The Economic Club of New York

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Chairman Designate,
Council of Economic Advisors

Sir Geoffrey Howe
Chancellor of the Exchequer

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Questioners: David Roderick, Chairman,
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Introduction

Chairman, Peter G. Peterson

Good evening ladies and gentlemen. There is much to admire about our first speaker this evening, the Chancellor of the Exchequer. But one of the things I admire the most, Sir Geoffrey, is your longevity in office. He has served longer as Finance Minister than any Finance Minister in the European Community or any major industrialized country in the world. Now I say that with very special personal feelings, Sir Geoffrey, because compared to my tour of duty in Washington, which was much shorter than I had anticipated, more abrupt and certainly less elegant than I had anticipated, you have already served three and a half times longer than I did as Secretary of Commerce. People accuse me of statistical obfuscation but I point out that this puts me in the upper 80% of the Secretaries of Commerce in terms of longevity in the United States. So I stand in awe of you, Sir, your stamina, and your discretion. I also admire your obviously close relationship to the Prime Minister. I might have said that you are reputed to be a good pipeline to the Prime Minister, but given the current state of affairs I didn't think that would be an appropriate image to use. We are also privileged this evening to have Lady Howe. I would appreciate it if she would stand, Lady Howe (applause) she is a remarkable person in her own right, was Deputy Chairman of the Commission on Equal Opportunity in England. Our exhaustive research, Lady Howe and I hope you will forgive this indiscretion reveals that you once gave a major speech in Kenya on the subject of equal opportunity. And the local newspapers were reported to have written a headline that was entitled, the British Sex Act

Revealed. (Laughter) I knew I shouldn't have said that. My wife is also here, Joan Ganz Cooney and Sir Geoffrey is your comparative advantage is as great mine, you would accept a quality in a moment I am sure, with your wife, as a basic principle.

So I would also like to introduce my little woman, as she adores being called, (laughter) Joan Ganz Cooney, would you stand please. (Applause) Our researchers revealed some other profound information about Sir Geoffrey. In addition to having a charming wife, he apparently also has a dog. And our research established that he has named his dog budget. When we asked one of his assistants why, the answer we were given, and this is a quote, "because it leaks". (Laughter) Now in this country, Sir, you might have wanted to name your dog David, David Stockman, that is. Well we will move on. Another profound fact that we have learned about Sir Geoffrey is that he sleeps only four hours a night. And Lady Howe, our research has not been conclusive on the subject, as to whether it is insomnia, worry, or simply hard work, we shall assume the latter. But Sir Geoffrey is honoring us this evening by making his only really major address to the United States here, after a very brief visit. We wondered Sir Geoffrey, why you were in such a hurry to get back to England. And the answer I was given was that you were terrified that if you stayed any longer you might catch the American disease. More seriously, let's move on to there is something called the British disease, I should explain. And some of us thought that was amusing, but apparently we were wrong.

Ed Loch has done some wonderful research, more seriously, Sir Geoffrey, on a lecture given by

one of your very distinguished predecessors 50 years ago. And here is what he says in 1932, peace is reigned, there has been no pestilences or unusual convulsions of nature, bountiful harvests have awarded the toil of man, science and organization have advanced together hand in hand and yet we are all poorer. The value of our possessions has been reduced, incomes we earned have been reduced, the dividends to which we are entitled have been reduced and wages have been reduced. And millions, in all of the great industrial countries are without employment. Many millions more are upon short time, and the only thing that has not been reduced are debts and fixed charges of all kinds. These have relatively increased to a formidable extent. You might be interested to know that the distinguished Chancellor of the Exchequer who spoke on this very platform was one Winston Churchill 50 years ago, who uttered those words. So it is now my great privilege to introduce a distinguished successor to Winston Churchill, Sir Geoffrey Howe. (Applause)

Sir Geoffrey Howe

Chancellor of the Exchequer

Mr. Chairman, ladies and gentlemen, may I begin by thanking you for the kindness and good humor of your introduction. I am happy indeed that it was you and not I that chose to reveal that indiscreet headline about my wife. (Laughter) I would never have dared to attempt such a thing. I am delighted and greatly honored by the invitation you have extended to me to speak to this distinguished gathering this evening, and alongside Martin Feldstein on my left here, which

makes the occasion even more daunting. And I am tempted to hope and reflect that the gathering might be like one that a British businessman once addressed in Japan. And he knew little about his audience, saved that they were renowned for their immense courtesy. So he began by bowing deeply to the assembled company, and was greeted by positively tumultuous applause. And he was so impressed by the reaction to that, that he bowed deeply a second time. And the response to that was a sullen, frozen, stony, hostile silence. He turned to his Chairman beside him and said, "What have I done wrong?" And got the response, these chaps don't like long speeches.

Let me begin at least by paying a tribute to all those in your country, in the United States, who provided help and support for my country, during the recent crisis in the South Atlantic. When once again, it fell to Great Britain to underline the lesson that aggression does not pay. The strongest alliances are not written on paper, but in the hearts of people. Never was that more true than during the fight for the Falklands earlier this year. I extend my thanks to you for your support. (Applause)

But I am here to speak about the wider problems that now affect countries throughout the world. Growth, it sometimes seems has almost disappeared. Inflation, deeply entrenched. And unemployment rising steeply. In the United Kingdom these problems have been compounded by some longstanding difficulties of our own. Our inflation rate has been rising ahead of other major industrial countries, for something like 20 years. Throughout the post-war period, output and productivity in the United Kingdom has grown much more slowly than in the rest of the OECD.

Falling to an average of about 1% a year since the first oil shock. We have a very large and predictably rigid public sector. Public spending in the United Kingdom accounts for about 45% of GDP. Almost all of our social programs, education, health, social security, pensions, are publically financed and many of our staple industries, steel, coal, railroads, civil aviation, ship building, all of the public utilities, have been largely or wholly state earned.

And finally, we have a highly unionized workforce. Only about 20% of the United States workforce is unionized, as compared with about 50% in the United Kingdom. And in Britain, unions have long enjoyed privileges and immunities, which by international standards are quite exceptional. There is one other problem, which it may not be easy immediately to perceive as such, rising North Sea oil and gas production since the mid 1970's. Of course, of undoubted value to the economy, has altered the balance of the economy and added extra problems of adjustment. It has strengthened our balance of payments, exerted output pressure on the exchange rate and so made more difficult the competitive position of many of our traditional trading industries, particularly in manufacturing. Enough you may think of the problems, what about the policies?

First, like you, we see the control of inflation as the central objective of policy. That is in no way to diminish the importance we attach to the reduction of unemployment. But today's rise in unemployment is not the bill we pay for reducing inflation now; it is the bill we pay for having allowed inflation to remain so high for so long in the past. And the key to controlling inflation,

we have no doubt, lies in control of monetary conditions through the operation of responsible financial policies.

