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ECONOMIC AND FINANCIAL CONDITIONS IN ITALY

Albert O. Hirschman *

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General Comment

Possibly the most interesting present day contrast in Europe is provided by a comparison between the Italian and French economies. The question most commonly asked with regard to the French economy is: Why does France, with its balanced economy and its manifold resources, continue to need amounts of outside assistance which seem quite disproportionate to the amounts received by most other recipient countries? With respect to the Italian economy, on the other hand, the following question is being put more and more insistently: How can it be explained that Italy, in spite of its fundamental poverty and its impressive array of unsolved economic problems, is not able to absorb and justify fully the relatively modest allocation of aid which is destined for it?

* The author spent one month in October/November 1948 in Milan and Rome, while on official travel for the Board of Governors. He is considerably indebted for the hospitality provided by the Bank of Italy and for the wealth of information made available to him by the staff of the Bank's Research Department.

It may seem strange that one should have anything but praise for a country like Italy whose performance is better than anticipated, i.e., a country that utilizes its allocated aid at a slower-than-scheduled rate, exports more than expected and, as a result, accumulates a small dollar reserve. Unfortunately, the Italian case is not as straightforward as that. There are in Italy backward agricultural areas and distressed industries. There are large numbers of unemployed and underemployed workers. Thus, while the failure to use ERP aid to the full may reflect genuine progress toward stable balance of payments equilibrium, there are grounds for suspecting that it may also reflect inability to tackle the country's basic economic problems. It must be remembered that the objective of the European Recovery Program is not to secure balance of payments equilibrium as an end in itself, but to produce eventual independence from extraordinary outside assistance at levels of consumption and of economic activity which are conducive to economic and social stability.

At this point we touch upon another contrast between the positions of France and Italy which helps to explain the differences in foreign aid requirements of the two countries. In France, partly as a reaction to the long and disastrous deflation of the thirties, an ambitious investment program was mapped out immediately upon the end of the war. This program must be assigned a large share in the responsibility for the continuous inflationary developments.

In Italy, on the contrary, there was little attempt to coordinate investment activity except for the portion that was undertaken directly by the State. During the first post-war years the natural outcome of this passivity was the inflation since even the most essential tasks of reconstruction required larger outlays than could possibly be forthcoming from savings. The necessity for an integrated investment program was felt even more acutely after the attainment of both economic and political stability had cleared the way for a basic consideration of Italy's long-term economic goals.

Continued indecision in this respect may be partly due to the uncertainty as to the phase of the business cycle in which Italy finds herself at present. A discussion is still raging in Italy about the question whether the recession which followed upon the Einaudi measures has been overcome. Economic policy makers find themselves confronted with the following paradox: Certain resources of the economy, even aside from manpower, are less than fully utilized; but if they were so utilized, the result might well be a renewal of inflation.

A similar paradox is presented by Italy's balance of payments position. ECA aid naturally exerts a deflationary effect, at least as long as the local current proceeds of the aid are accumulating in the counterpart fund. But the remainder of the Italian balance of payments has recently been characterized by a substantial surplus on current account and the resulting accumulation of foreign exchange reserves has led to an expansion of the credit base. Furthermore, even an increase in the effective absorption of foreign aid for investment purposes,

may produce inflationary results since increased imports of raw materials and equipment could require so large a domestic use of previously unemployed or under-employed resources as to lead to inflationary pressure in the markets for consumer goods. ^{1/}

There are therefore many good reasons for proceeding with caution. The advantage of having achieved economic stabilization cannot be overestimated. At the same time, the remaining continuing task of the Italian economy is to lift itself to higher levels of economic activity and investment. Here as always, action implies the taking of certain risks. Even when the national accounts of a country are known with good approximation, it is not easy to indicate the "correct" amount of investment. In Italy a priori deductions, while instructive, can only yield extremely rough guesses and are not able to replace as yet the method of trial and error.

While the diagnosis of Italy's position is difficult, the therapy to be prescribed is thus quite likely to be unorthodox. The overshadowing and, in Europe, unique problem of excess of manpower requires investment programs which will differ considerably from such programs in countries which are mainly concerned about a deepening of their capital structure. The necessity to walk on a very narrow path between deflation and inflation may suggest new methods of using both foreign aid and counterpart funds. Finally, it must be realized that we cannot possibly hope to solve Italy's problems within three or four years. ERP aid can avoid a deterioration in Italy's position and point the way toward economic development. Unless the Italian problem is seen in this light much time may be lost in looking for a simple formula that will "set things right".

