutiny, while the administration has proposed expanding its regulatory oversight to contain future crises. This has thrust Mr Bernanke into the political arena: he appears to be at odds with Tim Geithner, the treasury secretary and a former colleague at the Fed, over his proposal to strip the central bank of its consumer-protection duties. Just one senator voted against his confirmation in 2006; between 10 and 25 from both parties may this time, though that will not deny him confirmation.

Mr Obama could have succumbed to partisan priorities as well. The Fed chairman wields enormous influence over all economic policy, not just monetary policy, and a Democrat has not held the job since 1987. Mr Obama had many qualified candidates, from Larry Summers, his adviser and a former treasury secretary, to Janet Yellen, president of the San Francisco Fed. The president went with Mr Bernanke to keep together two principal architects of the response to the crisis—the other is Mr Geithner—and to eliminate market suspicions that he wanted a pliable loyalist in the job. In doing so, he has helped assure Mr Bernanke's legacy of making the chairmanship less political and more technical. You might even say academic.