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The Honorable John W. Snow
U.S. Secretary of the Treasury

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Questioners: Abby Joseph Cohen
Managing Director, Goldman Sachs

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Introduction

Chairman Barbara Hackman Franklin

Good evening and welcome. I'm Barbara Hackman Franklin, Chairman of the Economic Club of New York. And it's my great pleasure to welcome all of you, our members and our guests, to the 378th meeting in the 97th year of the Economic Club of New York. We're very pleased tonight to have our Treasury Secretary, John Snow, as our guest of honor, and we will hear from him a little later. Our speaking program will begin at the conclusion of our dinner service. And at that time, I'll introduce Secretary Snow, our two questioners, and we will proceed and will conclude promptly at 9:30 so you all can get home. For now, please enjoy your dinner and your table companions.

(DINNER IS SERVED)

Chairman Barbara Hackman Franklin: Good evening again. I have the happy task tonight of introducing our most honored guest, the Secretary of the Treasury, John W. Snow. Now as we all know, the Treasury Secretary is the principal economic advisor to the president, developing and recommending both domestic and international financial and economic policy. This focus on economic policy is always of great interest to us, to our members, and we're delighted whenever we can welcome a Treasury Secretary as our guest of honor.

John Snow was nominated by President Bush to be the nation's 73rd Treasury Secretary in January of 2003. He was quickly and unanimously confirmed by the United States Senate and sworn into office on February 3, 2003. He was originally scheduled to appear here shortly thereafter, but that event was postponed because of the war in Iraq. He's returning tonight to honor his commitment which we appreciate and he now joins a distinguished group of treasury secretaries – he is number 16 – who have addressed the Club.

John Snow is a most unusual and multifaceted individual. Academically, he seems to have it all – a bachelor's degree, a PhD in Economics, and a law degree. Before Treasury, his career spanned both business and government, mainly in the field of transportation. He got his start along that path as a young man when he was a driver on a Mister Softee ice cream truck. From that modest, but very practical beginning, he became a bigger and bigger wheel – bad pun intended, John. By the 1970s, he was serving at the U.S. Department of Transportation in a variety of positions including administrator of the National Highway Traffic Safety Administration, Assistant Secretary for Governmental Affairs and Deputy Secretary.

That exposure to transportation led him to the railroad business. He joined the CSX Corporation rising to become Chairman and CEO. He led that company through a period of tremendous change, refocusing on its core railroad business, and improving its financial performance.

Secretary Snow has also been a leader in the broader business community. As Chairman of the Business Roundtable, he played a major role in supporting the passage of the North American Free Trade Agreement, NAFTA. And as co-Chairman of the Conference Board's Blue Ribbon Commission on Public Trust and Private Enterprise, he and his fellow co-Chair, our own Pete Peterson, championed the need to improve corporate governance.

He understands the importance of small business in our economy, and as Treasury Secretary has promoted policies to strengthen that entrepreneurial environment. He's been a strong advocate for tax reform as well as tort reform, a sane relationship with China, while leading the effort to track terrorist money internationally.

Through all this record of accomplishment, and in the 30 years that I have known him, this man has grown, but he hasn't changed. He's still intellectual, thoughtful, self-effacing, a natural leader who is known for integrity and guts. It's a great honor to introduce him tonight, John W. Snow, United States Treasury Secretary. (Applause)

The Honorable John W. Snow

U.S. Secretary of the Treasury

Thank you. My gosh. Barbara, I appreciate that nice introduction. It could have just gone on and

on and on, and I'd have been delighted. Barbara let out a secret, a dark secret, that shouldn't be out, and that is that your speaker tonight is clearly educated beyond his depth. (Laughter)

As I look around the room and the head table here, I see so many old friends that if I started to call attention to all of them, I'd spend the whole evening doing that. Let me say it's wonderful to be here in the midst of so many old friends with a society that has had years and years of an important role to play in the economic dialogue of the city and of the nation. You mentioned, Barbara, the Blue Ribbon Panel, the Conference Board Blue Ribbon Panel on Corporate Governance. I'm not sure Mr. McDonough here on my left is so happy that all that happened and he's where he is now, but I sure am glad he is because he's doing an absolutely terrific job there.

You know the American economy today is regaining its feet. It's moving in the right direction. And that's after a series of body blows or assaults that make it pretty remarkable when you think about it that we are where we are today. And at the same time, at the same time we see the American economy growing, expanding, with fundamentals well in place for continuing good growth and expansion and job creation. We look at a world economy that looks pretty good as well. No crises, no financial crises anywhere on the globe today. That's pretty remarkable. Go back ten years. We've seen the spreads on sovereign debt fall practically across the board. We've seen the volatility come down. We see the global economy enjoying growth rates today that are the highest in 20 years.