Second, we are promoting more effective supply by removing unnecessary controls, reducing the public sector, changing the balance of labor market power and improving incentives. That involves changing the tax structure and that sets the scene for possible conflict between monetary and fiscal policy of which more in a moment. At this stage, suffice it to say, that the difficulty has never in my mind been one of theory, but only of practice. Or only, you may think is rather a modest four letter word with which to dismiss the problem for the moment.

This dual prescription is in sharp contrast with much of the post-war Orthodox economics. Which was based, of course, on the notion of the maintenance of effective demand. In fact, the problem in the United Kingdom, we are not alone in this, has increasingly been one of lack of effective supply against the background of excessive money demand.

Now, a word about inflation. In the second half of the 60's, our inflation rate roughly doubled to about 4 or 5% a year. In the 70's it averaged about 14% a year. And in 1975 and 1980, it hit peaks of 26 and 22%. High inflation generally can now be seen as one very important consequence. And in the United States, I suggest, a very important cause of the collapse of the Bretton Woods Discipline of fixed exchange rates. From bitter experience, we and many other countries have come to perceive that the only way of achieving a lasting reduction in inflation

does lie in the effective control of monetary conditions. So that has formed the cornerstone of our policies, and demonstrably they are working. Over the last two years we have gained a lot of experience about the appraisal of monetary conditions. As in the United States, we have been going through a period of technological change and innovation in financial markets. This means that from time to time, particular aggregates and indeed the aggregates taken together, can be difficult to interpret. Inevitably confirmation about the extent of monetary pressure has had to be sought from a wider range of information. And that is how, in London, we have been operating. Not insisting upon the achievement of the targeted outcome for a single aggregate, regardless of what other indicators were saying.

Of course, it isn't easy to change the presentation of policy in order to better reflect that flexibility. Without giving the impression of a slide into laxity. But I think that we in London can claim to have achieved that. We now encompass a range of monetary indicators within the target ranges, and we have explicitly take account of other indicators; the growth of money incomes, progress on inflation, real interest rates, and of course, the exchange rate.

I have been interested to see that the Chairman of the Federal Reserve has been adopting a similar flexible but firm approach. He told the Senate in July that in judging monetary conditions the Fed will look to a variety of factors, including the behavior of different components in the money supply; the growth of credit, the behavior of banking and financial markets and more broadly the behavior of velocity and interest rates. Our experience with a similar approach has

been good. I believe we have been able to retain the confidence of markets because we have given practical demonstration of our determination to keep fiscal and monetary policy moving in the same direction. Whatever the theorists may contend, in the real world, getting interest rates down means convincing markets that the government will not try and will not need to borrow too much. Otherwise, high interest rates resulting from falling bond prices, feed through from the capital markets to the short-term markets. Governments that believe in markets should need no convincing of this. But putting it into practice can be extremely difficult. It means taking a realistic view of the likely future path of public spending. And on that basis, facing the need in the short term to choose as we have had to do between lower taxes and lower borrowing. In pursuing a unified policy of downward pressure on inflation, by means of tight but not too tight monetary conditions, underpinned by reduced fiscal deficits.

We found it helpful and indeed I would say essential, to spell out for several years ahead a coherent set of median term objectives for monetary growth, and fiscal projections based on prudent and realistic economic assumptions. We did this by drawing up and publishing in March 1980 or median term financial strategy. And we thus, set out our plans for aggressively to reduce the growth of the money stock, and to do so without excessive reliance on interest rates.

We spelled out as well, our plans for a substantial reduction over the median term in the public sector borrowing requirement as a percentage of Gross Domestic Product. We have since updated those plans and published them afresh. And of course the details have changed. But not

the strategy. And the markets have come to respect it and act accordingly. They know that we are committed to reduce over a period of years the rate of monetary growth and inflation and to bring deficits and interest rates down and they have seen us doing just that. The growth of money GDP has been reduced from 17% in 1980 to 10% in 1981 and a similar figure is likely this year.

The public sector borrowing requirement which as a percentage of GDP reached double figures in the mid 70's has been reduced from 5.7% in '80, '81 to about 3.5% in '81, '82. It is projected at 3.5% of GDP again this year and so far we are on track to meet that estimate.

Of course we would have preferred to secure those lower deficits, solely by reductions in public spending. Clearly that is the best way. And we have made substantial and often unpopular cuts in spending plans but it can prove very difficult and slow to reign back spending programs at a time of deep recession, when there are obvious pressures on Social Security, employment assistance, and other entitlement programs.

Certainly I regard the achievement of lower taxes on earnings and on enterprise, as important for the health of our economy. High taxes worsen incentives, but there is a limit to the speed at which tax changes can influence output. And if I may say so, even supply side chickens are best counted, in my experience, after rather than before they have been hatched.

In my first budget in June '79, we did cut income tax, particularly at the top end. Because we inherited top marginal tax rates which rose on investment income to the positively Albanian rate of 98%. (Laughter) We got rid of them, but to control the deficit we did at the same time raise taxes on consumption. At the time we were criticized for that. But that tax switch from taxes on earnings to taxes on spending was essential, given the overriding priority of getting the deficit down. The same priority obliged me to raise taxes again in my 1981 budget. Confidence that our fiscal deficit was set on a declining path brought a clear benefit in the form of lower interest rates. Last year ours were well below yours by a full 4 percentage points in the spring.

So I ask, with all respect, is it fanciful to imagine that your authorities may before long agree upon and publish a median term financial strategy which offers the convincing prospect of a declining path for the fiscal deficit as a proportion of GDP. Of course I don't proffer the U.K. as a paradigm of rectitude and responsibility. But in this respect we have made important progress. Within the OECD many other countries have announced lower spending plans. Others are raising taxes and Social Security contributions. A number have done both. And some like Canada and France who temporarily sought to follow a different path are striving to get back into line. It is a common diagnosis and a common prescription reaffirmed and reinforced in Toronto this month. Once markets have been convinced that the United States will achieve a tighter fiscal stance, interest rates will fall further, boosting recovery worldwide, consolidating progress in the fight against inflation. You would gain; your friends and partners in the industrialized world would gain. And the benefits would be equally, perhaps even more strongly felt in the developing

countries, caught now in a double bind of high interest rates and high energy prices. It would not be the first time that a responsible United States lead has pulled the world economy around. I recall in this context, the name of George Marshall, whose memorial is the post-war resurgence of the West European economies. And I am confident that in today's difficult time of transition, the United States will once again provide that round of imaginative and far-sighted leadership.

