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MEMORANDUM OF CONVERSATION -- PUERTO RICO SUMMIT

June 27 and 28, 1976



President Ford: On behalf of myself and my colleagues, and the people of the United States, I welcome you to Puerto Rico. We have a formidable task ahead of us in these next two days -- to address major common concerns, and to identify areas in which improved cooperation among us can contribute to the well being of our citizens and to a more secure and prosperous world.

As we all know, meetings of this sort raise anticipations of dramatic results. But the important thing about Rambouillet, and our meeting here today, is that they are part of an essential and continuing bilateral and multilateral effort by the leaders of the key industrialized democracies to address common problems and to improve mutual understanding.

The complexity of our nations' economies, individually and collectively, means that we as leaders cannot afford to allow major difficulties to arise and then, by dramatic meetings, attempt to resolve them. It requires instead that we concert our efforts to prevent problems from arising in the first place -- to shape the future rather than reacting to it. It is with that objective in mind that this Summit is being held.

The central economic, political, and security importance of our countries to one another, and to the world, confers upon us special responsibilities. In the economic area, on which we will focus today and tomorrow, our strong commitment to shape constructive approaches can contribute to our common prosperity, strengthen our broader relationships, and prove highly beneficial to the world at large.

Recent experience has clearly demonstrated that, because of our interdependence, common problems are unlikely to be solved unless we apply our mutual efforts. They have, in addition, shown that our common concerns are far more significant than the differences which arise among us from time to time. We must, therefore, approach our problems with a political will and a spirit of cooperation which takes full account of the need to preserve and strengthen our broad and essential relationships.

The success of this conference will depend on our collective abilities to agree on sound directions for our economies and cooperative efforts in

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the various areas we will discuss. The vision and sense of shared purpose which results from these meetings will help each of us to pursue constructive policies at home, with respect to one another, and in dealing with global issues.

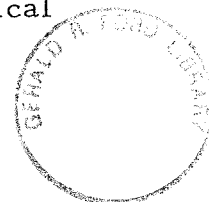
I am hopeful that the same positive spirit that developed at Rambouillet can extend through our meetings here at Puerto Rico and beyond. Much of the world's future depends on our constructive cooperation.

We have a full agenda and less time than we would like. Thus, I should like to begin by giving the floor to my friend, President Giscard d'Estaing, who will lead off this afternoon's discussion of the issues of recovery and expansion, and financial and monetary matters.

President Giscard: Thank you for calling on me, Mr. President. At the same time let me thank you for being host in this spirit of friendship and good understanding which we find here at this meeting. When we met at Rambouillet, six months ago, it was not clear that the world economy was committed to recovery. Today our economic situation is quite different from Rambouillet. In fact, most of the industrialized nations sitting at this table have experienced strong recovery, as contrasted with the 1975 situation, and even better than our hopes expressed at Rambouillet. I don't have a precise number, but all of us know that the rate of growth of the seven nations here in 1975 was minus 1.6%. When we met in November, the forecast for the seven nations was 4.25% growth for this year. Now the experts forecast for the seven nations is 5.6% for 1976. This is a strong rate of growth; considerably stronger than expected.

Our problem now is to transform recovery into sustained and lasting expansion. There are two risks: an increase in inflation, and the inverse risk -- a lull in recovery following restrictive policies resulting from balance of payments problems or a return to protectionist practices. The present recovery has been characterized by persistent, strong inflation. This is because the recession of 1974 and 1975 was the only one in history which was not accompanied by a price decline. Now, as a consequence, the recovery proceeds from a starting point of high levels of inflation left over from the recession. Now we are also seeing an increase in prices in raw materials, and the remnants of increases left over from support mechanisms used during the time of the recession. This pervasive inflation raises questions about domestic economic policy and international monetary relationships.

That is all I have to say by way of introduction. However, Mr. President, these issues reflect very much on our domestic economy and political situations; they are important issues for all of our countries.



With respect to the policy issues, our actions must center on the fight against inflation and be consistent with our policy of achieving full employment. The problem is that during this recovery in our economies insufficient progress has been made toward a trend to full employment. Inflation is still strong, but no where is there any lack of supply, so this is not a classical relationship-of-supply-and-demand problem; and there is also lots of unused capacity. Another problem is that there have been increases in the price of raw materials, wages, and profits, and such cost increases have contributed to inflationary pressures. A third problem is that inflation has been amplified by programs implemented to deal with the recession -- efforts to stimulate demand during the recession through deficits.

There are several approaches to dealing with this problem. We must cut down material demand. It is not necessary to follow a policy of cutting down monetary expansion of demand, which would lead to a more restrictive monetary policy and thus affect interest rates. Our Treasuries must be involved in the process of cutting demand. We should reduce demand through public financial measures, and we must cut budget deficits. This will be difficult but we must make the effort. If we can get into balance, this may also lead to constructive action on the trends of wages and prices. But, of course, the picture is different in each country, and this means that each country must use its own policies to achieve this objective. It may not be possible to get back into budget balance in one year for France, but we probably can do it in two years.

But we also need more international cooperation since we live in a world which makes such cooperation necessary. The traditional convergence in economic policies can reduce divergences in inflation and, therefore, exchange rates. The directions of monetary movements are tied to the disparities in inflation rates. Our goal is reducing the disparities in inflation rates in all industrialized countries.

With respect to the trend in 1976, balance of payments will be worse than in 1975. In order to sustain growth under these circumstances, we must find ways to involve the inputs of the oil-producing countries and fight protectionism. We must also consider ways to aid the developing countries. The situation of the developing countries is difficult; there is likely to be a drop in their internal demand.

But economic cooperation also needs to take place with respect to monetary issues. We need consolidation on the international monetary level. What was decided at Rambouillet was a satisfactory level of consolidation of the monetary situation. The key element in this are developments between the

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dollar and the "snake". We have had, since Rambouillet, a six-month period of relative stability in exchange rate markets sustained by a demonstration of intent to cooperate and the action of the central banks and treasuries, with greater cooperation among them. But today the situation is different. Now the deficit in balance of payments for the OECD would be roughly \$20 billion in 1976 against only a few billion in 1975. This calls for a new orientation. Now we must agree to a deterioration in balances. The strongest countries must agree to a reduction in surpluses and must maintain capital exports to the developing countries. We must use the existing mechanisms to finance deficits of the developing countries. Some countries are in special conditions, but some have the ability to finance major deficits. The US has made some earlier suggestions in this area of financing (The Financial Support Fund) and it would be desirable to ratify and implement them. With respect to the IMF, this involves the use of Special Drawing Rights, and we must also use the oil country surpluses, which are roughly \$40 billion.