And as I say at the forefront of all of that is the engine of growth for the world economy, the United States, and the policies with which the United States is so well identified, whether it's this administration or the prior administration that had able people like Tim Geithner in it. We continue to point the way; I think it's fair to say, in the world economy, to the right set of policies to make the world economy function better – trade, open markets, free flow of capital, and fluctuating exchange rates.

Why do I mention fluctuating exchange rates? I think when we look at the world economy today, fluctuating exchange rates are one of the prime reasons, one of the prime reasons we don't see the crises that we saw in the past. Because through fluctuating exchange rates, we introduced a natural adjustment process, a buffer, a buffer that avoids the buildup of pressures, discontinuities, and imbalances, that unless released, unless released end ultimately in discontinuities and crises.

That's why we have been so forceful through the G7, through the G20, in advocating greater flexibility of countries' currencies in their exchange rate. And we're making progress, we're making progress. The G7 has now embraced the notion of greater flexibility in currencies. The G20 has embraced the notion of greater flexibility. And that's a landmark development. It was only a year ago that many people thought that wouldn't be possible, but now it's the established policy of the leading countries of the world.

And, of course, China is the focal point of a lot of this attention because with the pegged currency, the RMB, pegged to the dollar, we don't have the flexibility that we and the G7 and the G20 see as desirable. And the G20 just met down in Chile and made that point again. It's a point I've made to the leadership of, the economic policy leadership and the political leadership of China.

And the response we've gotten back is, yes, we agree with you. We agree with you. We can't go there tomorrow, but we understand that moving to flexibility of the exchange rate is important. It's important for our own purposes. It's important so we can use monetary policy the way you use monetary policy in the United States to maintain the stability of the currency and to maintain in domestic purposes, maintain, use monetary policy to promote growth – true policy, the true purposes of monetary policy. But yet China today can't use monetary policy for those purposes. It's really on the shelf because it's supporting the exchange rate and therefore isn't capable of being used freely with respect to the domestic economy.

The Chinese have now acknowledged that's a problem. They've acknowledged it's a problem. And they're taking a number of steps to address the financial architecture of the country so they can move to flexibility. By financial architecture I mean allowing easier capital flows in and out, allowing interest rates to play a larger role in allocating capital within the system, developing

finance mechanisms like auto finance which they're moving to, cleaning up the bad loans, offloading some of those bad loans back as we did in the S&L days to leading financial institutions of the world including some represented right here in this room.

And in a, I think, dramatic development that shows the direction they're going, they recently entered into a Memorandum of Understanding with the Chicago Mercantile Exchange to set up a derivatives market on their currency. Now there's no need to have a futures market on a currency that's pegged, is there? Right? I think that's a pretty telling development. So we're moving the right way. And it's awfully important that we engage China in the right way – Barbara Franklin and I were talking about that – for the sake of the world economy. For the sake of our economy, for the sake of their economy, for the sake of a more prosperous planet, it's important that we embrace China in the right way.

And many of you in this room, I know, are trying to do that. Looking to my left here and seeing Bill Rhodes, let me pass a compliment again to him on something he's worked on that has been very important in strengthening the whole issue of sovereign debt, and that's the so-called CACs, collective action clauses in sovereign debt. More and more, that is becoming the hallmark of all issuances of sovereign debt. What it means is it's a built-in, workout mechanism when a country gets into trouble with its debt and it's an important new part of the global foreign sovereign debt picture. Bill, I thank you for continuing to lead the parade there to make those CACs, those collective action clauses more widely available.

So what I've said is the American economy is back. It's sound. It's going the right way. The global economy is moving the right way. Maybe a word or two on the U.S. economy. The U.S. economy leads the world and our ability to grow the way we've been growing has made possible faster growth rates all across the planet. There's no doubt about that. One of the problems, though, is that you can't have just one engine of growth. And for too long we have been, among the industrialized countries of the world, that one engine of growth.

And that's why when the president went to Sea Island with the other heads of state; he put on the table a proposal for an agenda for growth. That agenda for growth – set of ideas – came out of some prior meetings with the finance ministers where we talked through the problem of deficiency in global growth and the fact that the United States can't continue to grow at a differential rate to the rest of the world as we've been doing without imbalances, important imbalances that show up in things like the current account coming to the forefront. And that's now widely accepted. But what produces growth in the United States, because we have a unique economy, isn't necessarily what is best designed to produce growth in Germany or Japan or France or Italy.

And so the idea here was that each country would pledge to take the steps necessary to create greater growth in their own economy, that they would seek to remove the impediments to

growth. Now what are the impediments to growth around the world? Well, it's things that get in the way of markets working well basically. In Germany, you know what it is, it's labor markets and tax rates. In France, it's pensions that take too large a share of the GDP. In Japan, it's a banking system that needs to get fixed so it can release resources for the rest of the economy. It's capturing resources that are best used in other sectors. Each of the G7 countries has now pledged to take the actions with respect to their economy which was essential for their growth. I think that is a really and truly important development and the president has played a leadership role in making that possible.