Now what of the United Kingdom's supply side policies? Experience tells us that success there is just as important as in macroeconomic strategy. Our managers have been complaining, our industrial leaders have been complaining for too long, the extent to which governments have provided for them, intolerably restricted terms and conditions of service. And I am reminded of a story from my native Wales many years ago, of a couple in the Nice Ballina Swansea who advertised in the local South Wales Evening Post, for a maid. These were in the days of upstairs, downstairs, when maids were to be found in plenty. And Diane Blodwin interviewed a number of recruits for this important position in their house, and eventually they appointed a little treasure called Mevanwi, to be their maid. And at the end of Mevanwi's first day in service, Diane Blodwin was going to bed, and congratulating each other on Mevanwi's great qualities. And suddenly there was a knock upon their bedroom door and there was Mevanwi in a condition of great distress. And Diane Blodwin looked at her and said, Mevanwi what is the matter. And she said, come with me, come to my bedroom and I will show you at once. So they went along the corridor to Mevanwi's bedroom and there she pointed with a trembling figure to a biblical text above her bed and she said, I am not prepared to stay in this household a moment longer on

the terms and conditions of service that apparently apply. And they looked at the text and there were the terms set out; prepare thyself, the master may come at any time. (Laughter)

Well as I say, the terms and conditions of service had been unduly restricted. So we have had to take vigorous practical action to improve them. Our poor record on productivity, had contributed to a prolonged and fruitless struggle over income shares, between workers and management. Excessive increases in money wages often unrelated to productivity, to the financial circumstances of the organizations concerned, had weakened competitiveness, undermined profitability. The rate of return on capital had been falling from well over 10% in the mid 1960s to about 3% last year. And the most horrifying statistic of course, has been the rise in unemployment as profitability has slumped. And employees have steadily priced themselves and others out of jobs. Unemployment has moved progressively upwards, from levels of less than 2% in the mid 1960's to today's level of 14%. These figures point up the urgency of success in our attack upon the spider's web of controls and regulations which have done so much to stifle the vitality of our economy.

Three and a half years ago, we had in place comprehensive controls on prices, on dividends, on pay, on salaries, and on foreign exchange movements. As well as on bank lending and installment credit. We also had in place a complex system of industrial development certificates, of obvious development permits, every one of those controls has been swept away. Administrative, zoning and other burdens on business, particularly small business have been

eased. The number of civil servants employed by central government has been sharply cut back and at the same time that size and monopolistic privileges of the public sector have been directly reduced. The return of state industries, assets and activities to the private sector is playing a crucially important part in our campaign to restore market forces. The policy of privatization has come in a number of different ways. The sale of shareholdings in former nationalized industries to the general public. British aerospace and cable and wireless are examples. Or the sale of shareholdings to management and staff as with the national freight corporation. We recently announced plans to transfer British Telecom, our telecommunications utility to private ownership. Electricity generation, and natural gas distribution were abolishing standard monopolies allowing private enterprise to compete introducing private capital. In the labor market we have legislated to control the closed shop and picketing; to encourage strike balance; to restrict some of the more startling examples of union immunity. Already despite current troubles over pay in the National Health Service, there has been a general improvement in industrial relations, with the number of industrial stoppages in 1980 and 1981, lower than in any year since World War II. In 1981 the United Kingdom record in terms of days lost in industries and services was indeed rather better than the record in the United States. And we have taken another whole range of measures to encourage new and small businesses. Before I leave the subject of the United Kingdom internal market, may I add a brief word about the impact of certain United States policies. We have seen in the past two years how high American interest rates have been accompanied by a sharp rise in the dollar putting pressure on U.S. companies leading to calls for protectionism, and increasing the risk of trade warfare. Steel is a paramount

case in point. And I hear similar calls from United Kingdom companies. I say, only this, it is vital that these calls should be resisted on both sides of the Atlantic.

Second, I remind you that there is very considerable surprise and dismay in my country, and indeed throughout Western Europe at the political interference with trade, and the fulfillment of contractual commitments represented by decisions of the United States administration, to withhold exports and re-export licenses for shipment to the Soviet Union of equipment and technology for the gas pipeline.

The United Kingdom government has taken action to protect the interest of British companies. I do not wish to say more in public today, but I must express the very firm hope that as with the OECD consensus on export credit, we can find a rapid solution to the dispute. Indeed we must do so. For the threat to the alliance which it represents can bring benefit only to the Soviet Union.

Let me return to my main theme, the benefits of our policies are beginning to show through in improved underlying U.K. industrial performance. Manufacturing competitiveness has begun to improve. On inflation, our financial policies are clearly bearing fruit. I admire of course the determination with which the United States administration has worked to bring consumer price inflation here down to one of the lowest rates in the western world. It is therefore with some pride that I now look forward to RPI inflation in the United Kingdom, by the end of this year running at about the figure 6.5 % that is now current here. That will be our lowest rate for over

ten years. Two years ago, United Kingdom inflation rate was running at well over 20%. Which would be the first United Kingdom government for over 20 years to achieve an average rate of inflation lower than the one which it inherited from its predecessor. Not surprisingly many of your businessmen are now finding the U.K. an increasingly attractive place to invest. The American chairman of one of our major companies remarked not long ago on the transformation in the economic climate that has taken place since 1979. He pointed out the monolith of union power has been shown to be mythical. Managers he said, are now showing new attitudes towards systems, stocks and efficiency. The U.K. is still a low wage economy, relatively speaking. It has a well educated and motivated workforce.

Grants and tax advantages in Britain are as good as anywhere in comparable countries and those are his words and not mine. I am encouraged and flattered by that picture of a more dynamic and potentially more prosperous Britain. But it will be unrealistic and I'm hopeful to close without adding a word about the serious problems of transition which still remain. The adjustment to a lower rate of inflation never was going to be easy. The burden has in fact been greater than it might have been, largely because of the recklessly high pay settlements that were the legacy of the previous government's former income policy. The exchange rate rose sharply with the second oil shock and the impact of rising north shore oil production, both these factors had an adverse effect on profitability and hence on unemployment.

More recently, the continued sluggishness of economies around the world, including your own,

once again a reminder of the heavy but necessary costs of curbing world inflation, has checked the pace of our own recovery.

That serves only to underline the need for further progress in reducing the rate of growth of pay and salaries, so as to make room for improved profitability and for extra jobs. This is the area where we still need the greatest improvement. Settlements in our next pay round must be significantly lower than the last one. Experience has taught us not to look for salvation from any mechanistic incomes policy, they simply don't work. But that in no way weakens my belief in the vital importance of pay moderation. That is the key to defeating unemployment at the higher levels of productivity that are essential.