There are a number of technical problems; however, this would not be an appropriate place to discuss them or to make detailed suggestions. But on currency markets there is not much we can do now. We should renew our order for central banks to increase cooperation, to avoid swings and exchange rates among major currencies. We should also consider whether it would be useful to have a small group of specialists examine policies in exchange markets in situations of recovery and inflation. These are my opening comments, Mr. President.

President Ford: I thank you, Mr. President. I now call on Chancellor Schmidt of Germany.

Chancellor Schmidt: Before making observations on what my friend Valery has said, I want to express my gratitude to President Ford for taking the initiative for a second meeting after Rambouillet, and for his generous invitation to be here at Puerto Rico. We all know how useful Rambouillet was. I am convinced it was very helpful in our efforts to achieve recovery.

I subscribe to what was said by President Giscard about progress since Rambouillet. I believe we exercised cooperation in analyzing and combating recession and in creating increasing domestic demand instead of permitting failing world demand. We used corresponding measures, policies which were compatible. We also avoid restrictive trade measures at the expense of one another. And we exhibited a large measure of solidarity dealing with balance of payments problems. These payments problems will grow in 1976, as Valery said, and inflation is also beginning to grow. It could be bigger in 1977 than in 1976.

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Thus, I share the broad impression that the world recession is behind us, although there are exceptions. But I have seven or eight questions, or problems that I would like to point out:

1. Demand is still not rising evenly in all sectors of our economy.
2. The upturn is evident primarily in private consumption and investment in stocks rather than in fixed investment.
3. Fixed investment is still too small, and must increase as a percentage of GNP.
4. Prospects of reducing unemployment are still not adequately insured for all of us.
5. A final victory over inflation is not yet in sight, so recovery could be hurt by new inflationary pressures like in 1972 and 1973.
6. There are differences in degree in inflation rates and the balance of payments of some important countries.
7. New disturbances between North and South cannot be excluded. They may not be of the magnitude of the 1973-74 OPEC price increases, but they could have an important effect on the world economic system.
8. West-East matters will play a greater role in the world economy in the future than in the past. This is not only exports of fixed investment and plans toward the Soviet Union, or wheat. It also applies to the amount of Soviet dependence on Western money markets. This is a matter of very high importance.

Our priority must be to check price increases and to strengthen confidence among investors thereby increasing investment and creating higher levels of employment. If we have an inflationary environment there is less confidence. Increases in inflation increase risk, and make it seem prohibitively expensive to undertake large investments. Expansion requires that prices be held in check. And employment increases are not possible in the face of growing rates of inflation. Each country must choose its own instruments. Each country knows best how to undertake disciplinary measures in its monetary, credit, and budgetary policies. It is particularly important that business exercise restraint in its price policies in order that labor accept improved profits due to higher labor productivity, and it should pass on cost improvements.



The policy mix varies by country. We need to give basic acceptance to economic measures which we consider to be right. There are some intriguing examples. I cite particularly Jim Callaghan's wage deal with the unions in Britain as an example of a process of better understanding among social groups about economic policy.

Only if we narrow differences between various countries' economic performances will we be able to restore exchange rate stability. Finance ministers and central bankers have been successful in working from day to day on problems arising from different velocity of inflation in different countries. We have seen exchange rates in different countries reflect different rates of inflation. There is an overriding necessity to make the economic upturn stable, which will then stabilize exchange rates. We must, therefore, stabilize prices in order to stop erratic movements in exchange rates.

Questions one through eight can also be put into one category -- the dangers of further destabilization. That, Mr. President, is my concern.

One more issue, Mr. President. I am confused and worried about the increasing number of conferences which talk about these matters and which pretend to take decisions. I feel reminded of what was pointed out at Rambouillet by Harold Wilson. The facts bore him out. We have had meetings on world economic issues, international systems, and management of the world economy in Paris, Nairobi, Geneva, Washington, and Kingston. It is becoming impossible for leaders to follow what is going on and to give instructions to their representatives. It is important that this type of meeting insure basic common tendencies of thought.

I have dealt with the inflation issue and how we have overcome recession. Now we need to make recovery stable and permanent. If we again lapse into inflation, we could again find ourselves back at square one in less than two years.

President Ford (to Chancellor Schmidt): We have done a great deal of research following Prime Minister Wilson's comments at Rambouillet on the number of international bodies. We found the list very imposing when it is all added up.

Mr. Prime Minister.

Prime Minister Callaghan: Mr. President, in this setting of Puerto Rico, we should recall Harold Wilson's exact phrase at Rambouillet: that there are a number of international beachcomers looking for new committees to set up. (Laughter)



Mr. President, we agree with Chancellor Schmidt. We are meeting here in Puerto Rico in an atmosphere different from Rambouillet. At Rambouillet there was a feeling of gloom. There was no real optimism that recovery was underway. Now we are talking about how to stop the recovery from coming to a premature end in six months. I very much hope that cycles are not becoming shorter, that we are not in a period in which business cycles are quickening.

I feel compelled to make three points in respect to this recovery. One, however far the recovery has gone, rates of growth are not exceptional. My second and third points have already been made by Helmut and Valery. I repeat, however, that at this stage in the cycle inflation is too high. My third point is that unemployment is much higher at this stage of the business cycle than at any previous corresponding stage. Both of these things are worrying to us. Clearly it is for individual countries to fashion their own policy to the requirements of each. But, equally, it is difficult for industrialized countries to pursue policies in the long run which differ very much from one another.

