Man in the news: Ben Bernanke

By Krishna Guha

Published: August 17 2007 19:09 | Last updated: August 17 2007 19:09

At the Federal Reserve's annual retreat in Jackson Hole, Wyoming almost eight years ago to the day, Ben Bernanke presented a paper to Alan Greenspan and other central bankers from around the world setting out how they should respond to changes in the price of stocks, bonds and other assets.

At the time, Mr Bernanke was chairman of the economics faculty at Princeton University, one of the foremost academic economists of his generation, but unknown outside his profession.

Eight years on, Mr Bernanke has succeeded Mr Greenspan as chairman of the Fed. The eyes of the world are on him as he grapples with the real-life, not theoretical, dilemma of how to respond to financial market turmoil. The dramatic response on Friday to the Fed's moves to make money directly available to cash-starved institutions at less penal rates and hint at a possible interest rate cut shows how his decisions affect global markets .

In his 1999 Jackson Hole paper Mr Bernanke and his co-author, Mark Gertler, argued that a central bank should move rates in response to changes in asset prices, but only to the extent that they affect the outlook for the real economy. A year later in an article in Foreign Policy magazine he put the question in layman's language: "If Wall Street crashes does Main Street follow? Not necessarily."

Mr Bernanke still believes that smart central bankers should keep focused on the real economy. This is the paradigm through which he will assess whether to cut interest rates. But the real world is not as clear cut as academia. The Fed chairman faces uncertainty about how much of an effect market turmoil is having on the economy. Mr Gertler, now a professor at New York University and visiting scholar at the New York Fed, says: "I would be the first to admit there are grey areas."

The decision requires managing noisy and contradictory constituencies. Most traders are desperate for a rate cut. Jim Cramer, hedge fund manager and rambunctious CNBC television pundit, spoke – or rather shouted – for them when he demanded the Fed wake up and cut rates. "Bernanke is being an academic . . . He has no idea how bad it is out there. He has no idea!"

But many economists and central bankers believe a rate cut risks the "moral hazard" of bailing out reckless investors. Bill Poole, president of the St Louis Fed, told Bloomberg only a "calamity" would justify a rate cut now. Friday's move navigated the middle-ground between the two camps. But traders rejoiced, with one TV pundit calling Mr Bernanke a "rock star".

Mr Bernanke's position is made harder by his predecessor's long shadow. Investors loved Mr Greenspan, who over the years defused a string of financial crises. But some economists fault him for allowing investors to believe that if things ever got really bad, the Fed would step in to rescue the markets.

This is not the first time Mr Bernanke's reputation has been on the line. Last spring, only a couple of months into the job, investors started to bid up the expected rate of inflation. Traders mocked "Helicopter Ben" – a nickname derived from remarks he made that the Fed could always halt deflation by dropping money from a helicopter.

Mr Bernanke showed then that he was not cowed. He responded with a tough speech that punished those who had doubted his inflation-fighting credibility. A few months later he made a hard call to halt the series of rate rises, earning the admiration of Fed colleagues that he would not take undue risks with the economy to prove a point.

"One of the things he has in common with Greenspan is calmness – unflappability, if that is a word," says Alan Blinder, a professor at Mr Bernanke's old university of Princeton and former vice-chairman of the Fed. "Greenspan was calm in a storm. Bernanke is like that also."

Even if he lacks the assiduous political touch of his predecessor, Mr Bernanke is not unaware of the political context. He served as a Fed governor and chairman of the White House council of economic advisors before becoming Fed chief. He remains close to White House officials, but has also wooed Democrats on Capitol Hill, where senior figures appreciate his humbler image after "uncle Al".

Yet it is his instincts as an economic historian and theoretician who has studied the Great Depression and other financial crises that will guide him now. Larry Meyer, a former Fed governor and chairman of Macroeconomic Advisers, says Mr Bernanke knows better than most – having written extensively on it – how the credit system works and the role collateral plays in it.

Mr Bernanke has a risk-management approach to monetary policy as a balance of risks around an economic forecast. Above all he has the intellectual confidence to make big calls, buoyed by a precocious childhood in which he skipped first grade and came top in his state of South Carolina for his college entrance exams, before going to Harvard and MIT.

Casual observers often mistake his modest demeanour and collegial style for a lack of assertiveness. In fact Mr Bernanke is supremely self-confident and firm in argument. "You cannot intellectually push him around," says Mr Gertler, who once shared a house with Mr Bernanke.

Mr Gertler says the only time he has ever seen Mr Bernanke intellectually defeated was when the two of them and Mr Bernanke's wife, Anna, took on Ken Rogoff, now a professor at Harvard, at chess. "Ken turned around, looked away, and still beat the three of us," he says.

Yet even Mr Bernanke's admirers admit that he lacks his predecessor's decades-long experience of markets and legendary intuitive feel for real-time data, which proved critical in times of crisis. Mr Bernanke will consult more widely, and possibly more deeply, than his predecessor.

More than any others, he will seek advice from Don Kohn, the Fed vice-chairman and veteran of Greenspan-era crises, and Tim Geithner, president of the New York Fed, the Fed's man on Wall St, who, as a Clinton administration Treasury official, battled the economic crises of the 1990s.

But his actions will determine whether he has the judgment and leadership to assess when a financial crisis risks becoming an economic crisis, and when it does so, to know how to intervene to deal with it.

"He takes moral hazard very seriously," says Mr Blinder. "That said, he is keenly aware of the central bank's responsibility not to let the economy go down the tubes. This is the dilemma."