Recovery or Stagnation?

The Italian economy still feels the after effects of the rude shock received in September 1947 when Einaudi's credit restrictions and a number of concurrent circumstances halted and reversed the inflationary process. Let us recall that Italian industry had long been used to a privileged position. Built up under tariff protection before the first World War, it expanded during the Fascist period thanks to further protection, stringent anti-labor legislation, and direct financial help from the State, particularly during the period of autarchy and war preparedness. Finally, after the war, the progress of inflation assured profitable operation to practically all branches of industry. The incentive to repair damaged plants was considerable since often a relatively small outlay permitted reactivation of an entire factory.

^{1/} See "Inflation and Balance of Payments Deficit," this Review, August 24, 1948, Page 6.

With the reversal of the inflationary movement in September 1947 which coincided roughly with the completion of the most urgent tasks of reconstruction, Italian industry was suddenly "on its own." The results were: (1) a general contraction of economic activity; (2) the clear emergence of various distressed sectors--particularly in the iron, steel, and engineering industries--which needed and obtained immediate financial aid from the State; (3) a continuous pressure by industry on both Government and public opinion to have its problems solved summarily through tax relief, devaluation, or--best of all--renewal of inflation.

This pressure even went so far as to underplay the considerable recovery of production that has taken place ever since the early part of this year. A reader of the financial press cannot escape the impression that a deep depression is still raging in Italy. This impression becomes almost a certainty if one accepts at face value the index of industrial production compiled by the Confederation of Industry. Fortunately this index is the least reliable among the various indicators of business activity. Both the newly revised index of the Institute of Statistics and indirect measures such as freight traffic and use of energy in industry point to a slow upswing throughout the current year. The recovery is most marked in textiles, iron and steel, chemical industry, and automobile production (excluding trucks, whose production has fallen off as a consequence of large scale surplus property sales).

In September, the revised index of the Institute of Statistics definitely broke through its prewar level as well as through the peak level reached a year earlier at the height of the inflationary boom. With the index standing at 108 (1938 = 100), much of the lag of Italy's industrial activity behind that of the other Western European countries has disappeared.

Indexes of Italian Economic Activity

Industrial Production		Use of Energy in Industry		
Institute of Statistics revised series 1/	Confederation Industry	All sources of energy	Electric Energy distributed by Edison	
1938 = 100	1947 = 100	1947 = 100	1947 = 100	

1947					
1st quarter)	76	75	75	77	
2nd quarter)	107	101	101	110	
3rd quarter) 91	108	115	118	115	
4th quarter)	104	108	106	98	
1948					
Jan.	86	95	97) 94) 95
Feb.	87	96	98))
March	93	102	105) 97) 104
April	94	103	105))
May	96	106	103) 111) 109
June	101	111	103))
July	102	113	102) 109) 114
August	99	109	102))
Sept.	108	119	113)) 116

1/ The index given here represents a new series which has only recently become available as a result of the re-calculation of the old index on the basis of the arithmetic average instead of the geometric average used so far.

The use of the geometric average has long been advocated by Italian statisticians. Something may be said for it in the compilation of price indexes, but its use for indexes of industrial production seems to be quite unwarranted. It is certainly misleading at the present time since all other countries compute their indexes of industrial production upon the basis of the arithmetic average. Because of considerable differences in the extent of recovery between the various branches of Italian industries, the downward bias of the geometric average was bound to become rather pronounced in an index giving the level of economic activity on the basis of a prewar year. In fact, the changeover from the geometric to the arithmetic average has produced a very substantial change in the level of the index. Rather than 82, the average 1947 level turns out to have been 91 (1938 = 100). In August and September 1948 the revised series gives 99 and 108 respectively instead of 83 and 96. Since the index of the Confederation of Industry which was generally about 10 points lower than the old Institute of Statistics series was often used concurrently with the latter, the new series makes us see the level of post-war Italian recovery in an entirely new light.

It should be pointed out here that the new series is far from being an ideal measure of total industrial production. It still is a provisional index based on a limited number of sub-series and comprising only about 1/2 of total Italian industrial activity. The more important gaps consist of the mechanical industries (whose output is probably lagging behind the average), and the food-processing industries (whose output ought to be approximately back to prewar levels).

