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Bernanke's Next Term May Be Even Harder than First

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WASHINGTON - For Federal Reserve Board Chairman Ben Bernanke, winning President Obama's approval to run the central bank for another four years may have been the easy part.

The Fed chief now faces a Senate that, though likely to approve his nomination, will only do so after putting him through the wringer over his missteps. Once Bernanke begins a second term next year, he will face more pressure to take back the trillions he has dumped into the market - all while not knowing how Congress may change the Fed's role as it considers a dramatic revamping of financial regulation.

"This is probably going to be one of the most challenging four years that has ever faced any Fed chairman," said Oliver Ireland, a former Fed lawyer who is now a partner at Morrison & Foerster LLP. "You have to get the economy back on keel, and you're also looking at substantial changes in the regulatory structure that involves the Fed in ways we don't know yet."

Randall Kroszner, a former Fed governor, echoed that sentiment and said the central bank faces three core challenges: stabilizing the economy, withdrawing liquidity and regulatory reform.

"Each one is a very big challenge but the Chairman will face all three in the next four years," he said.

In the hours after Obama and Bernanke stood together Tuesday in a school on Martha's Vineyard, Mass., to announce the nomination, agreement was nearly universal that the Fed chief's first priority during a second term would have to be withdrawing all the liquidity the central bank has supplied to financial markets.

"The largest challenge he and the Fed face is when and how to withdraw the stimulus," said Robert Litan, a senior fellow at the Brookings Institution. "They want to do it in a way that defangs inflation before it rears its ugly head but without kicking the economy back into a recession."

The Fed's balance sheet has swelled to accommodate the central bank's myriad programs to provide the banking sector with liquidity. On the day Bernanke took office, Feb. 1, 2006, the Fed recorded $834.6 billion in total assets. This number rocketed to $2.1 trillion last week, and some Fed officials have said they expect the balance sheet ultimately to top out at $2.5 trillion.

The programs, ranging from cash and Treasury auctions to aid for investment banks and money market mutual funds, have been credited with helping the financial industry avert disaster. But if the economy begins to recover while that money is in the marketplace, the prospect of inflation rises.

Bernanke and other Fed leaders have spent months playing down the risk of inflation, reminding audiences that most of the central bank's assets can simply roll off the balance sheet as they mature. But others worry that the Fed's policy will not be so simple, especially with longer-term holdings.

"It's a lot harder because they bought more relatively long-term assets like mortgage-backed securities and longer-dated Treasuries," said Steve Wyatt, the finance chairman of the Farmer School of Business at Miami University in Ohio.

The Fed holds $736.1 billion of Treasuries on its balance sheet, of which more than $333.4 billion matures in more than five years.

Still, Kurt Karl, the chief U.S. economist at Swiss Re, said the Fed could manage its portfolio of Treasuries and mortgage bonds by selling the securities periodically.

"You're kind of holding it and selling it from time to time, or holding it to maturity until the loans get repaid," he said. "I don't see any major issues there. Even under stressful conditions, the MBS markets have been quite liquid in many parts."

Beyond tending to the Fed's balance sheet, Bernanke faces an uncertain future when it comes to regulation. The Obama administration's proposed regulatory revamping would hand the Fed systemic risk authority and take away its consumer protection powers.

If the Fed wins systemic risk powers - a big question mark, given congressional sentiment - much of Bernanke's time could be spent overseeing institutions that would suddenly come under his purview, including thrifts and the largest financial companies.

"How's that going to work out?" Ireland asked. "There are enormous practical challenges."

The Fed has toughened its oversight of consumer protection, most recently in a 660-page proposal introduced last month that would enhance disclosures for mortgages, home equity lines of credit and fees paid to originators. Robert Gnaizda, who is of counsel to the Black Economic Council, said he hopes Bernanke will take advantage of Obama's backing to use his bully pulpit more when it comes to consumer issues.

"I think he will," Gnaizda said. "This is a statement that he's free to do so."

Others said the Fed would continue to focus on consumers if Congress left it the authority to do so while also paying more attention to capital regulations, including the Basel II standard.

"You're going to see a major reevaluation of Basel," said Mark Calabria, the director of financial regulation studies at the **Cato Institute.**

Bank and thrift regulators spent years haggling over the Basel II capital standard before agreeing to a final version in 2007. In the crisis' wake, the rule has been criticized for not accounting for off-balance-sheet assets and its light treatment of mortgages.

Though the banking agencies have sparred as they responded to the market turmoil, Bernanke's renomination was greeted with praise by his fellow regulators.

Federal Deposit Insurance Corp. Chairman Sheila Bair said Obama "could not have made a better choice."

His reception will probably not be so positive in the Senate, which must vote on the nomination. Calabria, a former aide to Sen. Richard Shelby, the top Republican on the Senate Banking Committee, said as many as 20 senators might vote against Bernanke.

"There are a lot of people in the middle gauging what they'll do with their vote," he said. "One of the problems with Bernanke is there has never been a recognition on his part that the Fed was at fault in any way."

Senate Banking Committee Chairman Chris Dodd said the renomination is "probably the right choice" but promised a "thorough and comprehensive confirmation hearing."

Sen. Shelby said the committee should "carefully examine the impact of the Fed's failures as a bank regulator, how such failures contributed to the financial crisis and whether Chairman Bernanke's performance as the chief regulator merits his reconfirmation."

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