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Should Ben Bernanke Be Reconfirmed?

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Ben Bernanke's nomination to be reconfirmed as chairman of the Federal Reserve Board passed out of the Senate Banking Committee and will next be taken up by the full Senate.

But, despite being named Time's Person of the Year for his efforts during the financial crisis, the Bernanke nomination has run into strong pushback – both in terms of tough questions from the committee and in the form of a "hold" on the nomination, placed by Senator Bernie Sanders of Vermont.

The conventional wisdom among economists is that political control over an independent central bank is regrettable and should be resisted. We like to think of the Federal Reserve as a bastion of technocracy, with monetary policy steering a course between recession and inflation just on the basis of "objective evidence" regarding the relative balance of risks (i.e., if monetary policy stays too loose for too long, we'll get inflation, but if interest rates are tightened prematurely, the economic recovery will stall.)

But the fact of the matter is that, in any well-functioning democracy, independence is earned based on credible and ultimately successful actions — not granted for all time and without conditions. The questions raised about Mr. Bernanke's performance in office and his likely future actions are almost entirely appropriate – and focus attention on a major weakness in the case for his reappointment.

The issue is what economists like to call "time inconsistency," but which everyone else just regards as common sense: If I swear up and down that I won't bail out your firm in a future crisis, will I really keep this promise when the crisis hits and the consequences of "no bailout" look absolutely awful? And if you know that, most likely, the bailout will be there irrespective of how you behave, for example because your firm is so big relative to the economy – why should you be more careful or take less risk?

Bernanke's problem is that he says he won't help big banks when they next get into trouble. But is this plausible?

To be fair, Bernanke does not refuse to talk about the problem that is widely known now as "Too Big To Fail" or the repeated boom-bust-bailout cycle that is increasingly referred to in official circles as the "doom loop." But, when asked what will break this loop, his answer is weak:

"A new regulatory structure should address this problem. In particular, a stronger financial regulatory structure would include: a consolidated supervisory framework for all financial institutions that may pose significant risk to the financial system; consideration in this framework of the risks that an entity may pose, either through its own actions or through interactions with other firms or markets, to the broader financial system; a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; and a new special resolution process that would allow the government to wind down in an orderly way a failing systemically important nonbank financial institution (the disorderly failure of which would otherwise threaten the entire financial system), while also imposing losses on the firm's shareholders and creditors. The imposition of losses would reduce the costs to taxpayers should a failure occur."

In other words, "if big banks should fail in the future, we'll take them over and impose meaningful losses on creditors."

But this is simply not plausible – and don't take our word for it, look at the probability of default implied by the Credit Default Swap (CDS) spreads for Bank of America. The market view is that Bank of America, despite all its problems and a risky balance sheet, is only slightly more likely to default than is the United States government (which, despite recent rhetoric, is still one of the most reliable borrowers in the world). The market view for all other major US banks is essentially the same.

In other words, Mr. Bernanke's key audiences – in financial markets – do not find him credible on the central issue of the day, presumably because he is unwilling to condone measures that would ensure today's massive banks become "small enough to fail." If potential creditors do not fear losses, they will provide funds on easy terms to our big banks and we will re-run some version of our previous bubble. This is how our financial system works.

The Senate will decide soon, but Mr. Bernanke has made his case and the market has already voted.

Given his testimony, his written response to Senators' questions, and the market reaction, we recommend that Mr. Bernanke not be reconfirmed.

By Peter Boone and Simon Johnson

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