It is probably true that the recovery experienced thus far is due to increased sales of consumers' goods and to sharply increased exports; there seems to be little expansion and modernization of industrial plants as yet. The recent raising of electric power rates from 14 to 24 times the prewar level should, however, permit some expansion of hydro-electric power generating facilities. Moreover, a favorable symptom is the increased activity of the capital market. During the first nine months of 1948, new stock and bond issues were floated in the amount of 91 billion lire ^{1/} against only 47 billion lire during the same period in 1947 when, of course, a large fraction of inflation profits was reinvested.

The Ailing Industries

In spite of the general upswing of economic activity, Italian industry still faces a number of unresolved problems. There are, in the first place, those heavy and large scale engineering industries which are either owned by the State through IRI or have received considerable funds from the State through such financing agencies as IMI and FIM. It is now recognized that Italy could well use a small iron and steel industry of its own as a convenience to an expanding mechanical industry which has its own specific requirements; but in order to produce at competitive prices, the industry stands in great need of modernization and concentration. The transformation of the industry in this sense is now being planned as part of the investment programs scheduled to be carried out through ERP (and possibly World Bank) loans and by use of part of the counterpart funds.

Even graver problems are faced by those engineering industries which had been built up primarily for war production. While a part of the industry has been reconverted successfully, there are large firms (Ansaldo, Breda, Caproni, etc.) which still stand in need of radical reorganization. These are also the industries which are mainly affected by the problem of surplus workers; i.e., by the fact that it has proven impossible for the management to dismiss workers who are not needed at present levels of production. The total number of surplus workers is, however, estimated at not more than 100,000 and this number is being slowly decreased in a variety of ways. It is indicative of the slowness of progress that the Ansaldo management considers as an important forward step the fact that it has succeeded in persuading several thousand surplus workers to stay home while continuing to receive their pay rather than to be idle on the premises of the factory.

While the heavy and engineering industries have been in the foreground of public discussion, the reactivation of the building industry is possibly the most important task for further industrial progress in Italy. While the repair of damaged buildings has been rapid (over 2 million rooms have been repaired since the end of the war) new building has lagged considerably. The superficial visitor will be impressed by the great number of imposing office and apartment buildings

^{1/} At the rate of 575 lire per dollar which has prevailed throughout 1948, this amounts to about \$160 million.

that have sprung up in the destroyed parts of the center of Milan; but this is one of the rare instances where unsubsidized construction was possible and profitable. Rent control having proven to be the only enforceable control in Italy, the average Italian family spends today a nominal sum for rent, much less than for tobacco and entertainment. This anomalous situation will be corrected in time, but even if rent were to absorb 10 percent of the average family's income, building would not be profitable at present costs and interest rates.

Even in 1931, when the last complete census of dwellings was taken, the housing situation in Italy was anything but satisfactory. Insufficient building in the '30s, the destructions of the war, and the continuous increase in population, make the present situation one of the worst in Europe. But a large investment in a public housing program is to be urged not only on social grounds. The housing shortage has become a great bottleneck which hampers further economic progress all round. Thus, the problem of surplus workers would immediately become soluble if there were a revival of construction activity with consequent absorption of workers, many of whom had originally been diverted from the building trades. Public administration and all large scale enterprise would immensely gain in efficiency if transfers of personnel were not practically made impossible by the housing situation. Rents could be gradually raised--and thereby non-essential consumption be reduced--if a large number of dwellings became available at prices which would be higher than present rent ceilings but materially lower than the exorbitant rates asked today for apartments in new houses. Finally the impulse which a new construction activity would give to the many industries connected with housing would not only importantly contribute to solving the obsessing manpower problem, but would mean for many small and medium firms throughout the country the difference between stagnation and prosperity. As a result, unit costs could be reduced with favorable effects even on exports.

It is of course somewhat unorthodox to advocate a large scale housing program in the midst of a still critical balance of payment situation. But, as will be shown later, balance of payment disequilibrium is far from being the most difficult Italian problem. Furthermore, by making an essential contribution to the increased efficiency and flexibility of Italy's economic structure improved housing is certain to be of indirect but invaluable help in bringing about a better balance in Italy's external relations.

