Introductory Remarks before the Conference on
Federal Credit and Insurance Programs

Federal Reserve Bank of St. Louis
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Welcome to the Federal Reserve Bank of St. Louis' 30th Annual Economic Policy Conference. This year's conference theme is "Federal Credit and Insurance Programs." We have assembled an outstanding group of scholars and policy analysts to discuss the current status and likely future direction of several important federal government programs for credit and insurance.

I'll frame the policy debate from an economist's perspective. Imagine a world in which every household could borrow and lend as much as it wanted within its lifetime budget constraint. Within the budget constraint, the timing of consumption could be divorced from the timing of income receipts. In this idealized world of complete financial markets, households and businesses can utilize their lifetime financial resources and manage their financial risks in the most advantageous way possible via private trading. Interest rates determined by the free exchange of claims on purchasing power over time would regulate the credit market. Suppose also that every household could insure itself financially, or sell insurance if it chose, against all possible future misfortunes. The insurance market would clear when all contracts were voluntarily settled at what economists call actuarially fair prices.

Moreover, suppose that all the information needed to make good decisions were available without cost. In this economy, every household's economic welfare would be as great as possible given the economy's finite resources. Economists describe such a world as one with perfect and complete markets.

If we lived in a world of complete markets, would there be any need for government intervention into financial markets? Government intervention into credit markets would probably not be an efficient way for society to deal with problems of income distribution and externalities. Thus, I think the correct starting point for analysis is a presumption that there is no justification for government intervention in private financial markets.

Justification for intervention requires two steps. First, that market failures can be corrected by intervention and, second, that actual functioning of government, in the real world and not in an ideal world, makes such correction possible and productive for society.

Perhaps the appropriate starting point for analysis of market failure in this context is that information is a valuable and sometimes scarce and costly good to obtain. Moreover, because debt contracts cannot be enforced to the point of slavery, credit markets do not and cannot allow a household complete flexibility in consuming its lifetime wealth nor do insurance markets allow protection against all conceivable risks. Indeed, in our own nation's distant past, private markets for credit and insurance must be described as primitive. In some parts of the world, the same is true today.

Economists have created an enormous literature exploring the imperfections and incompleteness of actual financial markets during the 50-plus years since Kenneth Arrow, one of our distinguished panelists, and a few others first wrote down mathematical models of an idealized economy of complete markets.[1] The roster of market failures enumerated by another of our distinguished panelists, Joseph Stiglitz, includes:[2] 1) failures of competition, 2) public

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[1] Kenneth J. Arrow and Gerard Debreu, "Existence of Equilibrium for a Competitive Economy," *Econometrica* 22 (1954), pp. 265-290.

[2] Joseph E. Stiglitz, *Economics of the Public Sector* (New York: W.W. Norton and Company, 1988), Second Edition.

goods, 3) externalities, 4) incomplete markets, 5) information failures, and 6) macroeconomic failures, sometimes also termed co-ordination failures.

We recognize that a market failure is a necessary, but not a sufficient, condition for improving welfare through government intervention. Market failure is not a sufficient condition because governments also fail and they do so for systematic reasons explored in the public choice literature. Professor Stiglitz lists four principal reasons for government failure when attempting to correct a market failure: 1) limited information, 2) limited control over market responses, 3) limited control over bureaucracy, and 4) limitations imposed by political processes.

The first two reasons for government failure remind us that some market failures simply are intractable—that is, the same limitations that cause markets to perform poorly, such as insufficient information available to participants, may prevent government intervention from improving matters. The second two reasons for government failure—limits on effectiveness posed by bureaucracy and the political process—are handicaps government itself brings to the situation. Moreover, it is important to recognize that some government failures may be inherent in the nature of democracy.

Thus, we must keep in mind that identifying a market failure is not enough to justify a government intervention. We also must satisfy ourselves that any government failures that might result from the proposed intervention do not do greater harm than good.

Today, government interventions are extensive in private markets for credit and insurance in the United States and around the world. The record of government intervention in these markets is mixed. Part of the problem may be that interventions once appropriate are not phased out as conditions change. Thus, every government credit program deserves frequent evaluation and re-evaluation, and such an evaluation is the agenda of this conference.

The subject is a huge one, and not every issue can be examined in a single conference. Our sessions cover a range of federal programs in U.S. credit and insurance markets. These programs include social insurance of various kinds, loan guarantees, extensive intervention into housing and mortgage markets, deposit and defined-benefit pension insurance, and insurance against disasters, both natural and man-made, such as terrorism. Our aim is to discuss the market failures these programs are designed to overcome, and the performance of government interventions.

We have assembled a program of scholars and policy analysts of the highest rank who may disagree with each other in analyzing a particular program, but who share a common interest in examining the rationale for, and execution of, a variety of federal credit and insurance programs. I know that our presenters and discussants will shed new light on some very important programs. I believe that we will provide assistance to policymakers who are responsible for these programs.

I'll now turn the program over to Bill Emmons, who is the moderator of our first session.