I close with a question. Is the United Kingdom story as I have told it, relevant to your concerns here and now? I think so. Because on both sides of the Atlantic, we agree that what governments have to do is to nurture the real mainstays of growth. Stable money and an economic climate which positively encourages competition and enterprise. In the U.K. the benefits of government policies are, I believe, beginning to come through, on inflation, on interest rates, on competitiveness, and unevenly and frustratingly slowly on economic activity. Our responsibility is to stick to the policies being pursued on public spending taxation and borrowing. So as to create the conditions for greater prosperity. And that is what we are determined to do matching flexibility to persistence and learning from the experience of others. (Applause)

Chairman Pete G. Peterson: Thank you very much Sir Geoffrey. It is now my privilege to introduce an economist, a great one to be sure, but nonetheless an economist. (Laughter) Sir Geoffrey I don't know how it is in your great country, but our country has become increasingly ambivalent about economists. Those of you over 50 will remember that the definition of ambivalence used to be watching your mother-in-law drive your brand new Cadillac over a cliff. (Laughter) That has now changed as I understand it, to watching a busload of economists go over a cliff. The obvious question is, why then, the ambivalence and the answer is, there were three empty seats. Don't feel badly Martin that works much better with investment bankers, I can assure you.

I also did a cruel thing with Martin, I talked with his office. And I asked about what is his idiosyncrasies were. And I was informed that he is a very peripatetic fellow. And not too long ago he visited 18 places on one trip. And one day, according to highly reliable sources, a call comes in for Martin which goes, "Marine, I am in Fargo South Dakota, can you tell me why I am here?" (Laughter) I don't know about you, but I didn't find the question interesting enough to get the answer. But how does one refer to this gentleman? I am inclined to refer to him as superbly qualified for his new assignment. But Martin this has become one of the ultimate cliches in Washington. That this term has been devalued by its use with hundreds of mediocrities that have gone to Washington, but nonetheless, this is a man who is superbly qualified. By training, by outlook, let me just give you a couple of his credentials. He is clearly one of the nations leading authorities on savings and investment incentives. Lord knows we need more of that. He is

perhaps the ultimate authority in the United States on Social Security. I am told by his academic colleagues that he appears in more footnotes than any economist in the United States, which I assume is a euphemism for meaning you are plagiarized much more than any economist in the United States. So I had a diabolical idea with Marty. At the time I asked him to appear here I was a Director of his at the National Bureau of Economic Research, so I had a little leverage on him. I suggested that we have a conditional invitation. That in return for being awarded this great honor of appearing here, he would announce his unequivocal support for a freeze in Social Security benefits, a reduction in indexing to a level half of the wage increase, taxing all Social Security contributions, and raising the retirement age to 70. To show this man's political sensitivity, he told me he would like to continue this discussion on November 3rd, (laughter) our election, Sir Geoffrey is November 2nd, as I am sure you know. But be it a cliche or not, this man is truly superbly qualified for this assignment. I know of only one other economist in recent times who could be said to be as superbly qualified, and he is sitting on the platform to my right. Alan Greenspan. So it is my great pleasure to introduce to you this evening, the Chairman Designate of the Council of Economic Advisors, given that the accident of timing is that he appears for his confirmation hearings tomorrow, we would appreciate it if we would consider his comments off the record. I now present to you Marty Feldstein, Chairman Designate of the Council of Economic Advisors. Marty.

Martin Feldstein

Chairman Designate, Council of Economic Advisors

Thank you very much Pete, I hope I have the opportunity to introduce you sometime. (Laughter) I am certainly very pleased and very honored to be here this evening and to share this platform with Sir Geoffrey Howe. I lived in England for six years and I continue to have a keen interest in British affairs. Although there are many significant differences between our two economies, there have also been very important similarities as Sir Geoffrey's remarks brought out.

In both countries the 1970s were a decade in which inflation soared and productivity declined. The Thatcher government and the Reagan administration have shown a clear determination to reverse those unfortunate trends. Both of our countries are now suffering the effects of substantial recessions that were inevitable consequences of stopping the accelerating rate of inflation. But in the United States, as in Britain this is a time of economic transition. I refer not only to the current stage of the business cycle, but also to the more fundamental change in economic policy and in the role of government in the economy that we are both witnessing.

Speaking now of the United States, I feel strongly that the next few years, perhaps even this next year, will be a critical time for economic policy. The decisions that are taken during this period will determine the shape of our economy for many years to come. They will determine whether the revolution in economic policy that is currently underway will be successful or whether

instead we will return to rising inflation, falling productivity and an ever growing role for the government.

Let me now review with you some of the very serious economic problems that I see as I look at our national economy. None is more obvious than that over 10 billion Americans are now unemployed. In many families this unemployment means severe financial hardship and personal suffering. Indeed, nearly 2 million people have now been unemployed for longer than six months. An unusually high fraction of total unemployment. But high unemployment in our country is not just associated with recessions. Even when economic activity is at its peak, unemployment remains unsatisfactorily high. At the past two business cycle peaks, over 6 million persons were unemployed. The extremely high current level of unemployment is the result of increasingly rapid inflation that afflicted our economy during the past 15 years. The overall rate of inflation rose from an average of only 2.5% in the 1960's to more than 7% in the 1970's. The Consumer Price Index finished the decade with a jump of more than 13% in 1979 and started the current decade by rising more than 12% in 1980.

I think at that time there was a widespread and indeed justifiable fear that the inflation rate might continue to increase until its spiraled out of control. The very substantial decline in the growth of the money stock that occurred in 1981 stopped the rising rate of inflation. More precisely though, the slowdown in the expansion in the money stock decreased the growth of nominal GNP, that is of GNP measured at current prices. Part of this slowdown in nominal GNP took the form of

lower inflation and part of it took the form of a decline in real economic activity. If the rate of inflation had declined faster, the recession would have been milder, or might have been completely avoided. But sticky wages and prices are an unfortunate but real feature of our economy and imply that inflation can only be reduced at the cost of a temporary reduction in output and employment.

The extremists among both the supply-siders and the rational expectation monetarists who predicted that inflation would be reduced without raising unemployment have been decisively proven wrong. The progress against inflation has nevertheless been very substantial. And much more rapid than many economists, especially those with a Keynesian prospective, expected as recently as last year. The Consume Price Index in 1982 has been increasing at about half of the rat of increase in 1979 and 1980. Producer price increases have also dropped sharply and wage inflation is beginning to decelerate.

Although monthly inflation rates will continue to be volatile in the year ahead, I believe that the underlying inflation trend is now definitely pointing down. Economic recovery need not be accompanied by a new round of rising inflation. There is, as you know, substantial slack in the economy and many firms are in a good position to increase output without higher costs and rising prices. However, if the recovery proceeds too quickly, the progress against inflation could be reversed. It is therefore, extremely important to avoid over stimulating the economy as it enters the recovery. Experience has shown that attempts to fine tune a recovery are frequently

self-defeating. The use of expansionary monetary and fiscal policies to accelerate a recovery has frequently been the cause of an increased rate of inflation or of a short lived recovery.