In the UK signs of recovery are present, but this is nothing like the position of our neighbors. We certainly agree with the need to contain inflation, and I agree that victory is not in sight. The Chancellor (Healey) says it is, but he has long vision. If our new agreement with the unions sticks -- holding wage increases to 4-1/2% -- and I believe it will -- it received an 18-1 majority in the TUC, and the mood of the UK indicates that support for it will stick -- by the end of 1977 we will be able to look you in the eye or very close. We expect these to bring our rate of inflation down to single figures. If not, I will have Dennis explain why not.

But we also see unemployment as a major social evil. We place high priority on reducing unemployment. It is not just an economic issue, but a political issue. We should not have policies which allow this excessive rate of unemployment to continue into the 1980s. The OECD growth scenario is a worrying feature in this respect. If this scenario is followed, the UK will have unexceptional high levels of unemployment; these could lead to political changes, which will be extremely uncomfortable. We remember in the UK the high rates of unemployment in the 1930s. These were very divisive. Therefore, the UK is different from Germany in this respect; we find unemployment much more uncomfortable than high rates of inflation.

Thus, we place as much emphasis on lowering unemployment as Helmut does on reducing inflation.





The main question is, can we find policies to reduce inflation and also reduce unemployment. I believe that the policies which can do this require maximum cooperation between the various social partners -- government, employers, and the trade unions. In other countries unions are not as strong as they are in the UK. Therefore, we need social cooperation. Trade union restraint is needed if we are to reduce unemployment. Still we have to adjust our policies every year, and next year will be extremely difficult. We also know we need fiscal and monetary restraint if our other policies are to be successful. Thus, what we need in the UK is a balanced policy among all these elements.

I have questions as to whether further restraint measures are needed to keep inflation in balance. Except in Japan, exceptionally high rates of growth are largely due to a turn-around in stocks. There is no lasting economic stimulus in stocking, and thus rates of growth may moderate. In addition, fiscal and monetary tightening is already in the pipeline -- France and the Netherlands already appear to be increasing taxes, thus there will be a public contraction by many countries to eliminate their deficits, as in France. There will also be a tightening as the one-shot public employment programs run out.

In addition, if the OECD's predicted 5.6% rate of increase in GNP turns out to be right, this would be only modest when compared to other cycles. But a plus-5% growth path would still leave high levels of unemployment at the end of the decade. We think the forecast should be higher. For instance, we think the estimate for the UK of 4-1/2% is too low. With respect to the UK, export lead growth is really our salvation. It is now 11% per annum, and we want to keep it up. This would be jeopardized if the stronger economies overreact to inflation. If our exports are jeopardized by overreactions elsewhere, we would be seriously hurt. If inflation continues or worsens, my views on this could certainly change; but for now I am very much concerned about premature tightening up.

I agree with Helmut that central bank cooperation has been a great help to us and the world as a whole. And I agree with President Giscard that we should renew instructions to our central bankers to cooperate to a higher degree. We should not give this too much publicity since that would create uncertainty. I agree with what was told to me many years ago. "Money is like a woman's virtue, the more it is talked about the less secure it is." We should not say much about this afterwards.

President Ford: Thank you. I now call on Prime Minister Moro.



Prime Minister Moro: Economic recovery in most countries is greater than forecasted. But a sustained pace of recovery is necessary. High rates of inflation could reduce expansion, but the risk of putting the brakes on too hard must also be remembered. We must also remember that there are persistently high rates of unemployment in many countries; and in many countries the path of recovery has been delayed, for example, Italy. In addition, some countries are threatened by a re-emergence of balance of payments problems combined with inflation.

We must continue to expand exports to get out of our vicious cycle. Therefore, we need an increase in international growth to allow recovery to spread to all countries over the world. This can help us to cut employment and thus to cut the waste of human resources, which is politically bad for the Western democracies. We need this to organize our societies based on progressive labor, and thus we need high employment to do this.

Let me give you some figures on the Italian economy. At Rambouillet, I pointed out the improvement in our balance of trade, employment, and prices. The only negative figure was a decline in production. Unfortunately, although GNP is now increasing, this has hurt our balance of payments, which has also been affected as well by increased in prices, and our inflation has been affected by the drop in the value of the lira.

Our government must make a decisive approach to structural balances which caused the crisis. We have now emerging a short-term program combined with a program for structural change. This will deal with public finance expenditures and tax revenues. It also examines a program which leads to a reduction in excessive wage demands to rates closer to those with our trading partners.

We also need a credit policy to help promote investment and we must cut down on energy imports. The success of our overall program will depend essentially on whether Italy can achieve economic recovery and reduce its high level of unemployment. This is a major political commitment. For this, we need a consensus of Italian social forces, and we need the support of the rest of the world so we can emphasize exports, which are necessary for our economy to make a new start. Unless there is financial solidarity which allows countries such as Italy to face speculative attacks, there will be a problem because we cannot allow our exchange rates to depreciate and thereby cause higher rates of inflation.

President Ford: Thank you, Mr. Prime Minister. I would like now to call on Prime Minister Miki.





Prime Minister Miki: When we assembled at Rambouillet in November, all of our national economies were showing declines. Unemployment was at high levels. Our free economies and democratic governments were on trial. That meeting, and subsequent months, have helped us to attain the self-confidence we needed to stimulate our economies. In the beginning of the year there was a turn for the better in our economies and an increase in trend as well. There was also an increase in confidence in the abilities of our governments to run our economies effectively. But our recovery should not be short-lived. Instead, efforts should be made to stabilize the recovery; that is, to sustain it on a stable basis. Therefore, we need flexibility and broad policies, as well as international agreement and cooperation to expand world trade. We want to find, at this Summit, ways to increase cooperation. The US has been the prime mover in the world economy by virtue of its having recovered first. This is important when the world economy is still in a delicate period, and when cooperation is still needed among us. And we need the cooperation of the LDCs as well.

The GNPs of the countries represented here represent 60% of world GNP, and these countries account for one-half of all world trade. They also base their body politic on the principles of liberal democracy, and defy challenges of the right and left. We as leaders should thus get together frequently.

