

**OPENING SESSION OF THE 2007 NATIONAL GOVERNORS
ASSOCIATION WINTER MEETING
FEBRUARY 24, 2007
WASHINGTON, D.C.**

Thank you.

I'm honored and delighted to be with you and to appear with such a highly respected co-speaker, John Chambers. As governors, you are in a position to play a central role in the economic future of our country – the subject I've been asked to discuss today – at a time when, in my view, our longer-term economic prospects are at a critical juncture, with extraordinary opportunities but also critical challenges. I speak frequently with major investors, business people and policymakers, from all over the world, and, while opinions differ as to the probability of various future scenarios, almost all agree that this is a time of extraordinary change, complexity and uncertainty, with great potential but also serious risks. Having said that,

little if any of this concern is reflected in global markets. A well-known European investor friend of mine said a while ago that, the only undervalued asset in the world today is risk. But, that doesn't change the realities.

My remarks will refer to the longer term, which should be the principal focus for policymakers, not the next year. As to the next year, while there certainly are risks, most economists project a high likelihood of reasonably good GDP growth. However, as I'll discuss later, current growth is dependent, to a significant degree, on high levels of borrowing at multiple levels in our economy. And, that growth is masking unsound underlying fundamentals – ranging from that borrowing to sub-optimal public education – that must be addressed. We should be using our current prosperity to pay our way now, buttress our finances for the longer term, and invest in the future. But, that is not our current policy path, independently of how you allocate the political responsibility.

To proceed, the global economy and the global competitive environment are undergoing transformative change of historic proportions, including rapid technological developments, global integration with respect to both trade and investment, the spread of market-based economics and productivity-enhancing policies around the globe and the emergence of China and India not only as large potential markets but, more immediately, as powerful competitors. The US economy has great strengths, including a dynamic culture, flexible labor markets, and a willingness to take risk that could enable us to thrive in that environment, particularly since great change can be especially beneficial to an economy with the flexibility and dynamism of the American economy. However, to realize that potential, we must meet hugely consequential challenges, and failing to meet those challenges could lead to serious difficulty. In that sense, the United States' economy is at a critical juncture for the longer-term, with the outcome

heavily dependent on how well or how badly our political system responds to our challenges. (Moreover, that imperative to meet our challenges is all the greater because the transformation of the global economy heightens the opportunity if we do but also the potential difficulty if we don't.) And, states and cities can and should play a major role in this response. Today, however, we are far from where we need to be with respect to almost every one of these major challenges. And, moving forward effectively will require a willingness in our political system to reach across party and ideological lines for common ground, and to acknowledge difficult realities and trade-offs, and then to make politically tough choices. Arguably, developing that willingness is our system's most fundamental challenge.

Let me expand for a moment on the global economic transformation, with two additional points. Firstly, the range of goods and services subject to trade is rapidly expanding due largely to revolutionary developments in

communications technology, and includes not only manufacturing and low-end services like call centers, but potentially virtually all of the large number of knowledge-based activities that can be delivered electronically, including legal research, reading x-rays, software development, and so much else.

And secondly , India and China have vast present and potential capacity, rapidly increasing productivity due to education and other measures, and added cost advantages due to non-market exchange rates. China and India face their own great challenges, and could falter. However, I believe, having spent much time with private and public sector leaders from both countries, that these leaders understand their challenges and are strongly committed to do what is needed to stay on their current path.

All of this occurs in a context where median real wages on the United States have been roughly stagnant for the last five years, and have grown very slowly for 25 of the last 30 years, with the only exception being the last

five years of the 1990s, and that picture is roughly the same if benefits or consumption are considered. Also, economic dislocation seems to have increased substantially, and income inequality favoring a very small top tier has greatly increased. While the popular perception is to attribute all of these conditions disproportionately to globalization and trade, the picture is much more complicated, with technology a far more powerful force and other factors involved as well.

I will discuss trade in a few moments. But first, let me say what I think we should be doing to succeed economically.

To start, I believe that economic policy should have three objectives; robust economic growth, broad participation in that growth and increased economic security for workers and families that doesn't undermine the incentive to work. Moreover, I believe that those three objectives can be mutually reinforcing. On the one hand, sustained growth is the single most

effective way of promoting broad income growth and economic security, through tight labor markets and by creating a larger pie to split. And, on the other hand, broad income growth and increased security can further economic growth firstly, by providing workers with the resources to access education, training, health care, and so much else that increases productivity, and secondly and very importantly, because sound economic policies around trade and market-based economics will only have broad public support if the great preponderance of the people expect to benefit from those policies.