I sincerely hope that the very high price in unemployment and lost output that we are now paying to reduce inflation will deter future governments and future monetary authorities from pursuing policies that might rekindle the inflationary spiral. The economic recovery will reduce the unemployment rate of course but will not eliminate the problem of unemployment. Even when capacity utilization is high, and further increases in demand would only increase inflation, the unemployment rate will remain uncomfortably high. Probably between 6 and 7% if nothing is done to correct the more fundamental causes of high unemployment.

There are basic structural problems in the labor market that must be tackled successfully if the permanent rate of unemployment is to be lowered. Nearly half of the unemployed are less than 25 years old. Their unemployment reflects the inefficiency of our labor market in matching people and jobs rather than any overall lack of demand. New ways must be found to strengthen the skills and incentives of prospective workers of all ages and to deal with the special problems of unemployment in those industries that have lost competitiveness in the world economy.

These are, of course, long run problems, but I believe we should start tackling them as soon as possible. The other long run basic goal is to increase the productivity of our economy and thereby raise real earnings and everyone's standard of living. Although many things contribute to

productivity, capital accumulation in the form of business plant and equipment is the channel that is most influenced by government policy. Countries that devote a larger share of their national income to investment enjoy a higher increase in real incomes. U.S. investment in plant and equipment has been pathetically low. For the past two decades the United States has saved and invested some 15% of Gross National Product. Since three-fifths of that investment has been needed just to replace the capital stock that is wearing out, only 6% of GNP has actually been devoted to net investment. That is to increasing the net capital stock. This 6% net investment rate is less than half of the average among the other industrial countries of the OECD. Moreover, since half of this 6% net investment has gone into housing and inventories, only a paltry 3% of GNP has been used to increase the real net stock of plant and equipment used by a nation's business. Very, much less than half of the rate in other industrialized countries.

Our ability to invest as a nation is ultimately limited by the supply of savings provided by households, businesses and governments. Our low national rate of saving reflects a wide range of government policies, from tax rules that penalize saving and discourage business investment, to a Social Security program that makes saving virtually unnecessary for the vast majority of households, to credit market rules that limit the rate of return available to the small saver. These anti-saving policies can be traced ultimately to the Keynesian fear for saving that has permeated economic thinking and economic policy for the past 40 years.

As you may recall, Keynes argue that the British depression of the 1930's was due to inadequate

spending or equivalently to excessive saving. The implication of his theory was therefore clear, develop explicit policies to discourage saving and encourage consumer spending. That theory designed for the British depression of the 1930's came to have a powerful and inappropriate affect on the economic policy of the United States and I would say Britain in the 1950's and 60's and 70's. While the Continental European and Japanese governments have been telling their citizens with both words and incentives that saving would create the capital for better jobs and a higher standard of living. Our government was induced by the Keynesianism fear of saving to tell the American public that saving less and spending more on American made consumer goods was the key to jobs and prosperity.

Unfortunately, this combination of adverse incentives and misguided cajoling was so potent that the United States and Britain have had the lowest saving rates in the industrial world during the past two decades. And I am sorry to say that the United States has outdone even Britain in that particular race and we are now at the very bottom of the world lead table for saving.

Fortunately though, all of that is now beginning to change. Within the economics profession there is a widespread retreat from the Keynesian notion that the way to increase income is merely to expand demand. Instead of Keynesian demand management, the new view focuses on capacity creation through capital formation, research and innovation. I believe that, that is the essence of supply side economics. I think it is most unfortunately, therefore, that this idea of stimulating supply rather than demand got such a bad name when the label of supply side economics was

attached to some extreme rhetoric about self financing tax cuts and to euphoric forecasts of a painless transition to rapid but inflation free growth.

Although I reject such extremes, I do believe that it is very important to revise government policies to stimulate supply by creating capacity and by reducing disincentives and barriers to individual effort. The importance of increasing capital formation was clearly recognized in the 1981 tax legislation. It was strong, bipartisan support for several substantial changes aimed at encouraging individuals to save more.

I believe that the tax changes that were made last year will gradually increase the rate of saving in our economy. I am also convinced that more needs to be done to remove the savings disincentives created by government policy in order to encourage individuals to accumulate at a faster rate. The business part of the tax bill concentrated on lowering the effective tax rate on corporate source income and thereby stimulating business investment. Although the 1982 legislation clearly undid some of the provisions enacted in 1981 the combination of the 1981 and 1982 legislative changes and the lower rate of inflation, together do mean that the effective taxes on the incentive to invest in plant and equipment is generally more favorable today than it was when the decade began. But that is not enough. The effective tax rate on nonfinancial corporations, their shareholders and their creditors has increased sharply since the mid 1960's and this high tax rate continues to discourage investment. By the late 1970's taxes took more than two-thirds of the real return to capital invested in these businesses. The low rate of investment is

reinforced by high real interest rates that are caused by government deficits and the fear of future government deficits.

I think that the Congress and the administration must reexamine the problem of capital formation and try to devise additional ways to stimulate a high permanent level of business investment. Our nation's rate of saving reflects not only the decisions of households and businesses, but also the amount of saving or borrowing done by the federal government. Federal deficits compete directly with private investment for the resources made available by private saving. The projected deficits of 4% or more of GNP represent a dramatic reduction of our potential rate of net investment, when you compare them with net investment rates for the past two decades of only 6% of GNP. One of the most difficult, but most important challenges now facing the Congress and the administration is to find ways to reduce those projected deficits without distorting economic incentives by inappropriate tax increases, without hurting the poor by badly designed spending cuts, and without weakening our potential capability for national defense by unwarranted reductions in military outlays.

Shrinking the projected deficits will certainly require a create reexamination of our tax and spending programs with careful attention to the economic and military consequences as well as to the budgetary affects. But I firmly believe that the deficit can be gradually eliminated and that this can be done without violating our goals of protecting the poor, strengthening military security and reducing the burden of distortionary taxation.

Non-defense, federal government spending has increased from 9% of GNP in 1960 to 12% of GNP in 1970 and about 18% of GNP in 1980. A doubling in that 20 year period of the share of GNP going into non-defense spending. Reducing non-defense spending from 18% of GNP to even 15% of GNP is equivalent to reducing the deficit by about $120 billion at the 1985 level of Gross National Product. Thus, the future deficits that are now anticipated could be completely eliminated by shrinking the share of GNP consumed by non-defense spending back to the share that prevailed just a few years ago. Such a reduction in the government's share of GNP does not require actual cuts in dollar outlays, but only a slowdown in the growth of the dollar outlays for these programs.

I focused my remarks on the structural problems that face our economy, rather than on the current condition of the business cycle. I think that, that emphasis is correct. As I noted earlier, excessive fine-tuning during the past 15 years has been contributing to our economic problems rather than curing them.

I believe that the economy now seems about ready to recover. I think real GNP should be higher in 1983 than in 1982. In a recent national survey of leading private economic forecasters, the expected growth of real GNP between this year and next averaged 3.5% with half of the forecasts between 3% and 4%. If the current mix of macroeconomic policies is not altered, it does not seem unreasonable to me to believe that the actual GNP path will be in that range. But it

is difficult to predict the near term outlook with both precision and confidence, especially when the economy is near a turning point.