With regard to the Japanese economy, since last year increases have occurred in demand at home and abroad, and as a result there will be a 6% increase in real growth in 1976. The increases in exports to the outside world have contributed to the economic recovery, but recently domestic increases in demand have been more significant, for instance, private housing. With respect to prices, we have had an 8% increase in the consumer price index and a 5% increase in the wholesale price index. But there is a trend toward stabilization. Recently there has been only a very moderate increase in wages even without an incomes policy.

With respect to monetary policy, much work has taken place on the international monetary system. We welcomed the Jamaica reforms. These are indispensable for the growth of the world economy. We ratified these reforms on June 18. With regard to exchange rates, it is very difficult to maintain an exchange rate through government intervention. We, in principle, leave exchange rates to the forces of supply and demand. We intervene only to frustrate movements toward market disruption. Japan now has a surplus in its foreign trade. We have a large surplus with the US due to the American recovery and to a lag in Japan in imports of raw materials. But our current account could move into deficit soon. On May 31 we ratified the OECD safety net to help in balance of payments cooperation. We hope the US and others will take similar action.

President Ford: Thank you, Mr. Prime Minister. I would like now to call on my friend Prime Minister Trudeau of Canada.

Prime Minister Trudeau: Thank you, Mr. President. Let me begin by reflecting on the state of our economies, and I will try to be brief because much has already been usefully said on this subject.

Canadian economists believe that during the last period of expansion all of our countries reflatd at the same time, and we overdid it. The problem was added to by a tripling or quadrupling of oil prices, which caused severe problems for all of us. Then, our corrective actions amplified each other. We overshot our goal. This history should be a warning to all concerned not to do it again. We all should warn ourselves of this danger and the need to establish cooperation here and with our central banks.

Against this background, I have two remarks. We know that cycles have coincided in the past, but they will not necessarily do the same in the future. I know from Mr. Callaghan that he is cautious about restraining growth because of its negative effect on other countries. In fact, our cycles need not be in phase. Maybe it is safer if they are not in phase so that they can pull each other in a moderating direction. If they are not in phase, we could learn from one another; for instance, we can learn from the UK experience in dealing with wage and price controls. We can pool our experiences and learn from one another's successes or failures. The UK experience is helpful in teaching us how to deal with the unions. Germany's experience can be helpful likewise in understanding how to deal with the problems of the labor unions. We should try to be in touch so we can learn from one another and be helpful to one another.

Chancellor Schmidt has spoken of the need for discipline and Prime Minister Callaghan on the need for a proper philosophical outlook. At some point we can help each other on these fronts. Our economists cannot give us a guarantee that we will not have high unemployment and high inflation again. The same type of action as taken in the past could have the same effect. In our democratic society we have today a revolution of rising expectations. Some of us have been successful in containing these; in other cases these have resulted in the danger of inflation. But in all societies we are faced with the problem that people want more for themselves, not in the future but now.

On the monetary and fiscal policy, on which instruments we must rely, we have a danger of making it too restrictive, or of causing inflation if it is not restrictive enough. But the real problem is that we do not do enough



to change peoples' expectations. If we have a tough fiscal policy, high taxes, people want to be better off after taxes than before, so wage demands are higher. And, because we want to provide equality of opportunity, we provide welfare payments. But it is hard to make people understand that with old age pensions, health care, etc., they do not need the same real incomes as if they had no paid medical care or old age pensions. Our peoples must understand that need for discipline. This is in part a philosophical problem. We must discuss this problem. We can help ourselves and one another. For instance, perhaps we might be able to help President Giscard sell to his people the capital gains tax by demonstrating that it does help economies.

President Ford: When we met at Rambouillet last November, the discussions centered largely on how to assure a balanced recovery from the deep recession of 1974-75. The US economy was on the path to recovery at that time, but the upturn was not yet as visible.

I am pleased to note that we now meet in an obviously improved economic climate: in a number of countries, including my own, pre-recession levels of output have been regained or even surpassed. Unemployment is beginning to recede, considerable progress has been made in reducing rates of inflation and our own recoveries are also reflected in a significant expansion in world trade, thus contributing to recoveries elsewhere. In many respects, our success in turning the recession around reflects the fact that we were able to refrain -- in the face of strong political pressures -- from instituting overstimulative measures in our economies and from imposing restrictions on trade. Both these courses would have been short-sighted in nature and would have proved counter-productive.

But, lest we get carried away with our accomplishments, may I suggest a number of sobering thoughts. The main problem that led to the deep recession was the climate of inflation that persisted for a decade, severely exacerbated by the oil price increases of 1973-74. The global inflationary climate resulted in large part because governments overcommitted themselves to ameliorate social inequities at home and abroad and to achieve an ever rising standard of living. These commitments proved to be too ambitious in economic terms both in what they actually attempted to achieve as well as in the expectations they raised among the public. Thus, a major task for the next several years is both economic and political -- not only to restore our economies to a sustained growth path, but also to set realistic goals that are accepted by the public at large.

Our task is not an easy one, but I believe we have learned from the experience of the past several years. Perhaps the most important lesson

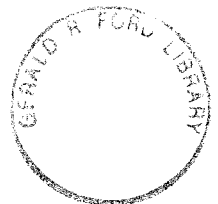


is that inflation, by itself, creates recession and is thereby a major cause of unemployment. Hence, a necessary condition to restoring and maintaining full employment is to eliminate the inflationary tendencies from our economies. I have, in this connection, been heartened by the support our Ministers received at the OECD on a strategy for sustained expansion based on the premise that the steady growth needed to restore full employment will not prove sustainable unless our countries make further progress toward eradicating inflation. Such agreement in diplomatic forums is important, but it is even more important that we in fact put actions behind our language.

Secondly, we must pay greater attention to the state of confidence in our economies. Consumers, in the face of inflation, increased precautionary savings. Business, fearful of the future course of our economies and the unpredictability of our policies, curtailed capital investment -- the key element of economic growth and job creation.

For these reasons, a lasting turnaround in price expectations is crucial to the attainment of high employment levels. Furthermore, because of the recent inflationary experience, expectations of renewed inflation may be triggered relatively more quickly than in the past and, once renewed, will prove increasingly hard to erase. Under these conditions, we must be doubly certain that our fiscal and monetary policies in the period ahead avoid undue risks of setting off another round of inflation. It would be more prudent for short-term policies to err on the side of caution rather than on the side of expansion.