And a year and a half ago, two years ago, when I came in to this position, the American economy needed some help too because it wasn't growing very well. We had growth rates in that first quarter of '03, of what, 1.4%, well below the growth potential of the American economy. And I remember distinctly conversations with the president on the subject when I was being interviewed for the job, talked to about the job, on tax policy and what could be done with tax policy. I remember, in fact, the conversation with him where he said to me what do you feel about the proposal on the dividends? The president's economic advisors, and I think one of the most important, Glenn Hubbard, is in the room – who really played an awfully important role in what I'm about to talk about – he said, what do you think about this proposal on dividends?

And I said, well, Mr. President, I think it's a good idea. He said, well, you know, there's some talk that maybe we should only go halfway. We should have a 50% exclusion on the dividend,

not the 100% exclusion. What do you think of that? And I said, well, Mr. President, I'll tell you where I come from on that one. There's a principle here that everything, all income, ought to be taxed once, but I'm not aware of any principle that says you tax it once and a half. He looked at me and he said, John, you know, I always work better when I'm moving from broad principles and we moved on to another subject, but while the newspapers continued to cover the subject as if there was some strong chance that the administration would come forward with a 50% exclusion. Glenn, you were successful, wherever you are out there, you were successful. And I knew you were going to be successful. Okay, well, I'm glad you did that. I'm glad you did that because it was the right thing. It was the right thing to do.

And the tax cuts, the so-called Jobs and Growth Bill that the president sent to the Congress back then in early 2003 that finally carried the day in May, overwhelmingly, I remember this well, overwhelmingly, 50-50 tie in the Senate broken by the vice president, that legislation made a difference. It's made a real difference. It put some oxygen into the economy at a time when the economy needed some oxygen. It breathed some life into the economy. And it was good short-term tax policy, but it was also good long-term tax policy because it did reduce the tax on capital, particularly the tax on equity capital. It did produce lower marginal tax rates.

I think it's an axiom of economics that you always get less of anything that you tax, anything that you make more expensive. So if you make the formation of equity capital more expensive, you can expect to get less equity capital. If you make taxation of risk taking higher, you can

expect to reduce risk taking. If you tax work, industry, and effort harder, you can expect less of that. So the reductions in marginal tax rates, they help the economy in the short term, particularly the expensing provisions for small business, but they also will help the economy in the long term achieve higher sustainable growth rates.

And we're seeing it now, we're seeing it. This economy is performing pretty darn well. We've had the highest GDP growth rate in 20 years since those tax cuts took effect. We've had 12 months now of job creation. The unemployment rate has marched down from 6.4 to 5.4. In 49 of the 50 states, the unemployment rate is lower today than it was a year ago – 1.7 million jobs created. You know those numbers. I was reciting them to the president recently. And I told the president that I was convinced that his Jobs and Growth Bill made a big difference. When we were walking out, the vice president said, but John, did you forget who made that possible? No, I said, I didn't, Mr. Vice President, we're always going to be grateful to you for that. So we're on the right path. It looks to us like we're going to have growth rates in the second half of the year between 3 ½ and 4. When you're growing at 3 ½ to 4% you're able to create lots and lots of good jobs.

But now let me deal briefly with an issue that must be on the minds of many of you and that is did the tax cuts come at too high a price? Too high a price in terms of long-term deficit and debt levels of the country? That's a fair question. I saw my old friend Pete Peterson and I told him I was going to try and take this issue on. And he said, he unfortunately couldn't be here for the

dinner but he was going to come back hopefully and was going to ask for equal time.

Let me, this is a serious issue, when you cut taxes you create a lot of positive effects on the economy that I've outlined and dealt with, addressed. But you recognize when you do it that government receipts, government revenues for a time are going to come down as well. It's the price you pay for doing it – some reduction in government receipts at least for some time until the growth really clicks in. Now that's a conscious decision, isn't it? From my point of view, it was the right decision. It was focusing on the priorities of the moment.

What the president faced was another deficit – a deficit in growth, a deficit in jobs, a deficit that was limiting the potentiality of the American economy, and the potentiality of a lot of people. We estimate that about 3 million more people have jobs today than would have had jobs but for those tax reductions. But it did, did, reduce government receipts.

Now, the urgent problem, the immediate problem was creating growth in jobs. We had the opportunity to focus on the deficit later and that's what's being done now. Let me make it real clear to everybody. We agree that deficits matter. I've long been from that school of thought. So is my partner in all this, Steve Friedman, from that school of thought. Deficits matter. The size of the deficits today is too large. They're unwelcome, and they're going to be dealt with. The president is committed to cutting them in half over the course of the next five years.

But let me say they're understandable. They're understandable when you lose $7 trillion because of the bursting of the equity market bubble. Seven trillion dollars, that's a larger amount than the economy of Germany and Spain and Italy put together. That's what came out of the U.S. economy. And when that market was moving along the way it was back in the late 90s, government receipts rose to a level we'd never seen before, over 21% of GDP. Never seen it before. It was terrific – Tim sitting over in Treasury in those days.