The recent decline in interest rates, is surely a welcome relief to financial markets and should provide a stimulus to spending by businesses and households. It is important to recognize, however, that interest rates may continue to rise and fall. I don’t think we should be disturbed by these oscillations and I am sure we should not try to eliminate them by a fine-tuning of monetary policy or by redirecting monetary policy to a focus on interest rates as such, to the exclusion of the monetary aggregates. I believe that as inflation continues to decline, the basic trend in market interest rates will also be in the downward direction. Even if the economic recovery causes a temporary rise in real interest rates, the effect of these higher rates will be to dampen the recovery, and not to end it. It is far better to have a sound and gradual recovery than one that rapidly overheats and fails to persist.

The 1980's can be a major turning point for the American economy. After more than a decade of rising inflation, declining productivity, and an increasing share of taxes and government spending in the national economy, we are ready for a change. Among professional economists, there is a retreat from the Keynesian economics characterized by a misdiagnosis of unemployment, an unjustified fear of saving, and an unwarranted optimism about the positive effects of government spending and activist demand management. In its place, there is now a return to the basic economic truth that a nation’s wealth and prosperity depend ultimately on its

capacity to produce and therefore on its stock of physical capital and the skills and efforts of its labor force, its entrepreneurs and its investors.

I believe that government policy is at last beginning to recognize that fundamental fact. I think that the future will therefore bring with it, better economic policies and thus a better economic performance in the years ahead. Thank you. (Applause)

QUESTION AND ANSWER SESSION

CHAIRMAN, PETER G. PETERSON: Marty, thank you very much for demonstrating so convincingly why all of us who know you say you are superbly qualified. I would now like to introduce our questioners. On my left, David Roderick, Chairman, Chief Executive Office of U.S. Steel. David would you stand please. (Applause) And on my right, an old friend, Peter Grace, Chairman and Chief Executive of W.R. Grace. Peter would you begin the questioning. Please stand. (Applause)

PETER GRACE: Who will I question first, Pete, anybody?

CHAIRMAN PETER G. PETERSON: Peter, knowing you, I don't know if it would make any difference what I said to that. But ask whatever question you want of whichever speaker you would like.

PETER GRACE: I will question Sir Geoffrey first. In the last two years you have succeeded in cutting the United Kingdom inflation in half from 18% to 9%. Unfortunately this has been accompanied by an increase in unemployment. For instance, in July U.K. unemployment was 25% higher than the United States at 12.3% versus 9.8% for the U.S. What are the odds that you could lick the unemployment problem without rekindling hyperinflation?

SIR GEOFFREY HOWE: Well I think the answer to the question in a sense was in the passage in my speech in which I said that the rise in unemployment that we are facing today is the consequence not of the fight we are waging against inflation, but of our failure to face up to the need to fight that battle sooner in the past. I am quite certain that the experience of other countries besides our own and besides yours, now underline the proposition that it is no way to tackle unemployment, to relent in the battle against inflation and to try to reflate the economy by monetary means. This is the lessons that I think one learns from the examples of the countries that I mentioned; France and Canada, which have indeed attempted to move in that direction and they find it necessary themselves, once again, to recommence, they are weary to ask if curbing the growth of their deficits is controlling the size of public spending. It is crucially important as Martin Feldstein was pointing out that the success of the battle against inflation should be accompanied by the fastest possible adjustment of performance by particularly wage bargainers within industry. If they adjust downward the rate at which their pay, salary, wages and other costs are rising, then they accelerate the process in which the room for real growth is enlarged.

That is the only way forward. We can hasten it by steering government policy so as to reduce deficits and reduce interest rates, as fast as we can in line with falling inflation, by steering government policy to the removal of supply side restrictions on the liberalism and changeability of markets. But the way not to do it is to try and retrace our steps down the road we have followed so vainly for the last 10, 15 or 20 years. (Applause)

DAVID RODERICK: I'll direct a question to Martin. Marty, the inflation rate, as you have indicated has really come down from very worrisome levels of a couple of years ago, but obviously as Peter has said in the case of the U.K. that really has been achieved at a tremendous reduction in terms of output and unemployment. In your judgment based on the factors that are in place today, and new labor settlements, OPEC and other considerations, how much further can we expect inflation to be reduced in the United States?

MARTIN FELDSTEIN: I think that the progress that has been made in the last two years, as I indicated in my remarks, was much more rapid than most economists had anticipated. I think that we can expect to see continued progress, obviously not at the same relative rate that we have had in the past, but I think there has been a change in the momentum. I think the price setting behavior has changed, I think, the wage dynamics for everything we see has changed. The major labor negotiations that will be coming up this year are all in very soft markets. I think that we really are going to be moving very gradually now but toward lower and lower rates. I think the thing that has happened in the past few years, as we come clearly away from the double digit

range, is we have removed the jitteriness on the part of price setters and wage setters who, when the inflation rate was at 10 and creeping up to 12 and beyond, saw every shock to the price level as a signal for them to try to move ahead before they fell behind. I think there is less anxiety now among wage setters and price setters; that together with the substantial softness in the economy which I don't think is going to turn around all that quickly, even though the economy will begin to recover. I think both of those are going to help us to bring down the rate of inflation. One caveat I would mention, though, is that the part of our gains in our domestic price level have come about because the dollar has strengthened substantially in response to high real interest rates. As our real interest rates shrink relative to other countries, we may see some turnaround in the dollar, and to that extent we will be importing a higher price level than we currently have and that will slow the progress of real recovery if the Fed stays with its current degree of monetary tightness.

PETER GRACE: My question is for Professor Feldstein. In the United States we obtain about 45% of all federal tax revenues from taxes on income. This compares with 35% in Germany, and only 18% in France. Now the savings rate in Germany and France are about double that in the United States. To what extent do you consider that our relatively high dependence on income taxes and relatively light on consumption taxes has been a disincentive to work/save/and invest. And what action do you think should be taken in this area?

MARTIN FELDSTEIN: That is a very complicated question. I think that separate out the savings

part from the work part. I think taxes, whether they are taxes on consumption or taxes on income, have an adverse affect on work incentives. But the distinction that you correctly draw between consumption and income taxes does make a very big difference to savings incentives. I don't think we should have a consumption type tax of the European sort of value added tax. I think we don't need another tax in the United States, but I think we need to reform our income tax structure to move it more in the direction of tax and consumption, of exempting savings or the income from savings, and I am very impressed with the progress that was made in the direction in 1981. It showed a real change in thinking on the part of Congress to adopt the IRA's, to bring down the top rate on capital income, to increase earlier the exemption on capital gains, to bring down the tax rate on estates. All of that I think shows a more appropriate understanding of the need to shift the kind of income tax we have in the direction, focusing on consumption and exempting savings.