Expansionary policies have clearly been politically easier to implement than policies of restraint, especially when our levels of unemployment are still high. Moreover, in the US many Federal expenditures are inflexible and subject to automatic increases. But the underlying growth trend of outlays is in excess of growth in our GNP and in our tax base. Therefore, it is essential that we attempt to constrain the growth in expenditure levels if we are to reduce the budget deficits in this country. We have been unable to maintain short-term fiscal fine tuning on the side of restraint. Therefore, we must recognize that we have exceptionally long-lead times on reducing the rate of growth of expenditures and, should it be required, on raising taxes. It is important that we initiate our fiscal policies well in advance to forestall too much of the burden of potential restraint falling on monetary policy. The problems I have just described with respect to the US appear to be common to many industrialized nations.

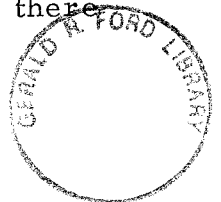


Appropriate short-term policies are a necessary, but not a sufficient, condition for a return to high employment levels. A return to sustainable, non-inflationary growth presupposes a reordering of priorities and, in particular, a shift of resources toward private investment. The distortions in our economies resulting from inflation and recession, and the needs created by the rise in the relative price of energy, means that we must increase our capital stock if we are to employ our people productively and are once more to achieve rising standards of living. This means that we must create a financial climate that generates sufficient savings flows and channels these into productive investment. In my country, and I suspect also in yours, such a climate cannot be established without a significant and lasting reduction in the financial requirements of the central government and the local authorities.

The policy problems I have mentioned are not easy to solve. But their solution constitutes our main task today if we are to consolidate the current recovery, to restore high-employment levels, and to lay a firm basis for continued stable growth. To achieve this, it is more important than ever that we judge the impact of economic interdependence correctly. The current economic upswing is becoming increasingly widespread. The prompt and substantial strengthening of world trade that is accompanying our recoveries already demonstrates how fast and how strongly changes in internal demand are being transmitted across national borders. The early and strong upturn of commodity prices -- at a time when producer stocks are still high and capacity is ample -- it is a further indication of the possible inflationary impetus that could result from the worldwide recovery. The possibility of the reappearance of bottlenecks early in the upswing and of a resulting regeneration of price and wage pressures cannot be discounted.

Therefore, the lessons from our past experience should not and must not be disregarded. In formulating national policies the strength of worldwide demand must explicitly be taken into account. Thus, we need to strengthen our mutual understanding of changes in the economic parameters affecting the world economy. The mutuality of our policy goals is clear. The main contribution the US can make to the international economic community is to achieve stable conditions at home. In shaping our policies to this effect, their external impact must be taken into account. But such external considerations must not override the overall objective without which neither we, nor the international community, can regain full employment.

President Giscard: We have heard positions here which are very strong anti-inflationary positions, especially from Chancellor Schmidt. And Prime Minister Callaghan has raised an important question -- are there



policies to fight inflation and also lower rates of unemployment. I fear that if we put too much emphasis on fighting inflation we might have to accept high levels of unemployment. In the present state of our economies we can fight inflation on one hand and increase employment on the other. But there are problems. In Europe, immigrant workers are not adapted to work requirements and pose problems to training. Therefore, there can be an increase for the supply of jobs, but still a high level of unemployment. It is helpful to say we will fight inflation, but it is also necessary to say that we will make structural improvements to increase employment.

A second point, regarding what Prime Minister Callaghan said, is that there are different kinds of measures which can be used in fighting employment. He referred to the problem of balance of payments and financing. We should be careful, because growth is not certain. We should not put the brakes on too early, because this would hurt those countries less far along in their recoveries. But I believe that there are some countries which can improve their budgetary circumstances while increasing their growth as well. In France, for instance, we could reduce our budget from 38 billion francs to 15 billion francs. This is compatible with growth. It requires the implementation of certain budgetary and monetary tools, and we should bear in mind our partners in determining how fast to get to equilibrium.

There is also the issue of financing a deficit of \$20 billion. There is now a steady growth in foreign trade. This will be difficult to sustain. We should try to avoid foreign deficits which could cause a stop in growth by forcing countries to put on the brakes.

Chancellor Schmidt: Before coming back to the remarks around the table, I would like to remind you of something else. This forum can help improve the confidence of our peoples on our future economic path. We should interpret this as a necessity for increased confidence by laborers, boards of directors, investors, unions, and the body politic. So far, Rambouillet was a real success. It did add to confidence in our countries. Here in Puerto Rico we should try to add to the growing confidence already developing. This includes countries in different economic situations. I would point for communique wording along these lines -- to take note of world economic growth after the recession and the fact that we were successful in our joint efforts and we foresee additional success, including for those countries that think of themselves as lagging behind a little. We should not paper-over our differences in the degree of recovery. We should make it clear to the world that we do share a common conviction that we led the world economy out of the deepest recession since the 1930s. Domestic opinion can count on this upward movement, and thus will stay with us in the future.





We can tell our peoples that this does not mean we are entering a dramatic new stage, and it does not mean increased pensions and other nice things. We are not entering heaven on earth. There is nothing to be gained which you do not have to pay for, and this applies whether you are conservative, liberal, or socialist. One last question, could the Prime Minister of Japan tell us whether you meant, in the 60% GNP figure, to include the Soviet Union and China.

Prime Minister Miki: I will examine this and let you know.

Chancellor Schmidt: I would also like to come back to a point on which I dispute Prime Minister Callaghan. This was raised by Prime Minister Trudeau and myself. With respect to the relationship between inflation and unemployment we have bright economists who say you can achieve the right growth path, using fiscal and monetary policy to create domestic stability. Some say this to a limited degree, some to a greater degree. However, in the long run we could overdo it. For instance, the supertranche idea in the IMF was to create additional monetary demand. The world as a whole is not lacking in monetary demand. Iran and Saudi Arabia are rich in capital. Some put this money into sterling and I applaud that. But many spend their money thereby contributing to inflation in our countries. Some of them have a 40% rate of inflation in their own countries. Thus, the expansion of the revenues in Iran and Saudi Arabia have added to world inflation.