But then the bubble burst. And then we got the recession, and the recession came. And then we got 9/11. And then we got the wretched corporate scandals, really sort of unthinkable behavior, shocking behavior in corporate boardrooms and CEOs and so on. Plain, outright fraud in many cases where not just the corporate people,, but the other gatekeepers, the people who were supposed to be watching out for investors' interests – lawyers, accountants, boards of directors – failed in their responsibilities. That shook confidence in our equity markets. I think it still is an overhang. Bill, again let me say I'm grateful of where you are doing what you're doing. That was a real blow because it shook trust. And once you shake trust, it's awful hard to get it back. We're still trying to rebuild trust.

So there have been a lot of body blows to this economy, but we're now coming back as I say. And as I meet with central bankers and meet with finance ministers from around the world,

invariably they come to the question, how could the American economy be doing so well in the face of all that it's been hit with – probably the most serious set of challenges that any administration has faced in terms of the economy in modern times, maybe as far back as FDR. But on the deficit, again I want to be clear, we're on the watch. Deficits matter. They're too large. They're unwelcome, and they're going to be reduced. But how do you reduce the deficit? That's the question. How do you reduce it? Well, you've got to have growth in the economy to reduce it because growth in the economy creates jobs, profitability, profitable enterprises, better equity markets, eventually, and therefore more receipts. And we're now seeing, as the economy is doing better, we're seeing the receipts come up, coming up pretty markedly. That's why we were able to take the estimate for this year's deficit down quite markedly, by some $70 billion. And Wall Street has estimates that are even larger than that.

But it's not enough. It's essential. Growth is essential to bring the deficit down, but it's not enough. It's not sufficient. We also need to watch spending. And spending has been a problem – we acknowledge that. And the president has sent to the Congress a budget that outside of these priority areas of defense and homeland security is the tightest on spending, on discretionary spending in decades – less than one-half of one percent. If we stay on that course, a course of growth in the economy – we've got to have growth – and tight spending, we'll be able to cut the deficit, I'm confident, in half over the course of the next five years.

What does that mean? Well, the deficit has averaged about 2.2, 2.3, 2.4% of GDP over a 40-year period. By cutting the deficit in half over this five-year period, it will come down to a level which is low by historical standards. It'll come down to about 1.5%. And at that level it's quite manageable. It's low by historical standards. But you're saying you haven't addressed the other deficit, the other deficit that many people think is equally serious or more serious and it's related to it – the current account deficit that I'm sure David is going to ask me about later, or Abby.

I'll take a minute on that briefly. The current account deficit really reflects the fact that America is not generating a lot of savings, but the rest of the world is. And the savings of the rest of the world are finding their way to the United States because the United States on a risk-adjusted basis is the best place to put capital. Now the reason the rest of the world is generating so much savings is that they don't have enough investment opportunities. They aren't investing, because they aren't growing. That's back to this agenda for growth – they've got to grow faster.

Higher growth rates in the rest of the world would mean they buy more from us. It would also mean they'd have more good investment opportunities for their higher rates of savings. That would help. For our sake, we need to encourage more savings in the United States. That's why we've sent to the Congress proposals, tax advantage proposals to encourage savings – things called lifetime savings accounts and retirement savings accounts and so on.

Some combination thereof higher growth in the rest of the world, better investment opportunities in the rest of the world to absorb some part of those savings and higher savings rates in the United States – partly augmented, partly facilitated by reducing the dissavings, dissavings of the deficit – I think clearly holds the keys to resolving that problem. It's an imbalance in the world economy, but the best way to get at it is higher growth rates in the rest of the world and higher savings rates in the United States.

Now with that, I think I may have gone over my time a little bit, but I look forward to the questions. Thank you very much. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN BARBARA HACKMAN FRANKLIN: Thank you very much, Mr. Secretary, for that overview, extensive overview of our economic situation, policy matters, China. We appreciate that. So we'll turn to our questions, questioners. On my right is Abby Joseph Cohen from Goldman, and on the left is David Malpass who is the Chief Economist...I'm sorry, Managing Director, I should have said that, Abby, of Goldman, and Chief Economist David Malpass of Bear Stearns. Abby, the first one is yours.

ABBY JOSEPH COHEN: Barbara, thank you very much. Mr. Secretary, thank you so much for

sharing so many interesting and important perspectives with us this evening. I'd like to pursue one of the topics that you raised, and that is the question of the confidence of business decision makers in the United States. We find a situation in which corporate profits are strong, corporate balance sheets are in great condition, lots of cash available, and yet job creation has been disappointingly slow. We're moving in the right direction, but it's slower than we might like. It's been erratic. What can we do about it other than be patient?