Agriculture

On the whole agriculture has made further progress during the past year. Total agricultural output is estimated at about 86 percent of 1938 as against 82 percent in 1947. This index, however, does not include livestock which has reached pre-war levels; moreover, 1938 was a year of bumper crops, so that total agricultural output can be estimated as only slightly below the average pre-war level. The characteristics of the current crop year are an improved wheat harvest (6.2 million metric tons as against 4.7 million in 1947), but a poor olive crop (.87 million metric tons as against last year's bumper crop of 1.50 million). With

respect to pre-war, the main changes are the replacement of grain acreage by pasture and the reduction in yield probably resulting from both insufficient application of fertilizer and uncertainties as to prices. Little improvement is taking place at present on the farms because of widespread and most diverse speculations as to the "Agrarian Reform" which is being elaborated by the Government.

There is wide agreement about the desirability of making a special effort to improve conditions in Italy's "depressed area"--the south. Public works programs should favor these sorely under-privileged provinces. But besides housing the most effective measures may be, not large scale plans for irrigation and drainage, but an organized effort to make available to the southern peasants large quantities of insecticides, fertilizers, selected seeds, and modern tools at low prices or on favorable credit terms, combined with the creation of an effective system of "county agents" who will dispense sound technical training and counsel.

Money and Finance

During the period following the Einaudi measures of September 1947, the paradoxical contrast between falling prices on the one hand and expanding currency circulation on the other, was frequently commented upon. It was explained by the fall in the velocity of circulation; in other words, by the cessation of the flight from the lire, which had been quite marked during the first half of 1947. A more complete explanation must take account of a number of inflationary and deflationary factors whose combined result has been the main revenues of monetary and price stability throughout 1948.

The principal inflationary factor has been the budget deficit but an important role was also played by the accumulation of foreign exchange reserves during the current year. The main deflationary factors have been an increased desire to hold money, the blocking of the major part of the counterpart funds, and some liquidation of inventories.

An examination of the December balance-sheet of the Bank of Italy shows that, in the course of the first nine months of 1948, the increase in circulation has been at an annual rate of only about 95 billion lire (or approximately 12 percent of the total circulation as of the end of 1947) as against an increase during 1947 of 283 billion lire (or 57 percent of the total circulation as of the end of 1946). Moreover, the increase which has taken place cannot be traced primarily to the operations of the Italian Treasury. The current account liability of the Treasury at the Bank of Italy increased by 5 1/2 billion during the first nine months, but this must be offset against the temporary sterilization of most of the counterpart of American aid. Actual deposits of sales proceeds at the special Bank of Italy account stood at the end of September at 29 billion lire, but have rapidly increased in recent weeks.

The main source of expansion of circulation was, during the current year, the monetization of the balance of payment surplus of Italy with a number of countries. During the first nine months, there occurred a slight reduction in rediscounts and advances, but a massive increase of 117 billion lire in an account called "Miscellaneous Debtors" which represents advances to exporters and to the Italian Foreign Exchange Institute (Italcambi). In part this monetization is due to a genuine surplus of Italy with various European countries whose currency Italy is accumulating. In part, it is the reflection of a better-than-expected export performance to, and a lower-than-expected import demand from, the dollar area so that the 50 percent of export proceeds which are sold to Italcambi were largely accumulated. This strange phenomenon of a sectional surplus within a balance of payments whose overall position is passive had occurred previously in 1946. At that time it contributed to the inflationary process while during the current year it helped to stem and stop the deflationary tendencies. It permitted an expansion in the credit base which led to an increase in bank deposits and thus assured the covering of the Treasury's needs without appreciable borrowing from the Bank of Italy. 1/

The Italian budget is still one of the most unbalanced in Western Europe. For the current fiscal year, expenditures have been estimated at 1,250 billion lire and receipts at 800 billion lire. The deficit corresponds roughly to the budgeted volume of investment expenditures such as public works, railway reconstruction, etc. It may be hoped that, thanks to increased monetary stability and to the constitutional ruling that every new expenditure has to be accompanied by a new source of revenue of equivalent amount, this year's forecast will prove more reliable than those of the recent past. Part of the deficit (77 billion lire) is scheduled to be met through releases of counterpart funds. For the remainder the Government counts on the money market which therefore would have to raise about 30 billion lire a month. According to recent performance this seems entirely possible. Throughout 1948, the Treasury financed its cash deficit almost exclusively by borrowing from the banking system.