They will ask for higher oil prices as soon as they feel the world economy can bear it.

They will argue, in justifying this, that the prices of their imports have gone up, when in fact these countries themselves will have contributed in part to this inflation. In other words, the oil rich countries will add to world inflation because their own domestic demand is too high. And it is impossible for them to spend all their money overnight so they will add to the push of inflation in the world. Also, other developing countries want increases in the price of such exports as copper and sisal, and they will also add to the push of worldwide inflation. I, therefore, fear that inflation will add to the psychological problems described earlier by Prime Minister Trudeau. If we consume now as long as we live we will not save for later, for our children.

This is particularly important because investment is a necessary element to our economies to maintain high levels of employment. If there is not enough fixed investment to create full employment, the only remedy would seem to be investment by the state. In our systems the state can invest



in certain things such as railroads and roads, but in our system we also need investment by private enterprises. But they will not invest unless there is a lower rate of inflation. As long as inflation goes up, they will not invest. Thus, over the long run achieving high employment has to do with limiting inflation.

Let me respond also to Jim Callaghan. Germany is not only concerned with high rates of inflation, we are also concerned about unemployment. As you may recall, high levels of unemployment, roughly 7 million people in 1931-32, was the reason Hitler came to power. So we are also, in Germany, concerned by unemployment.

Although I am not in an ideologue, I firmly believe that if prices increase by about 10% we cannot get back to full employment. We must, therefore, be able to convince the trade unions to fight inflation and thus to create jobs. If I understand the UK and Italy, I think you are doing the right thing in cooperating with workers with the objective of limiting wage settlements, and thus trying to reduce cost-push inflation. And if I read Dennis' goals correctly, they will in the UK have to diminish public expenditures because they are a source of inflation. I believe you cannot get high employment with 10% or more inflation rates. I am not asking Britain and Italy to fight inflation as hard as we in Germany are doing now, but they must keep at it.

Chancellor Healey: The first thing one learns as Chancellor is that economics is a branch of social psychology; you cannot judge the future on the basis of the past. For example, all of us have seen an increase in savings during the recent inflation. But we could probably have imagined that inflation would kill the savings.

Chancellor Schmidt: It may have increased savings but it certainly hampered investment, which was predicable.

Chancellor Healey: That is true. Investors want to know if their return on capital will be sufficient to cover the rate of interest. But another curious thing is the relationship between unemployment and inflation. The two of them have been moving together since 1968 -- unemployment and inflation worsened together. Prior to 1967 inflation went up by only 2% per year and the rate of employment went up only a bit more. By 1975 we had high rates of inflation and unemployment was higher in all countries. It makes no sense to argue that the only way to get inflation down was to keep employment down. In fact, you cannot get employment up unless you get inflation down. In the last year the change has been striking -- inflation has been falling and the rate of increase in unemployment is also falling.



In the US both inflation and unemployment are falling, and the same has been true in Germany in the last few months. I hope they will both be falling in the UK by the end of the year. I fear, however, that inflation is increasing again. Haverkamp says that the CPI for Europe will be 13% for this year, versus 6% in the last six months of last year.

The conclusion I draw from this is that we do not know the precise causes of inflation. Indeed, there is not one single cause. If we want to keep inflation down we need appropriate fiscal and monetary policy, incomes policy, and structural policies, which Giscard talked about, and the correct psychology and philosophy. But different countries experience different conditions. We should not give the impression that there is a uniform policy which all countries should seek. In the UK since last July we have kept the growth of public expenditures below the growth of gross domestic product. We hope the public expenditure will not grow and that GDP will be up 5%. We may be the only country to have public expenditure grow at a rate less than GDP. But then again, we started off worse than most countries with respect to high unemployment, higher rates of inflation, large budget deficits, and a balance of payments deficit.

Our public expenditures average about 9 billion pounds. But we have financed these without printing new money, and we did it outside the banking system. The money supply grew at a rate of only 8% against a very high increase in inflation and GDP. And the monetary supply fell last month.

A key to our efforts is a new type of consensus with our social partners. This depends on the attitude towards income policy. We need to persuade the trade unions to limit wage increases, to increases only one-half as much as price. This is difficult to do for two years running because it means they are consistently accepting a drop in real wages. But all of us have had a bitter experience on unemployment and inflation. We all need the proper mix of measures to achieve high employment and low inflation. We should not give the impression that there is one answer. If we do this, it could brake the consensus which is so important to us. We should not be pushed into measures which force us to lose this consensus.

President Ford: At Rambouillet, sound progress was made in dealing with issues in the international monetary sphere.

On structural reform of the monetary system, we resolved differences among us that had long appeared insoluble, and we formulated a blueprint for reform that subsequently was adopted by the entire IMF membership in Jamaica.



On the more immediate operational issues, we developed a shared analysis of the existing international monetary situation, and of techniques for dealing with the problems we faced. Also, we agreed to closer co-operation and consultation both among our Treasuries and our central banks, to give us a better understanding of each other's problems and policies.

On both structural reform and the immediate issues, we have agreed to focus on fundamentals. We recognize that we must develop stability in the underlying economic and financial conditions in our own national economies if we are to achieve the international monetary and exchange stability we all seek.

Recognition of our basic problems is only the first step towards solutions. We must make further progress in dealing with and preventing emerging difficulties in the monetary field.

As I see it, for the present and for the months ahead, the international monetary issues on which each of our governments should concentrate fall under four headings:

First, I know we all agree that as a matter of urgency we must complete the agreed monetary reform package. We must press ahead with the legislation required to ratify the amendment of the IMF Articles and the increase in IMF quotas.

Second, we must continue to develop the machinery of consultation agreed at Rambouillet. That machinery has been operating with great effectiveness and has enabled us to prevent the exchange market problems which have emerged in recent months from becoming even more serious.

Third, we must undertake to eliminate persistent payments imbalances, either surpluses or deficits, in any of our countries. This is an important precondition for achieving stable underlying economic and financial conditions. In the present, potentially difficult international financial situation, it is particularly important that we each follow policies to eliminate these persistent payments imbalances.