DAVID RODERICK: I would like to direct a question to Sir Geoffrey. You commented in your talk Sir Geoffrey that the fixed exchange rate system, of course, as we know is gone, and we now have the floating approach. In view of the continuing strength of the American dollar versus say the Japanese yen, the British pound, the Deutsche mark, the Canadian dollar, do you believe that the relationships that are out there today are rates that really have economic validity or are they rates to some extent that are being manipulated by individual governments for trade reasons. For example, the value of the yen versus the dollar. The trade deficit versus this country or the trade surplus. I think over the last three years has risen from about $8 billion in favor of Japan to 12, I

think it is up to $18 billion this year. Nonetheless while that is happening, the yen continues to weaken versus the dollar. Is that some evidence that perhaps the floating rates leave the possibility of manipulation?

SIR GEOFFREY HOWE: Well my experience has taught me to avoid pronouncing in any absolute form upon the "rightness or wrongness" of any level of exchange rates. If one pays some difference, I think one must, to the proposition that exchange rates are primarily determined by market conditions. So I decline your seductive invitation (applause) to pronounce precise judgment. But, if it may be noticed that the yen has not been notably strong in recent times, it may also be noticed that the dollar has not been noticeably weak and it takes two to tango even in exchange markets. (Laughter and applause) The dollar, if I am correct, has risen, I think by about 30% over the last two years or so. Now the fact is, and this is the serious point I want to make. Wherever you try to identify the point, and whatever precise conclusion you reach, it plainly is possible for international trading conditions to be unnecessarily disturbed by unduly sustained, unduly prolonged divergences of exchange rates, from something that may be closer to the most sustainable rate. And one of the propositions that I put forward and I spoke to the IMF last year which was taken up in the BSI Communique this summer was the proposition that once the former fixed exchange rate system of Bretton Woods had disappeared then there does rest upon the governments responsible for the 5 P currencies, the dollar, the pound, the yen, the franc and the Deutsche mark to do more than they have so far have been doing to try to secure convergence of their economic policies, to make sure that there isn't too great a

divergence between fiscal and monetary policy; sustaining interest rates that are higher than they need otherwise be. Sustaining the exchange rate in consequence of that. Higher than might be more compatible with the maintenance of smooth trading conditions. Now reverse that and the same may be true of another currency. I refrain from making precise judgments, but I am glad that the International Monetary Fund is now beginning to take a representative role in discussion with the Finance Ministers of the 5P currencies to discuss whether we can adjust our policies, to bring their performance more closely together, to avoid the kind of divergence that you have been talking about. I think it is important for all of those key currencies to do that. It is the first step back towards a more orderly set of currency relationships in which, as I said in my speech, pressures for protectionism are likely to be reduced rather than increased. So I think I have at the end of the day answered your question, although not precisely in the way in which you put it. (Applause)

CHAIRMAN PETER G. PETERSON: Sir Geoffrey, I might say that in our government I think you have done very well. We used to say something about this man is about as candid as a Finance Minster on the eve of a devaluation. (Laughter) You were vastly more candid than that Sir, in that answer Sir. Peter please.

PETER GRACE: Sir Geoffrey, speaking of exchange rates, the British industrialists were expressing great unhappiness when the pound was at about 250. Now you can buy 30% more pounds as you just said with the rate of 170. Are the British industrialists happy now? Do they

feel better about it?

SIR GEOFFREY HOWE: Well, far be it for me to ever reach the situation for claiming that such a wide and diverse group as British industrialists are happy. They are a pretty varied group of customers to satisfy. As you may have noticed. But undoubtedly, the upward pressures on the pound that followed the impact of the second oil shock, alongside the growth in the North Sea output, did as I said in my address, add formidably to the problems of adjustment for British industry, and manufacturing industry in particular, and those added pressures have now been reduced to the extent that our exchange rate is now back to the level at which it was as an effective measurement in May 1979. British industry is still not happy, nor am I. Because a great deal of the loss of competitiveness which we had suffered in previous years, because of the high rise in unit labor costs, because of high pay settlements, still persists. Although we have made formidable advances in productivity, there is still some way to go and British industry recognizes that, so do we, we intend to stick it out together because we know we are heading in the right direction.

DAVID RODERICK: I have a question for Martin. Recently, we have heard that a number, really 21 of the countries, third world countries primarily on this side of the Atlantic, Mexico, Argentina, Peru, with Brazil running right behind, all seem to be having trouble meeting their interest payments on their loans or at least their principle payments. In this country we have tried to pull back monetary expansion, but it seems that in the third world countries we have been

plowing money in causing tremendous inflation, or at least contributing to inflation in those countries and really supporting projects in those countries that are economically non-self-sustaining. If this medicine is good for the U.K. and the United States, wouldn't it be good for the third world?

MARTIN FELDSTEIN: You know when the International Monetary Fund goes into a country like Mexico, it requires, as a condition of the credit that it provides that they get their house a bit more in order. And that they cut their rate of growth of money supply, that they cut their level of government spending, that they bring down the size of their government deficit. Indeed when that set of policies for Mexico was being discussed, some of my friends in Washington, wondered how we could apply to the IMF and get them to impose that on us. (Laughter) But certainly to answer your question more seriously, these countries have gotten carried away. In many cases, on a rising tide of prices of the products that they were selling, oil prices especially in Mexico's case, looked at, from the point of view from the projections that they thought they were making reasonably in the past, for the future price of oil, their borrowing wasn't done reasonable. But now, after the sharp turnaround, they find themselves in a very serious position, particularly with high interest rates and a strong dollar relative to their own currencies, they are suffering a substantial economic problem. The only solution for them is to adopt the kind of controlled discipline that the IMF will impose upon them as conditions for getting aid.

PETER GRACE: Dr. Feldstein, despite the tax rate cuts enacted last year, inflation is pushing

taxpayers into higher brackets, through bracket creep. And it is a $39.5 billion cost as I see it, in 1982, on top of this, a new tax bill, which was just passed, increases taxes by about $100 billion over three years. How do you view the impact of these higher taxes on the general economy and what do you see as a solution?

MARTIN FELDSTEIN: I think you are correct in emphasizing the role that inflation has played in pushing people into higher and higher tax brackets. I think one of the most important things in the 1981 tax act was the introduction of indexing beginning in 1985. I think it is extremely important to... I gather there are some fans of indexing out there...I think it is extremely important, that that be maintained. If it isn't then all of the progress that has been made in bringing down personal tax rates will be lost and we will simply see the population shifting up into higher and higher brackets. So I think that is the most important thing to be done. If that stays in place and if the inflation rate stays on the course that it is on now, then the 5/10/10 series of tax cuts will have brought down significantly, certainly not 25% but something like a 7 or 8% point reduction of tax rates, and I think that will be a major achievement in finally turning around the rate of growth of personal taxes.

