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In This Issue

Satisfaction Guaranteed?

In "SPDAs and GICs: Like Money in the Bank?" (p. 2), Richard M. Todd and Neil Wallace document the life insurance industry's rapid shift toward deriving the bulk of its income from nontraditional products like single premium deferred annuities (SPDAs) and guaranteed investment contracts (GICs). They argue that continued rapid growth of this new income source is possible because of the satisfaction guaranteed clause in every life insurance policy. When policyholders buy these new products, they are promised, explicitly and implicitly, by their insurers and their state governments that their money is safe. But that perceived safety can have a high price. *Moral hazard,* a term insurers themselves use, is that price: perceived guarantees cause policyholders to have little incentive to monitor insurers and insurers to have a strong incentive to take big risks with policyholders' money. Moral hazard contributes to insurance company failures and suggests that society's resources are being misallocated. As Todd and Wallace point out, this is a situation which increasingly resembles what happened in the S&L industry.

As the number of failing insurance companies rises, the calls for more guarantees and more regulation become louder. On the surface, such recommendations seem logical. But are they? Todd and Wallace argue that increasing guarantees will only increase moral hazard. Tighter regulation might offset this, they say, but sustaining that level of control over the insurance industry would be difficult. A simpler, more effective change would be to eliminate guarantees altogether on products like SPDAs and GICs and strongly encourage insurers to make it absolutely clear to potential investors where their money will be invested.

Everything Goes?

In "Acceptability, Means of Payment, and Media of Exchange" (p. 18), Nobuhiro Kiyotaki and Randall Wright explain why an intrinsically useless object can become a money. People accept particular objects as payment in transactions because others do: The acceptance has more to do with social conventions than with the characteristics of the objects themselves. That doesn't mean everything goes when it comes to money, however. If an object is especially costly to hold, for example, it will not be accepted as a means of payment. Kiyotaki and Wright illustrate their explanation of money using a simple theoretical economic model.

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Editor