As we consider these priorities, I think it would be helpful if we discussed the prospects, and the need for adjustment in individual countries -- both those which have been recording the largest surpluses and those with the largest deficits. Action to promote and accommodate adjustment is clearly needed on both sides.



The United States, Japan, and Germany have all recorded very strong current account positions in the recent past and are in a position to attract capital in the private markets. It is important that we in these countries and others that are in a similar position, be prepared to accept a significant reduction in current account surpluses or increase in deficits and to utilize our ability to attract capital from abroad.

-- In the United States, our current account position has reversed very sharply, from large surplus to modest deficit, a turnaround of about \$15 billion. I am not concerned about that shift -- in the framework of world payments I have described, it is exactly the kind of change that is needed, and constitutes a move toward a healthier and more stable world payments situation. We acknowledge our responsibility to contribute to the preservation of the system by accepting an important part of the current account deficits which are inevitable in this period; and I pledge to do my best to resist the inevitable domestic pressures for protection and to build public acceptance of a substantial trade and payments deficit. But my colleagues from other large surplus countries will need to do the same.

However, action by the countries in surplus, the United States, Japan, and Germany, and a willingness to see those surpluses decline and vanish, cannot alone bring a stable and sustainable international payments structure. Of perhaps greater importance is the action needed on the part of the large deficit countries -- the UK and Italy in particular -- to reestablish stable economic conditions.

Fourth, we may need to consider in the IMF the possibility of providing additional IMF credit, where private and official credits have been exhausted, in cases of extreme need having significant implications for the system as a whole. Such credit beyond the normal standards of availability, should be conditional on and in each case tied to a rigorous and detailed program of monetary and fiscal restraint that will restore domestic economic stability in a reasonably short time. This credit cannot substitute for, and should not be provided without, sound domestic corrective action by the recipient; and it presupposes a commitment by the recipient to policies consistent with the fundamental tenets of the political and economic system on which cooperation among the industrial democracies is based. Such financing would complement normal IMF drawings and the proposed Financial Support Fund, and could be coupled with the activation of the General Arrangements to Borrow. I think such a move would greatly strengthen our defenses against possible disorderly adjustment moves which could damage the fabric of our liberal trade and payments system.



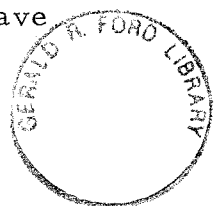
In summary, these four points provide an appropriate program for us to agree to at this meeting to help foster international monetary stability. I would hope we can all agree:

- To proceed to ratify promptly the Jamaica monetary reform package.
- To continue to strengthen our consultative machinery.
- To commit ourselves for the coming period to adopt policies to eliminate persistent payments imbalances, both surplus and deficit.
- To consider, for cases of countries in special need, a mechanism to supplement official credit tied to a rigorous corrective program.

Prime Minister Trudeau: With respect to the communique I agree with Chancellor Schmidt that we must emphasize an increase in confidence. We must create a climate of confidence as we are moving toward economic improvement, in order to encourage savings to be invested. But we should also emphasize that inflation can come back if we are not careful. Take President Ford's figures of 7% growth and 7% inflation. It seems to me that he was saying we must keep things in some sort of balance. If we talk only about confidence and not inflation, it will be a problem. The communique should state both.

President Ford: What I said, Mr. Prime Minister, was that our growth will probably be on the order of 6-6-1/2% and inflation of 5-1/2-6%. This is most encouraging to us. The decline in inflation should permit an increase in employment thus adding roughly 3,700,000 new jobs. We have 87,700,000 people employed which is an historic high for the US, although we still have the problem with the young and disadvantaged. We have also added a 15-20% increase in jobs available for college graduates. This is encouraging for us. I agree with Dennis, that we can have decreased inflation and increased employment.

Minister Columbo: This is a subject which seems to have resulted in a certain separation among the countries here. Inflation and unemployment are both important problems. The countries which raise the issue here do not want to solve the problem of ratios. We do not want to solve the problem of unemployment with inflation. Our experience has taught us a lot. In the process of recovery which has been widely observed, we have seen that it has been accompanied by symptoms of inflation, and a tendency for institution of policies to put on the brakes in countries which have



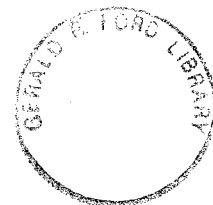
achieved high levels of recovery. This will hurt countries which have not yet been able to achieve high rates of recovery and have stagnating high levels of unemployment. We should reconcile our views on this here. We should insert in the communique some idea of fighting inflation to give the idea that we should conduct our policies this way, but we should also need an element of confidence as a psychological tactic. I go along with Chancellor Schmidt. We should confirm that there is a reason for confidence and that we are out of our sickness.

Chancellor Schmidt: I like to go back to a subject President Giscard raised and you referred to. Along with recovery and our now emerging imbalance of payments, there is disequilibrium in the industrialized countries and great surpluses in OPEC, and different conditions for raw material exporters with high prices. The question is how can we finance these deficits. Cooperation this year and in years to come is necessary to cope with balance of payments deficits. We will have a lot of trouble in some cases. The safety net is a good idea to help countries, but we will need to do a lot of thinking on how to finance deficits in balance of payments. We cannot allow balance of payments to be intrusted solely to exchange rates in currencies, i. e., to allow exchange rates to move along the trends of balance of payments. This seems to be an idealist view that all things will be rational. It could lead to an exchange rate process that is out of control. There is a requirement to meeting the need to finance balance of payments deficits.

I agree with what many of you are saying. Thinking about how to finance deficits does not mean giving up domestic policies to reduce imbalances. We must not leave our policies to others. We must do our duty with a great deal of commitment.

Prime Minister Trudeau: I would like to ask how does the suggested IMF credit proposal help countries in extreme need fit into the Jamaica agreement, the increased tranches and the Trust Fund. Also, Canada has a rather special payments position, particularly vis-a-vis the US. And what is the status of the thinking here on the trade negotiations -- it is possible to accelerate them?

President Ford: We believe we must bring these negotiations to a conclusion in 1977. Thus we will push to the maximum to achieve this result. We feel that it is an achievable result. With respect to imbalances, we are not talking about bilateral imbalances. We recognize the situation of the US vis-a-vis your country. This is not the issue I was referring to.