THE HONORABLE JOHN W. SNOW: Well, that's a good question. We're still, I think, recovering from, and feeling the effects, of those corporate scandals that I talked about. Boards and CEOs are going through a process of trying to figure out what their relationship is because Sarbanes-Oxley, the important political response to those scandals, called for new behaviors in the boardroom and in the executive suites. I don't think that Sarbanes-Oxley changed in a fundamental way the basic standards for corporate governance. Boards were always supposed to oversee management and not be the handmaidens of management. Boards were expected to probe the behavior of the management team and make sure that the books were kept straight. Management teams were expected to keep the books straight. Audit Committees were expected to be on top of that. And something broke down, as I suggested earlier, in all of that. In the process of that breakdown we saw failures in the accounting, massive failures I'd say. We saw failures in the legal profession, to call attention to malfeasance. And now we have this new law, and more than the new law, I think, this new environment. A new environment in which people are saying what are my responsibilities? What are my duties? How does this new world fit?

What's the prospect of litigation? Because the prospect of litigation has gone up in the face of this new climate. And there's hardly a CEO that I have met who isn't thinking about that issue – vulnerability to litigation in this new environment – as they try and figure out what the roadmap is. What are the rules of the road here? Now to get to your question, cash flows are terrific in corporate America, aren't they? Profitability has been very, very high. That suggests there would be more risk taking, more expansion, more hiring. But in this new environment I think there is a caution, a risk adversity, a risk aversion that is a new component of corporate capitalism. I was talking sometime back to a CEO friend of a major, major company who had been active with me in the Business Council and Business Roundtable and those groups. And I was testing this hypothesis on him – that this new environment is changing behaviors in executive suites. And he said, well, I don't know, but I'll tell you a story. He said, I've been CEO nine years and I recently went to the board with a major capital program. He said, I thought to myself, as I was doing that, if I had been a CEO for one and a half years, still trying to get my relationship with the board established, would I be so bold as to go forward with a multibillion dollar capital program? I think the question invites the answer. Probably not quite so bold. It takes a while for CEOs to develop that relationship with boards that really is comfortable. And we've had an awful lot of turnover in CEOs, and there are an awful lot of CEOs who haven't been CEO for two years sitting around the Business Roundtable these days, Bill. Do I think this has affected? Absolutely Abby. I think there is a new dynamic where, maybe an appropriate prudential behavior on the part of managements, but if goes on too long, it's going to shortchange our economy. It's going to shortchange the economy because what are managements supposed to be

doing? Managements are the element of our society who are supposed to take capital and make well-advised bets with it. Right? That's their job. And we know that when you make a decision like investing in this new technology, investing in this new market, taking the company into new markets in other parts of the globe, that it's risky, which means you don't know the outcome when you do it, which means you could be wrong. And as long as being wrong gets penalized too much, it means an awful lot of right decisions don't get made either. So I think we're going to have to sort our way through this for some time. But I don't – let me be clear – don't fault Sarbanes-Oxley here. I do fault the perpetrators of these wretched behaviors for putting us in this environment. I think corporate America has really gone a long way to cleaning up its act. I know the accounting profession has gone a long way to cleaning up its act. But I think it's going to take us a while, Abby, to get through this process of understanding the rules of the road in this new environment. Has it had a negative effect? I think it almost certainly has.

DAVID MALPASS: Thank you very much. And Mr. Secretary, thank you again for speaking to us tonight. My question is on; my first question is on tax reform. Could you discuss the process that – this can be hypothetical if you'd like – that might happen in say 2005 or 2006, you can tell us the time frame if you want to give us a hint, and what the principles might be. So on process I'm thinking, in the 1986 tax reform there was an extensive Treasury effort in 1982, '83, '84 to define some of it. And in terms of principles there came out the idea of a broader, lower rates on a broader base. So this time around might we be thinking about lower taxation of capital or of investment or of savings? Or is there a mantra that we can begin thinking about?

THE HONORABLE JOHN W. SNOW: David, that's a good question. Let me answer it as far as I can go at this time. The president recently announced that fundamental tax reform is something he wanted to pursue. He defined fundamental tax reform in terms of basically fairness, make the code more fair – simplicity – make it less complex, less burdensome to deal with – and more growth-oriented, more a code that will help business be more entrepreneurial, grow and expand. Those are the broad concepts. The president directed the Treasury Secretary to come forward with a set of recommendations to him and he called for establishing a bipartisan panel to present options to the Treasury Secretary. Now as early, I think the wording was as early in '05 as possible. You've spent time in Treasury. You know that the Office of Tax Analysis is always looking at modifications in provisions of the code and trying to price them out and see what effects they would have in terms of the deficit or in terms of revenue generation or in terms of GDP growth. I look forward to this new assignment. It's going to be, I think, a fairly all-absorbing assignment. I think the '86 experience that you know well is very instructive here. And the whole undertaking in the Reagan administration was shrouded in silence. Very little was said. Now why is it important to follow that sort of rules of engagement? Well, if you don't, everything gets out and everything is shot down before it gets a chance to really be moved through the process. I would think that sort of approach would make sense. I look forward to engaging with this panel and working with them on their options. But I'm heartened that the president has decided to make fundamental tax reform, which is never easy to do, never easy to do, a frontal piece of his national economic policy agenda. I wish I could go further, but if I do,

I'd be violating the very rules that I think are essential for ultimate success.