1/ To speak of an inflationary effect of the balance of payments surplus when, on the whole, there is a considerable deficit, may seem the result of an arbitrary segregation of two effects which compensate each other and which should be considered together. The effect of U. S. aid on the Italian monetary situation is, however, intimately connected with public finance; furthermore, once certain conditions are fulfilled the funds collected as counterpart of U. S. aid are destined to be expended so that the deflationary impact of U. S. aid will in time be cancelled. If, therefore, the balance of payments outside of U. S. aid shows a surplus, it is legitimate to speak of an inflationary impact of this surplus on the economy.

The banks have been able so far to fill the Treasury's needs without any increase in their rediscounts; on the contrary, the banks were able to keep a large margin of liquid funds (between 10 and 12 percent of total deposits) in excess of their legal reserve requirements. 1/ This resulted from three favorable factors:

- (1) expansion of deposits caused by a continuing conversion of currency into bank deposits after the cessation of fears about the future of the lira;
- (2) expansion of the credit base as the result of the balance of payments situation just described;
- (3) the relative lull in private lending.

During the first six months of 1948 private lending, as given by the discount portfolio and the current account advances of the banks, increased by 103 billion lire or by 14 percent, while the banks increased their holdings of Government paper by 112 billion or by 14 percent. Important additional financing was provided the Treasury through current account deposits held directly with the Treasury by savings banks and by increases in reserve accounts at the Bank of Italy, which the latter invests in Treasury paper.

Both the favorable balance of payments developments and the reduced importance of private credit expansion must be seen in conjunction with the decrease in raw material inventories, which can be documented in the field of textile raw materials and products. 2/

In spite of official optimism, it may be doubted whether the situation which has prevailed in recent months can be maintained throughout the current fiscal year. With the recovery of production private lending is said to be on the increase. When interest rates are lowered, as is likely to occur in the near future, this trend is certain to become more pronounced. The conversion

1/ Certain banks consider it necessary to have this excess liquidity because they practically never have recourse to the rediscount facilities supplied by the Bank of Italy. In general, however, this liquidity would be considerably reduced if there were sufficient demand for credit on the part of business.

2/ In the absence of direct data on textile inventories, a decrease is shown conclusively by indirect statistical evidence. In 1948 imports of textile raw materials have decreased considerably with respect to 1947, production of textile products has slightly improved, and domestic sales and exports have both increased substantially.

of currency into deposits and the reducing of inventories will not continue indefinitely. Finally, the continuation of the balance of payment surplus on the scale of the first nine months of 1948 may be doubted. 1/

It is not unlikely, therefore, that before too long the Treasury will experience some difficulties in covering its needs without providing additional reserves to the banking system. Provided, however, that the deficit can be held at the projected level the prospect of these difficulties is not alarming. From the economic point of view, it seems unlikely that even Central Bank financing of a part of the deficit -- say 10 billion lire a month -- could in itself unleash inflationary processes in an economy where anti-inflationary pressures are probably going to be exerted (1) by the slowness with which the counterpart funds are released and utilized, (2) by the widespread hoarding of bank notes, (3) by the probable decrease in the sectional balance of payment surplus during the coming months.

From the purely technical point of view the present situation leaves a considerable safety margin, since the Treasury's current account liability with the Bank of Italy amounts to only 55 billion lire (as of the end of September) after having stood at 98 billion lire at the end of July. The legal ceiling of this type of Treasury borrowing is set at 15 percent of total budget expenditures, or at about 187 billion lire for the current year.

Nevertheless, complacency with respect to the state of the budget is certainly not warranted. The deficit of 450 billion lire is unduly high if compared to the probable aggregate capacity to invest of the Italian economy. Total gross and net investments are estimated to have amounted to 1,000 and 700 billion lire, respectively, in 1947. Since that year was characterized for its larger part by a violent inflation, investments can be said a priori to have been higher than was compatible with monetary stability. Prices have now returned to the 1947 average while net national product is expected to expend from 4,800 billion lire in 1947 to 5,400 billion lire in 1948-49. As a result of this increase, a net investment volume of 700 billion lire may not be excessive, but should still be considered as the ceiling beyond which investments would be quite likely to have inflationary consequences. With a deficit of 450 billion lire and counterpart fund expenditures for additional public investment programs scheduled in the amount of 150 billion lire (out of total programmed counterpart funds of 250 billion lire, 77 billion are scheduled to be transferred to the Treasury for partial coverage of budget deficit and 26 billion lire are to be set aside for financing of industry) the private sector of the economy is left with a rather meagre margin for its own development. This situation explains (and justifies to some extent) the existing high level of interest rates for private lending.