Roughly two years ago, a group of policy people, financial people and academic experts formed what we call “The Hamilton Project”, to contribute substantively to policy thinking about achieving these three objectives and to help stimulate serious economic debate. We have since issued a comprehensive economic strategy paper and evidence-based policy proposals pursuant to that strategy, which we will continue doing even more

robustly this year, with a special emphasis on education, health care and energy.

To realize those objectives, our nation must meet challenges that I think of as falling into four baskets: 1) our multiple financial imbalances; 2) serious short-falls in education, infrastructure, basic research, energy policy, health care policy, inner-city programs, our social safety net and much else, that are critical requisites for economic success that markets by their very nature will not optimally provide; 3) cost/benefit imbalances in our regulatory and litigation regimes; and 4) international economic policy, including trade liberalization, relatively open immigration, and working with other countries toward flexible exchange rates. These all occur alongside serious exogenous risks to our economy, including terrorism, an oil shock and others.

As to financial imbalances, current economic conditions sit astride high levels of borrowing at multiple levels in our economy, and addressing this serious threat to our economic wellbeing lies almost entirely within the province of the federal government. Before getting to the other financial imbalances, let me focus for a moment on our fiscal position, because of its critical importance to our future. Federal Reserve Chairman Ben Bernanke said in testimony a few weeks ago about long-term fiscal matters with a special focus on revenues and entitlements, “We are experiencing what seems likely to be the calm before the storm”, and that storm, as he went on to say, could severely undermine our economic well being. We are capable of avoiding that storm, but only through politically and substantively difficult action, which should begin now.

To start, our fiscal deficits include significant projected deficits over the 10-year federal budget window, assuming the 2001 and 2003 tax cuts are

made permanent and assuming AMT reform. These deficits are instead of the surpluses we could have had and should have had in a time of relatively strong GDP growth and given the large surplus we had at the beginning of the decade. Those surpluses would then have better equipped us to face the entitlement obligations that will increase at a rapid pace with the looming baby-boomer retirements, and our other imbalances. Recent deficit and near-term deficit projections– though still substantial – have been lower than expected, due to unusual factors, such as temporary Medicare improvements and the tax effects of incomes being skewed more toward high bracket taxpayers and corporate profits being high relative to GDP. These unusual factors do not change even one iota the adverse impact of the unsound fiscal policies of recent years – however you attribute political responsibility for those policies. These unsound factors simply mean that with sound policies,

we could have been that much better positioned to face our other imbalances.

Now to turn to those other imbalances, we have a projected 50% increase in Social Security, Medicare, and Medicaid entitlements as a percentage of GDP over the next 15 years, a de minimis net national savings rate of roughly 2% of GDP, an almost unimaginable current account deficit of roughly 6% of GDP over three times the average of the 1990's – partly caused by our fiscal deficits, and heavy overweighting of dollar denominated holdings in many foreign portfolios. The combination of those imbalances – which is a new phenomenon – is a deep threat to our economy.

The vast flows of capital from abroad that have sustained us despite these imbalances, are exceedingly unlikely to continue indefinitely, though the timing of trouble – whether in the near term or years out – is unpredictable. The single most important action that we could take to

address these multiple imbalances – and to minimize the risks associated with them – is to make politically tough decisions on revenues, federal programs and spending, including entitlements. The objective should be to establish a fiscal path that systematically reduces the ratio of debt to GDP year-by-year and leads to long-term fiscal balance. And, we should at the same time make room for critical public investments. Obviously, the pace and specifics of this approach would involve deciding on exceedingly difficult trade-offs.

Let me turn now to public investment and the other requisites for a successful economy that must be met by government. Here, states and cities can play a major role in meeting our nation's economic challenges, both in traditional areas of local involvement and in more far reaching ways. To begin, education at all levels is absolutely critical to global competitiveness and states and cities are at the center of meeting these needs, especially at

levels K through 12. However, our public school system is almost universally viewed as being far from what it needs to be, and here states and cities have the opportunity to contribute greatly by undertaking education reform. For example, The Hamilton Project has put out discussion papers on changes in the way teachers are selected and rewarded, on summer programs for students from low-income families, and other areas. Health care is another area where change is imperative, and states have begun implementing new approaches to universal coverage and to efficiency. In poverty alleviation, too – an economically critical area – states have often initiated programs that then spread nationwide or led to action at the federal level. All of this is difficult politically. But progress in these and other critical areas, where states may be able to move forward more readily than the federal government and can demonstrate different approaches, is vital.