ABBY JOSEPH COHEN: Mr. Secretary, (AUDIO ENDS AND CONTINUES) that comes in the second stage of the cycle as jobs are created and you've addressed why that is happening more slowly this time around. But also in many previous cycles, we've enjoyed a surge of economic energy as the rest of the globe gets stronger and the United States, which has often been the world's largest exporter – not just the world's largest importer – but the world's largest exporter, has benefitted from that. Right now we have two extremely large trade deficits – one with China in large part because they don't buy anything from us. But the other one that people forget about is the extremely large trade deficit with Europe. Our exports to Europe have not grown since 1997. Do you have any thoughts on a micro-level that can be used to think about approaching each of these two deficits?

THE HONORABLE JOHN W. SNOW: Well, Abby, the deficit with China is too large. We know that. I don't think it's sustainable. That's why we're pressing the Chinese continuously for more market openings, to stop ripping off our ideas with their fraud on intellectual property and that's what it is – we might as well call a spade a spade there. And they know it. I mean we've had, I've had conversations with the premier himself and he acknowledges the piracy, the theft that's engaged in this, and it's big dollars of theft. They have in place pretty good laws on it, but they're falling short on the enforcement. And we're, Don Evans and Bob Zellick are really on the lead on that one. But on the basic question of are we getting into their markets, I think we're

getting in better. I think we're getting in better. I see a lot of financial service people over there. We're getting into those markets pretty well. Our exports are rising at high double digits, you know, but our imports are too. Actually our exports are rising a little faster than our imports, but the problem is the base is so large on the imports. Will that change soon, that is, that imbalance? Since the imbalance is so large, it's likely that it will change hugely in the short term. But it needs to change. It's absolutely clear it needs to change. And the Chinese recognize it's not sustainable and needs to change. I think the currency matter features importantly here. And we'll continue those efforts I talked about earlier to press the Chinese on greater flexibility in their currency. With respect to Europe, again I happened to be on the – I talked Bob Zellick today – I happened to be on the plane with him flying to New York, and he is pressing hard on greater market openings there, particularly agriculture. You know agriculture is a huge, just a huge issue. And he is encouraged – he's a realist but he's encouraged – that the WTO is making progress, that we're back on track for something fairly far-reaching to come out of this round. I do think that we will make progress there, but I don't have any current forecast of the imbalances or where they're going to go with Europe.

DAVID MALPASS: I'm going to ask you an exchange rate question but it's not going to be about which way is the dollar going because you won't answer that.

THE HONORABLE JOHN W. SNOW: You've asked me that too many times before, haven't you?

DAVID MALPASS: The Euro is spreading to more countries and it seems to be creating a bigger market for Europe and is one of the maybe few sources of dynamism for Europe, and they seem pleased enough with the experiment and it's continuing. Are there any lessons for us in that? I understand your point about fluctuating exchange rates. At times Fed Chairman Greenspan and others have talked about, for small countries in the Western hemisphere it might be appropriate for them to use the dollar. Are there any lessons for us from the European experience with the Euro?

THE HONORABLE JOHN W. SNOW: Well, you know the Euro is one of those really fluctuating currencies that the finance ministers and central banks and the Central Bank of Europe embrace this notion of a fluctuating exchange rate. Do you have to have a fluctuating exchange rate to achieve the sort of beneficial adjustments to the economy that you want to have? Well, probably not if you have idealized political behaviors. You know, think of the United States, we have – we don't think of it this way very often – we have a fixed exchange rate in the United States. And we probably have lots of imbalances among the 50 states and territories. But it works pretty well because there's another process of adjustment going on rather than the exchange rate. I mean it could well be that West Virginia has a big surplus with Ohio or vice versa or Indiana has a big deficit with California or vice versa. I don't know. And nobody really cares very much. Right? It's not very important. It's a fixed exchange rate with things other than the exchange rate providing the adjustment mechanism. What are those things? Well,

the free flow of capital and labor and businesses and so on – labor and capital mobility. The reason you need freely fluctuating exchange rates is it's hard to get political behaviors that allow the sort of domestic economy adjustments that are required where exchange rates are fixed. So we're going to continue until we have saints occupying the top political positions all around the world to think that probably you get better results with fluctuating exchanges rates. I know that's a point of contention with a lot of people, but it is a point of view that we have taken. I think it's the right point of view. David's been after me to tell him what's the right level of dollar versus the Euro or anything else for that matter. And I've always been quite reluctant to get into that discussion. It reminds me of a story of a predecessor who was speaking to a group, a small group, much smaller than this, and he was asked a question like the one David put to me. And he said, are there any press here? He was assured there were no press. He said, are we off the record? Are we absolutely off the record? He was assured that they were off the record. He then said no comment. (Laughter) That's troubled ground.