1/ Resort to Central Bank financing to cover the budget deficit will become more necessary not only as the result of the weakening of previous deflationary forces, but also with the disappearance of rival inflationary factors. For when the latter do not lend any more to the multiple credit expansion which permits the Treasury to borrow from the commercial banks, the Treasury must engage itself in providing new reserves to the banking system.

It is therefore essential that further progress be made toward budgetary balance. The most important tasks in this connection are recognized to be the following:

(1) The reorganization of the "imposta generale sull'entrata" which is a sales tax applicable at every stage of production. This tax stands now at the very high rate of 4 percent. It is universally admitted to be economically harmful, e.g. by giving an unfair advantage to vertically integrated firms and by placing a premium on exports of raw materials and semi-finished goods. Moreover, it is estimated that evasions are so widespread that, in the aggregate, they are equivalent to actual proceeds. Nevertheless the tax yields about 200 billion lire a year, or 25 percent of total budgetary receipts, and for that reason cannot be tampered with lightheartedly. A reform should consist in a lowering of the tax rate (already announced by Finance Minister Vanoni for 1949) combined with more effective control through the establishment of minimum standards of industrial accounting. A more thorough-going reform of the tax, possibly in the direction of the French production tax which now is essentially a tax on value added by manufacture, would be highly desirable.

(2) Direct taxation ought to be strengthened, particularly with respect to the actual process of levying the tax. At present, collection often lags as much as two years behind the earning of taxable income because of the lengthy process of bargaining between the taxpayer and the fiscal authorities.

(3) In general the financial administration badly needs modernization. The administration suffers in particular from the inability to shift personnel, from the absorption of personnel by a great number of small and extraordinary taxes, and from the fact that the tax collectors are underpaid and are therefore neither efficient nor always inaccessible to "arrangiamenti."

Possibly one of the best ways in which the United States could contribute to Italian recovery would be by the introduction of modern business methods and office equipment into Italy's antiquated financial administration. By reducing both tax evasion and the cost of public services, such a reorganization should free an increasing portion of current savings for the needed strengthening of the private economy. But this will not be enough. The low level of national income and its relatively low degree of concentration as shown by a recent sample survey will keep voluntary savings within narrow limits. Therefore, if Italy is ever going to tackle successfully its present economic problems, it will need a cash surplus in its budget after the end of the European Recovery Program. Only a radical and imaginative effort will make it possible to reach so distant a goal.

Lire Fund and Investment Policy

In few countries receiving ERP aid has the question of the counterpart fund aroused so much public interest as in Italy. This is natural enough; for

the foremost long-run problem of the Italian economy is that of capital formation and Italy is therefore prone to consider foreign aid as a means of supplementing the insufficient supply of domestic capital, rather than considering foreign aid as an end in itself necessitated by a transitory foreign trade situation and carrying the local currency fund as a somewhat embarrassing by-product. The preceding discussion permits a few broad conclusions as to the policy which should be followed with respect to lira fund and investment programs in general.

Italy has now been able to maintain monetary stability for over a year. The depression which followed immediately upon the reversal of the inflationary process is being overcome and production has been expanding over the past months without either the incentive or the consequence of renewed inflation. This gradual process of recovery may be expected to continue. At the same time, there are several sectors of the Italian economy which are crying out for a major investment effort. The question is therefore: Can this effort be started now without leading, within a short time, to renewal of inflation?