DAVID RODERICK: I have a question for Sir Geoffrey. During your speech, Sir Geoffrey you indicated a desire to not foster protectionist attitudes or cause trade distortions in the trading world. And of course I think that most of us here in America feel very strongly and support that view. Along that line, probably one of the most trade distorting type practices, of course, are

subsides to government controlled corporations, would you comment on when you would expect Europe to discontinue that practice? (Laughter)

SIR GEOFFREY HOWE: I am in no position to speak for the whole of Europe. (Laughter) Nor am I in a position, nor indeed would it be courteous for me to begin inviting those who identify beams in my eye to cost out motes(?) of various kinds from their own amongst my host. Because protectionism does exist on both sides of the Atlantic. I think the point you make about subsidization is of course important, and if I may take, since I suspect it may be lurking somewhere near the center of your mind, (laughter), the example of the United Kingdom steel industry, (laughter and applause) and I want to make the point quite seriously. My home town was one of the leading steel towns in South Wales Port Talbot. My grandfather, decades ago was one of the founding members of the Tin Platers' Union. And I practiced at the bar for many years, and my best plant at the bar was the Iron and Steel Workers Union. And in that town of Port Talbot, three or three and a half years ago, the number of people employed making steel was about 12,000. Today, the same volume of steel is being produced or painfully being produced by about 5,500. In the British steel corporation as a whole, in spring of 1979, there were 186,000 workers producing steel, the number is now to 103,000 and we have reduced over manning, which American corespondents quite rightly identified as one of the symptoms of the British disease, if I may pick up the phrase. Dramatically in the space of 3.5 years, when it persisted for far too long. Now that has been done at the cost of very considerable hardship to my towns people in South Wales and many others. And the overwhelming part of the so called subsidy that

is being paid to the British steel industry is going to the consequences and the costs of those redundancies of running down the over-maintenance of labor resources and of correcting the mistakes of over-subsidization if you like in the past. And if we continue on the present track record of the British Steel Corporation, under the leadership which we are fortunate to have of Ian MacGregor, a Scottish born American citizen as you know, then we should be getting back to break even and profitability within the reasonably foreseeable future. So we, I think can claim to be doing more than our level best to eliminate subsidization and doing so at the cost of very substantial political difficulty, at the cost of very substantial human suffering. We are doing that in a market which is itself open to steel trading competitors. I noticed this morning, that the percentage of the British steel market is being taken by what would be described there as low cost competing imports. Now it stands at about 40%. So we are not crying. We are restoring the competitiveness of our industry, in a world where the steel industry is undergoing dramatic changes, because as you know so much better than I, every newly industrialized country is moving into the steel business and deposing formidable pressures upon our industry as well as your own. In those circumstances we think that we have moved, as I say domestically in the right direction, and that the deal that has been struck, between the European community and the American administration, providing for a European share of your steel market of 5.75%. A deal which would bring together, not just some competitor industries, but the comprehensive range of competitor industries in the European Community with your own. A deal of that kind is the kind of arrangement that does make sense in today's circumstances. You have your problems, I know and I respect your leadership and your difficulties very directly. We have ours. We are trying to

deal with them. Beyond that, let's try to deal with the wider problem together, within the framework of the kind of agreement which I have outlined. (Applause)

CHAIRMAN PETER G. PETERSON: I think we would like one more question from each of you, so Peter this will be your last question.

PETER GRACE: I have one for Sir Geoffrey. The U.K. and the United States are the only major countries with a broad based capital gains tax. Recently the United Kingdom started indexing capital gains before taxing. Do you feel that capital gains taxes at the level of the U.K. and the U.S. are around 25%, 30%, the U.K. which would be around 30% after indexing, are a serious barrier to the growth of the private sector?

SIR GEOFFREY HOWE: I think that the taxation of capital gains, not least because of the complexities introduced into the tax system, and sadly the complexity becomes increased as one tries to meet the injustice of a non-indexed capital gains tax system, do represent an unattractive interference with the profit reward of enterprise in a free enterprise system. But, I spoke the other day to one of my Finance Minister colleagues, where their capital gains tax has been totally removed. And he underlined my own instinct that if one removes altogether a system of taxation on capital gains, then the inventive capacity of entrepreneurs and their tax advisors to transform income into capital, will once again be inspired to renewed zeal and energy. (Applause) So we do have, I think, to live with some kind of capital gains tax system. I am therefore, mitigating the

worst effects of it. We have raised the exemption levels so that a large number of people with reasonably small capital gains are out of the system altogether. And I have responded, as I have said, to the popular demand to make it less blind to inflation, as so often my fulfillment of the best aspirations of my customers hasn't led to immediate and universal acclimation in the streets. But I will go on doing my best. (Applause)

DAVID RODERICK: I have a question for Martin. As we know, both last year and this year, a great concern in Washington has been tax policy, or lack thereof. The question today seems to center on two taxes that I think clearly will be a topic in the next 12 months. One obviously is the so called suggested flat rate tax. I would like to hear your comments on that. And also, the other is an increased or expanded base Social Security tax and I would like to hear your comments on that Martin.

MARTIN FELDSTEIN: Let me not comment on the second one at all. Let me comment more on the flat rate tax though. The flat rate tax has suddenly attracted a lot of interest and I think that is because it means different things to different people. The flat rate tax can be a very good tax. The idea of a broad-based on consumption, taxed at uniform rate above some kind of an exemption is very appealing. I am afraid though that the interest in flat rate taxes will not lead to anything like that. But would in fact simply lead to another round of base-broadening designed to raise more tax revenue. So I am quite frankly nervous about the discussion about flat rate taxes and about the enthusiasm that it has created among people who don't ask very clearly just what is it that I

am buying under that label. I think until it is specified and I would be very leery of it, and if we are to move in that direction, I certainly hope that is in the form of a consumption tax that excludes savings before applying the tax. (Applause)

CHAIRMAN PETER G. PETERSON: We have many people to thank this evening. David Roderick...David we thank you for bringing your broad and insightful industrial mind to bear on these very relevant questions. Peter you continue to amaze all of us with the student that you remain and I say that most respectfully of public policy and the enormous knowledge that you have and we thank you sir for coming this evening. We would like obviously to tangibly thanks our very distinguished speakers. Lady Howe and Sir Geoffrey Howe, we would like to give you a token of not only our esteem but our city, a big apple from the Steuben Company to express our gratitude. (Applause)

And Marty, I hope you will trust me enough to believe that there is a similar object in this box. (Applause) And I know I speak for the audience in saying that you have reassured many of us that we have someone in a key post with a brilliant mind who is indeed superbly qualified for your post and we wish you well. (Applause) It is now 9:58 and I assume you will not be profoundly disappointed if we break up two minutes early. Thank you.