ABBY JOSEPH COHEN: Mr. Snow, I was going to ask you about the appropriate value for the New Jersey dollar, but I won't. Let's talk a little bit longer term. The United States will be facing a potential problem as the Baby Boomers get older, move into retirement years. What outlook do you have for the nation's pension systems? And perhaps even more troubling, what about the healthcare retirement systems? What can we do now to make sure that they're probably funded?

THE HONORABLE JOHN W. SNOW: Well, these are the large issues, the really large issues.

The fiscal deficit that I talked about, we will get our arms around I'm confident. You're putting your finger on the really far-reaching issues of the commitments, the promises that we have made basically to future generations through Social Security and Medicare and Medicaid. On Social Security, you saw that the president again entered the fray on that subject, once referred to as the third rail of American politics, on the idea if you touch that rail, you know, you're not going to be around. I think he's to be commended for doing it. It doesn't seem to me that, I mean the politics of it are difficult, but the math of it is really pretty straightforward. We started out with Social Security in...19…what, '37, '35, '37, late 30s. There were 16 workers for every retiree. When you got 16 workers for every retiree, you can make a pay as you go system which is what that is. You can make it work pretty well. You can make it work for a long time if you keep that ratio. Over time that ratio has been coming down. With the retirement of the Baby Boomers, we're going to get down to less than three workers. The math doesn't work anymore. There aren't enough people working to pay in to the system. So that we now know that the last, the last report of the actuary of the Social Security System, that the system goes bust in 2042. And since it's a trust fund, it can only pay out what money it's got. And in 2042 it can't continue to pay at the level it pays today – it falls to like 75%. Now the arithmetic of fixing that isn't all that hard. Change one line or the other or change them both a little, you know, the inflow line of revenues, take that up a little, take the expenditure line down a little, and you get there. It's not a huge problem. It's out of balance by, oh, about 1.9%. So, you know, a little bit on the revenue side and a little bit on the expenditure side and you can get there. The problem is how to get the political consensus to do it. This isn't wizardry. This isn't a subject that takes extraordinary brain

power. It does take extraordinary political leadership. And it can only be done; I'm convinced, in a bipartisan way. And we need to find a way to forge this bipartisan consensus which I think should be doable. When you think of the politics of it, all these surveys indicate that kids under 30, people under 30 and kids in their teens – I have a son, 22 years old, he was back from college a while back – and I says to him, hey, Chris, you and your pals in school ever talk about Social Security? He says, no, Dad, why would we ever talk about that? I said, well, you know, you might one day want to look to it, way out in the future. He said, Dad, don't you know, there won't be anything there for us. It's not going to be there. I said, well, Chris, you know, you really believe that? He said, oh, we all know that, Dad, come on, how naive can you be? (Laughter) Well, if 20-somethings think it won't be there, then there ought to be a political fix, you know. Because if they get something that's a commitment to the future that allows them to have something, they're going to feel they're getting a lot more than they expect to get now. That's how you make a political contract. On Medicare, boy, there is the big one. I mean Social Security pales, pales by comparison with Medicare. And what's so troubling to me about Medicare is that unless we can rein it in, it is going to be the budget of the United States. Some WAG once observed that you think of the United States government, what is it really? It's, you know, Social Securities insurance, veteran's benefits insurance plan, Medicare, Medicaid insurance plans, what is the United States government? It is a massive insurance company that has a small defense subsidiary. (Laughter) How do we deal with that, Abby? I think the only way to deal with it is to lower the rate of growth of healthcare costs. And I won't give you my speech on how you do that, but I do think there are things that can be done to reduce the rate of growth

of healthcare costs including getting all of us when we get healthcare to act more like the good consumers we are when we get everything else that we buy. We simply don't act like that good shopper who goes and comparison shops on the new car, goes to the internet, reads the local papers, talks to our neighbor, calls our son or daughter in California or Colorado or wherever, gets their input, and finally make a choice after talking to a few dealers and getting the best price. Who gets healthcare that way? I was doing a talk show a little while ago, one of these Sunday morning talk shows, and was making this sort of argument, pitch, to the host of the talk show. And at the end of the show we were walking off together and the talk show host, one of them said to me, hey, you know, I think you've got a point there on healthcare. I just had a physical and at the end of the physical, he came to have the discussion with the doctor and he said, you're just terrific, you're in great health, great health. But if you want, we can give you a couple more tests. And the guy, he said, you know, I thought to myself, I'm not paying for this, *The Washington Post* is paying for this, why not get the tests? Well, that why not get the tests predominates the way healthcare gets provided in this country. So it seems to me if we're really going to get this fixed, we've got to get more choice, more consumer behavior, more competition, more empowerment into the process. As the Treasury Secretary, it really worries you because as you look out to the future, as I say, as you look out to the future, it's becoming more and more the economy of the United States. Anything that's growing at the rate that healthcare is growing, that's already 15% and growing at 11, 12, 15%, you know if you're growing at 1% more than GDP, you're going to be GDP at some point, right? Well, this is growing at a lot more than 1% over GDP. So if we could bring healthcare costs down to