The answer to this question can be found only by trial and error. This would be the case even if the Italian statistics on national income, saving, and investment were more reliable and complete than they actually are. The following considerations, however, may serve to orient thinking on this subject:

1. Since the expenditure of the counterpart funds does normally nothing more than offset a deflationary defect of the same magnitude, such expenditure should be actively programmed and undertaken in an economy as long as it is still emerging from a deflation without any evidence so far of new inflationary danger signals. A very rough evaluation of the capacity to invest of the Italian economy (cf. supra p. 11) suggests that the planned program of utilizing the 250 billion lire, even if carried out -- as is most unlikely -- in its entirety during fiscal 1948-49, need not result in a renewal of inflation.
2. It will never be possible to start an investment program in Italy without taking some risk of inflation, just as it is not possible to break an inflation without taking some risk of deflation.
3. It is an over-simplification to present the whole argument only as the question: How much investment can the Italian economy stand without inflation? Rather than to engage in a futile search for the "correct" aggregate volume of investment, one should concentrate upon locating those investments which permit the breaking of important bottlenecks and will thereby lead to increases of output and improvements of performance out of proportion to the investment itself. A tentative list of such

investments ought to include an expansion of hydro-electric installations, an active housing program specially designed to increase occupational mobility and to absorb surplus workers from unprofitable branches of heavy industry, as well as the provision of facilities for technical training to increase the supply of skilled labor.

4. With raw material shortages being overcome, the possible inflationary dangers of an investment program consist today almost exclusively in the increased demand for consumers' goods on the part of previously unemployed or under-employed workers who would find employment through the investment effort.

5. In this situation, the most logical means of assuring elasticity is to provide a "masse de manoeuvre" of consumers' goods in the form of actual inventories, or, more practically, in that of a foreign exchange reserve which can be used whenever there appears an unusual tension of demand. Only if this use should be ineffectual should work on the investments themselves be halted as a last resort. The foreign exchange accumulated during the current year already provides the Italian Government with a certain amount of elasticity in this respect, but inhibitions against starting a sizable investment program are so strong that it may be well to institutionalize this type of backstop for an inflation. This could be done by the allocation of a lump sum in dollars which could be spent only to counteract inflationary pressures by agreement between the Italian Government and ECA. ^{1/} Last year's experience with franco valuta imports which, at a decisive moment, made it possible to depress the prices of key commodities like meat, fats, and sugar, is conclusive evidence of the usefulness of this approach to the fight against inflation. A fund of 150-200 million dollars should be sufficient for the purpose; the very fact that it is known to be held in readiness may be sufficient to increase confidence and to check speculative manoeuvres to the point of insuring price stability without any actual expenditures from the fund.

^{1/} Such a ~~sum~~ might take the form of an additional and conditional allocation of ECA funds. This would represent a form of assistance intermediate between straight balance of payments assistance and a stabilization loan.

Balance of Payments and Exchange Rate

The most encouraging aspect of the Italian situation is at present the trend shown by the Italian balance of payments. Exports have gained considerably during the first half of 1948. While full data are not yet available beyond June 1948, indications are that exports have continued to advance during the past months and have been the backbone of what industrial recovery has taken place. Volume indexes calculated in the Research Division of the Bank of Italy, and based on 1938, give the following picture.

	<u>Imports</u>	<u>Exports</u>
1946	68	39
1947	118	57
1948 (first six months at annual rate)	109	78

Since about 36 percent of total exports before the war went to Germany and Eastern Europe against only 11 percent during the current year, it can be concluded that exports to other countries have returned to their pre-war level.

The advance of exports over 1947 is particularly marked for raw materials and semi-manufactures. For the latter the volume is calculated at 116 percent of 1938. This development may be traced to the lowered capacity of absorption of the internal market during the early part of 1948, to the above mentioned effect of this turnover tax, and, more important, to industrialization abroad which assures better markets for semi-manufactures than for finished products. The improvement in Italy's position is less marked in value terms since the terms of trade have moved against her; import prices (in terms of dollars) have increased by 10 percent over 1947, whereas export prices have decreased by about 5 percent. Nevertheless, the deficit on trade account (with imports on a c.i.f. basis) has decreased from \$716 million in 1947 to an annual rate of \$650 million during the first six months of 1948. Exports have amounted to \$432 million during the first half of 1948 and may well reach the billion dollar mark during the full year, while imports probably will not exceed 1.5 billion dollars. One more similarly successful effort and, with the help of tourist receipts and emigrants' remittances, overall balance of payments equilibrium could be within sight for Italy.

What is the meaning of this startling development? First, it shows that devaluation, if combined with monetary stabilization, is still an effective weapon--probably more effective than is generally conceded. The average rate for the dollar during 1947 was 484 lire* while during the first six months of

* Mid-point between yearly averages of official rate and of "export" rate.

