Good morning. I’m Michael Moskow, president of the Federal Reserve Bank of Chicago. I’d like to welcome you to the first of two meetings focusing on what we’ve learned from emissions trading programs.

We’re here today to examine the workings of market-based environmental regulations. Today’s presentations and discussions represent a fundamental shift in the way we approach regulatory issues. By that I mean that regulators are moving away from command-and-control strategies toward market- or incentive-based regulation. The environmental sector is one of the most important areas where these changes are playing out.

Today’s meeting is designed to help us understand how these market-based regulatory programs work. Our goal is to apply the experience we’ve gathered to improve environmental regulations currently being written and designed. As a regulator of financial institutions I’m also looking to learn from market-based environmental regulation. Recently, regulators of financial markets have been discussing ways to improve the IMF’s ability to enhance financial stability by introducing more elements of incentive-based regulation. Closer to home, the Chicago Fed has proposed ways to use an incentive-based approach in regulating banks. The goal is to determine a level of regulatory capital that applies to a specific bank based on that bank’s market risk.

This shift to incentive-based regulation came about largely because of the many problems with traditional command-and-control regulation. One of the most fundamental problems with command-and-control is an asymmetry in information and expertise. Command-and-control regulations tend to require information from the regulated firm that can’t be obtained reliably and at reasonable cost. Firms often have a significant advantage over regulators in this area. Another problem is an asymmetry in expertise. Regulated firms tend to have far more expertise in how best to achieve the desired goals. As a result, command and control regulations are difficult to implement. More importantly, the
regulations tend to be far more simplistic than the activity they regulate. Too often regulations are “one-size-fits-all” rules that involve a host of cost inefficiencies.

I've observed the regulatory process, both from the inside and outside, for more than 25 years. Unfortunately, in my experience so-called regulatory “innovation” has usually meant looking for better ways of applying the existing framework. In most cases, regulators are well-intentioned and creative people, but they are limited by rigidity of the laws they’re required to carry out.

Today we're looking at a completely different approach - a truly innovative approach. Incentive-based regulation draws on the expertise and self-interest of firms to meet public policy goals. This approach helps address the asymmetry problems I mentioned a minute ago. It also helps create a cycle of continuous improvement as firms have an incentive to constantly develop new and better ways of achieving regulatory goals.

A second point I'd like to make is the need for regional solutions to regulatory issues. This is one of the principal findings of the Chicago Fed's comprehensive study of the trends facing the Midwest economy. We held a series of workshops featuring leading experts who presented research on a wide range of issues. The study looked at many different aspects of the regional economy—global linkages; the labor force and education policy; the rural economy; tax and regulatory policies; the performance of metropolitan areas; and changes in the manufacturing sector. One of the strategies to come out of this project called for greater attention to developing public policies on a regional level. As we go forward, it’s important that we search for ways to sustain the region's strong economic performance.

Environmental regulations designed to meet and exceed the required goals in the most cost-efficient manner can certainly play a part in this effort. And I’m quite sincere when I say “exceed the required goals.” The Midwest will need to do all it can to improve its quality of life — including having clean air and water — if it is to attract America’s increasingly particular workforce in the years ahead.

Fortunately, emissions trading programs are taking this regional approach. The first session on today's program features Connecticut's experience in emissions reductions trading. This afternoon we'll hear about a program for the Los Angeles basin, where permits have been traded for over four years now. Here in the Midwest, regional efforts have been underway as well. The states in the Chicago Fed's district, Iowa, Illinois, Indiana, Michigan, and Wisconsin, are part of the Ozone Transportation Assessment Group [OTAG]. Under the leadership of the Illinois EPA, this group of 37 states last June proposed regional solutions to the ground-level ozone problem.

Incidently, the Illinois experience with emissions trading provides some interesting lessons about designing regulation. More than 5 years ago, the Illinois EPA began to develop a regional emissions trading program for the Chicago area. It originally considered a program designed to control nitrogen-oxide emissions. Later, air quality modeling found that the first priority for controlling ground-level ozone in Northwest Illinois was not reducing nitrogen-oxide, but reducing volatile organic material emissions. The modeling showed that, unlike Los Angeles, the Chicago area would actually experience an increase in ground-level ozone concentrations if local sources reduced emissions of nitrogen-oxide. Unfortunately, these results could not be explained by El Nino. In response, the Illinois EPA switched from nitrogen-oxide concerns and developed what will be the nation's first emissions trading program in volatile organic matter. This program is called the Emissions Reduction
Market System [ERMS]. It has been signed into law and its first reduction requirements will become effective next summer.

This example illustrates the need for regional solutions in air quality regulation. Air is a transportable element whose quality can be affected by upwind sources. Air quality does not respect state or municipal boundaries. When we want to control it, we must consider a regional, national or — in the case of greenhouse gases— international approach.

The bottom line is that our approach to cleaning up the environment, much like our approach to economic growth and development, should involve working together across much wider geographic boundaries than we’ve been used to. And we will need to cross intellectual and cultural frontiers as well.

I expect today’s meeting to contribute to these efforts and look forward to a lively discussion and exchange of ideas. I’m particularly pleased that we’ve attracted a large and diverse audience, including regulators and the regulated community, public interest groups and academics. Much of the credit goes to Dick Kosobud, from the University of Illinois at Chicago, who arranged today’s program.

With that I would like to turn the floor to Dick Kosobud...