something like 1% of GDP, we can manage the problem. If we don't, the problem we're going to have is not just higher tax rates and huge borrowings in the future; it's going to be where do we get the people to man, to work the American economy when 25, 30, 35, 40% of all the real resources in the economy are going into one industry. Where, Bill, will you find the people to do derivatives markets? But that's the reality of it. It isn't just dollars and cents. It's real resources we're talking about here. So I haven't given you an answer on it because I don't think we have, anybody has, the full answer. But there are some things that are being put on the table. Health savings accounts are one idea to empower people to act like consumers. Pooling of insurance among something called Association Health Plans so that small businesses can pool insurance and then buy it, not just in their state because their state may have high cost insurance, but can go across state lines and buy it. My pet theory is we're going to have to rein in frivolous lawsuits as part of, not the whole part, but as a part of the overall answer because frivolous lawsuits that affect such a huge part of the medical profession are causing extra tests, extra procedures, extra costs. They're also causing lots of good doctors to leave the field and reducing the supply of health care providers. And whenever you reduce the supply of something you drive the cost up. So it's a lot of things that are going to have to come to bear on this problem. And I can't draw much solace in, there's a witty economist that was on the faculty with me at the University of Virginia for a while, met at AEI, named Herb Stein, who made the observation that anything that isn't sustainable won't be sustained and this unsustainable. Well, it's a witty observation but it doesn't solve the problem.

CHAIRMAN BARBARA HACKMAN FRANKLIN: Last question.

DAVID MALPASS: Mr. Secretary, Abby and I have been asking you the easy questions so far – exchange rates and pension reform and health care – and now the hard one. What about Congress? So Congress has been having trouble making decisions on spending and taxes. Their rules, the PAYGO rules expired a couple of years ago. Greenspan addressed these last week. He made the point that you have to decide on your process before you can go about making decisions. So he was encouraging Congress to do process, and obviously it's going to be critical to tax reform how that process comes out. In particular, Congress now scores so that if you make a big change in the tax code, they assume growth won't change. So you've really conceded the issue before you've started. My question is how do you see that process going in Congress? Are they going to change their process? Do you think they should? And what kind of process would really help?

THE HONORABLE JOHN W. SNOW: Well, we have proposed that they do adopt the so-called PAYGO rules for expenditures, and it seems to me that's the right way to go here. That is, if the PAYGO rules say that if you increase, you have a budget, and if you increase expenditures over that budget level in education, then you have to reduce them in something else, healthcare or something else, defense. I think that's a good rule. I think Congress should be made to live with the spending commitments that they make to themselves and to the American people. And I think it would help – it did help. You know when we had the PAYGO rules back in the 90s; we

saw the effects over some period of time. So I'd be for putting them into place. The debate we have is should they also apply to taxes. And, of course, the administration feels that the tax plan that has been put into law, but which expires because of the peculiar way we do taxes in the United States – peculiar because normally you would think, well, you get 51 votes and you can get something done – the way the Senate works, you've got to get 60 votes to get something done because they can filibuster and it takes 60 votes to close down the filibuster. So we have proposed PAYGO rules for expenditures but said not for taxes because we want to make the tax cuts permanent. We think permanently lowering at the levels that they've come to, but which expire, would make good sense. And to remove the reduced rates on dividends, the reduced rates on capital gains, the reduced rates on income, and the expensing, remove that, is really a tax increase. And the president has made it clear he's not for a tax increase. So we have a certain disagreement with the Democratic side in the Congress on that. But the PAYGO rules on expenditures, absolutely, I think they should be adopted and need to be adopted. And the problem we have, at least as I think about it and look at it, is much more a problem of spending and excessive spending. I think it's hard to make the case that we, as Americans, are under-taxed. That's really the proposition here. Are we under-taxed and we need to tax ourselves more? No, I don't think there's any evidence to suggest we're under-taxed. And the path we're on is to have government receipts go back to where they were historically, to about 18% of GDP which is the historic level – plenty to fund the United States government – as long as we control spending. So the real problem is excess spending. So I would put our chips on controlling spending. Thanks. (Applause)

CHAIRMAN BARBARA HACKMAN FRANKLIN: That is the last word. (Applause) John, thank you very much for sharing so much thoughtful and interesting, stimulating commentary, and we thank you also for your service to our country. Please join me in another round of thanks. (Applause)