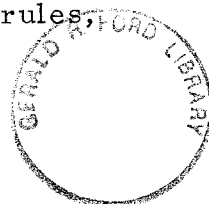
Secretary Simon: Mr. Prime Minister, with response to your question on the mechanism for financing countries in special need, we believe that it is a good idea to consider the concept of providing more credit with very stringent conditions. We believe that we can use, in this respect, the GAB of the IMF. We have the Congressional authority already for \$2 billion. This is part of the concept of the so-called "super-tranche". It implies very stringent conditionality as a supplement to IMF borrowings.

Chancellor Schmidt: I agree with the stress on the necessity of conditionality. It is in the interest of those who need the money to enable them to receive it but with certain restrictions. We also agree with the idea of renewal of the trade pledge and giving additional impetus to the MTN. I also wish to express our gratitude for the consensus reached since Rambouillet regarding rates of interest and length of repayment time in export credit provided to others.

In the trade area, President Ford, I would like to know if you could give us some information about the probable amount of Soviet food stuff purchases likely to be made from the US. It seems to me that our approach should be to bring to the consumers of the Soviet Union the understanding that they are no longer an autarkic ideological entity. The Soviet debt thus comes out to roughly \$40 billion -- some from the Arabs, some from the state banks, and some from private banks. All together it represents an enormous net flow of resources to the Soviet Union. The question is whether we have been politically paid off well so far. One reason, I am convinced, for the Soviet leadership's decision to undertake a policy of detente was to get real resources from the West.

President Ford: In response to your question on food sales, Mr. Chancellor, we have concluded a five-year agreement with the Soviets. They must purchase a minimum of six million tons of grain and a maximum of eight million tons, but that latter figure is flexible depending on conditions in the US. In 1975 they bought six or seven million tons. Thus far in 1976 they have bought three million tons in the current crop year. We have no specific information as to whether they will go to eight or beyond this year. We do understand that they do not have a very successful winter wheat crop, although planting looks good for the spring crop. If conditions are good for the spring crop, there will be less demand. If the season is highly successful, they could have a good year but they will buy six million tons in any case. Henry.

Secretary Kissinger: The basic problem is that the only way we can get political benefit is to interrupt the market system. Under market rules,





if we want to benefit politically, we must interrupt the market mechanism in order to exact political terms. Otherwise, this is just theory -- they come in and take what they can get. The President paid a heavy political price for the perceived interruption of the market for four months last year. Now we have some leverage in that they have to come to us for negotiations if they want to purchase about eight million tons. This is an aspect to which not sufficient attention has been paid.

Chancellor Schmidt: Roughly one-half of the East European countries' debt is covered by state guarantees. Many deals would never have been struck without the support of governments. The USSR's greatest difficulty is in feeding its people. They have slaughtered great numbers of pigs and cattle. They are facing difficult times. In Poland, they are having difficulties similar to those in 1972 which led to the coming of power of Gierek. These problems posed great difficulties for Communist leaders. Poland now faces worse problems than the Soviet Union, but the Soviet leadership is in similar difficulties as those of the Polish leaders. If we help them, we improve the stability of their political system. If we do not help them, we do not know who the next leaders might be.

But it is certain that their role in the world is ever increasing. Prospects are that the Soviet share will increase even more. I ask myself how much transfer of resources will be devoted to East-West relations and how much to North-South. Will North-South relations not necessitate neglect of transfers to the East?

We might be able to divert the Soviets from production of weapons or at least the sale of weapons to the Southern hemisphere. A number of countries say we give the LDCs too many weapons. We must be concerned that the USSR is gaining influence in the developing countries by supplying arms and by attacking us in the UN and in Nairobi. We must combine aspects of trade, monetary, and credit relations in our dealings with the Soviet Union and examine their political aspects.

This is not the place to talk about Southern Africa, but we appreciate its implications. Public opinion is not going to permit us to help the developing countries and then be kicked in the backsides in the UN and elsewhere as the Soviets gain influence by supplying weapons and propaganda. Our relationship with the Soviet Union on credit and trade ought to be appraised.

President Ford: Mr. Chancellor, with respect to Soviet debt, do you think they might ask for rescheduling?

Chancellor Schmidt: I would not be surprised at that.



Prime Minister Callaghan: I will talk about this tomorrow in detail. But the credit record of repayment of the Soviet Union and its satellites is second to none. In our judgment, and we have consulted the City of London, there may be a possibility perhaps of a slight roll-over. But they are not going to default; they simply won't do it.

President Giscard: Again addressing the issue of monetary and financial problems, I should like to raise the issue of aid to Italy. We are all well aware of the problem of Italy and concerned about it. But we should not now make the difficult judgment on aid to Italy. It is apparent that Italy will need aid above the ceiling established in the IMF, but we should not use the IMF for this purpose and thus create a precedent which other countries would invoke. We should not provide aid of this kind to the LDCs. I approve the principle of providing aid if necessary, but this would be an industrialized country assistance effort; thus we should fix the technique. We should not create an IMF precedent.

On trade, I can only comment on issues which are in conformity with decisions taken by the EC. The trade pledge is in conformity with this. It calls for agreement to avoid protectionist measures. We had to do this for fear at the time that the UK would implement protectionist measures, and now it doesn't need to serve that purpose anymore. On the other hand, US measures to restrict imports have been felt rather keenly in Europe. The pledge could be applied to such practices.

Prime Minister Miki: I will discuss the trade issue in greater detail tomorrow.

President Ford: We adjourn then until tomorrow at 9 a.m. The session will then be informal in dress. We will be having dinner in about an hour -- that also will be highly informal.

Prime Minister Miki: Excuse me, Mr. President. If I can make one additional statement -- I have seen the draft communique, but I wonder if it could be made shorter than the present 15 pages.

President Ford: I will take note of this request, Mr. Prime Minister. Our officials should be contacting your delegations to set up a further meeting on the communique, although I gather much work has already been done on this. In addition, I can give you at dinner a suggested list of speaking assignments for tomorrow's meetings.