1948 the dollar remained stable at 575 as the result of the new exchange rate arrangements introduced in November 1947. A look at the price and volume indexes quoted above shows that the elasticity of demand for Italian exports was quite obviously far above unity.

The second lesson of the Italian experience is that a country may, through currency devaluation and internal deflation, solve the balance of payments problem too soon; i.e., before the more fundamental economic and social conditions have been improved to an extent consonant with the broad objectives of the European Recovery Program.

It should not be believed, of course, that Italy is already about to achieve perfect equilibrium in its balance of payments. In the first place, reduced activity during the first part of 1948 combined with some liquidation of inventories to keep raw material imports at a low level. Secondly, the improvement of Italy's position has taken place mainly in its relations with non-dollar countries and, as a result, Italy has been accumulating increasing amounts of non-convertible currencies. Italian officials blame this development on the under-valuation of the lira in relation to European currencies, which are said to be maintained at artificially high levels in relation to the dollar. Exchange rates employed in private compensation deals seem to corroborate this thesis. Such rates are consistently lower (in terms of lira per unit of foreign currency) than the official clearing rates, which are based on the official cross-rate with the dollar.

At present Italy has underway important commercial negotiations with a number of its European trading partners and it may be expected that a way will be found to keep its balance of payments surplus with the other ERP countries within the limits of the net surplus (\$27 million) scheduled for 1948-49 in the Agreement for Intra-European Payments.

It could be feared that the recent devaluation of the lira with respect to sterling is going to interfere with this effort. However, the adoption of the official dollar-pound cross-rate for determining the value of the pound in lire is, paradoxically, likely to facilitate Italian purchases in the sterling area. For the difficulties experienced in this respect during the recent past stemmed in large part, not so much from real shortages, as from conscious policy of Great Britain intent on bringing about the desired change in the Italian exchange rate system. Hence Italy, should now encounter less difficulties in purchasing British coal and other sterling area raw materials. The impact of the partial devaluation of the lira with respect to sterling has already been felt since Italian importers, aware of the impending change, have made large-scale purchases of sterling in recent months and had thus driven the sterling rate on the free market almost to its official cross-rate to the dollar.*

* This applies to the "export rate" and not to the black market rate for sterling notes, which retained their heavy discount.

One of the most surprising consequences of the current expansion of Italy's exports has been the complete repayment by Italy of the Argentine loans which were granted last year. These loans included a long-term credit of 350 million pesos, which had been fully utilized before it had actually been issued on the Argentine market as originally intended. The other credit, in the same amount, was of the revolving type and had also been fully utilized. Through its export surplus in recent months, brought about by large-scale Argentine orders from the Italian textile and engineering industries, Italy has accumulated enough pesos to reimburse both credits and is actually said to hold 100 million pesos in excess of its obligations.

In its relations with the dollar area, Italy has also made significant progress. Italian exports to the United States have been recently at an annual rate of \$84 million, a figure which in real terms compares favorably to the 1938 level of \$41 million and which makes of Italy the fourth largest European supplier of the United States.

Imports on the other hand have fallen off as Italian industry reduced its large-scale raw material inventories accumulated during the inflationary period. As a result, Italy has been able to accumulate about \$100 million since the beginning of 1948. Total holdings of Italcambi plus the sums available in the exporters' 50 percent account now amount to the almost comfortable figure of \$200 million.

Italcambi receipts from tourists and from emigrants have shown an improvement this year as a result of the Italian Government's efforts to narrow the gap between the official and the black market rates. During the first six months of 1948 these receipts amount, respectively, to 8.5 and 22.5 million dollars as against 6.8 and 34.1 million dollars for all of 1947. The major part of tourist expenditures, however, still moves through unofficial channels even when the black market rate is practically equivalent to the official rate because of the tourists' habit of converting their foreign exchange at their hotel rather than at one of the authorized banks. At present, the black market rate for the dollar is about 10 percent more favorable than the official rate. This is still one of the smallest premiums in Europe. The rise since spring and summer when there was hardly any difference between the two rates is ascribed to the international situation and to arbitrage operations resulting from the steep rise of gold and dollar quotations in France.

All in all, there is little doubt that Italy has today one of the most "valid" exchange rates in Europe. As a result, progress in closing the balance of payments gap has actually out-paced basic economic recovery. Any future decision on allocation of aid to Italy should take account of this fact as it should also carefully weigh the dangers inherent in penalizing better-than-average performance.