Beyond these traditional areas, state and local measures to build around local strengths to promote economic growth often may be more effective than actions at the federal level. While all of you know far more about this than I do, let me mention some areas that illustrate this point. For example, states can provide infrastructure, venture capital and pilot project funding to catalyze new private sector activities and even new industries around the research capabilities and intellectual capital of our great universities, which stand out compared to the rest of the world and can be powerful economic resources for States and Cities. Obvious examples are the synergistic relationship between Stanford and Silicon Valley and the healthcare activities and biotech around major academic medical centers. Other opportunities would be financing for pilot projects in agricultural areas to provide ethanol from agricultural products other than corn, programs to promote manufacturing around our transportation hubs, and

specialized technical education in high school, community colleges and universities to attract knowledge-based industries to localities that have other attractions for the people those industries need, for example, our great cities with their vibrant cultural lives, or their converse, our vast outdoors, with their lifestyle appeal.

While the federal government clearly must be heavily involved in providing many of the underlying fundamentals for a successful market based economy, states and cities, by virtue of their local knowledge and of their ability to try different approaches, have a powerful comparative advantage in many areas. And, the potential that creates could be buttressed by federal funding, thus combining the benefit of nationwide revenue-raising with local leadership. Governor Napolitano earlier discussed her project, Innovation America, and Bruce Katz at the Brookings institution heads an undertaking called “The Metropolitan Project”, both of which provide

serious and thoughtful analysis and proposals as to how states and cities can move forward along these lines. And, just to add one more thought, Governor Napolitano's project refers to 'reducing regulatory barriers'. We must maintain appropriate regulatory regimes and appropriate redress for wrongs in our litigation system, but cost/benefit excesses in these areas are a serious impediment to economic activity, job creation, and increased standards of living. Much of the challenge with respect to addressing these excesses lies at the Federal level, but there is much that states can do also.

Stepping back, all that I've just described constitutes a powerful domestic policy framework for promoting investment, productivity, and job creation, for equipping our people to succeed economically in a rapidly-changing global economy, and for increasing wages and economic security.

Let me now return to globalization and trade.

There is an understandable temptation with today's transforming global economy and the real difficulties that many Americans are experiencing to create trade barriers and to place constraints on further trade liberalization. However, I believe that would be hugely counterproductive. Trade liberalization still on net contributes substantially to economic growth and to the economic well being of the great preponderance of Americans, though the global division of the benefits of trade may well be shifting from so heavily favoring the industrial countries more towards the rapidly growing emerging market countries. Still, trade liberalization leads to lower consumer prices, lower inflation, lower input prices for our producers, the rewards of comparative advantage, and drives business to be productive and efficient. Erecting trade barriers would have the contrary effects, for example, higher consumer prices and higher input costs for our producers versus foreign competitors. Barriers could also lead to retaliation against

our exports and to disruption of our currency. And, failing to move forward on trade would simply mean being outside rather than inside the net of preferential arrangements, since the rest of the world is moving forward without regard to what we do, as, for example, in China's highly energetic reaching out to Latin America, Africa and the ASEAN countries of Southeast Asia.

Thus I believe that both trade liberalization and a powerful, multifaceted domestic agenda are necessary for economic success, including broad income growth and increased security. One problem, however, is the politics of this dual approach. Too often, the advocates of trade do not support the domestic agenda and the means to pay for it, and those who support the domestic agenda do not support trade. I believe that all of us need to work to change these politics.

Let me conclude by saying that I have focused on the challenges that the United States faces, because how we address those challenges is central to what will happen economically in the years and decades ahead, and because you can play such an important role in that response. More broadly, though, our economy has enormous strengths, and, our country has a history of great resilience in meeting our challenges that could augur well. We can thrive in the years and decades ahead, and change can be our friend, not our enemy. But, our political system – with governors centrally involved – must rise once again, as our country has so often risen in the past, to address the tough issues of momentous times. Thank you.