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"ITALY AND HER PARTNERS: A CASE-STUDY IN THE POLITICS OF INTERNATIONAL ECONOMIC CRISIS MANAGEMENT"

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ITALY AND HER PARTNERS:

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The Italian Payments Imbalance: an international economic relations perspective

by

Marcello de Cecco

Introduction

Within a decade, the Italian balance of payments has experienced a large deficit, a prolonged surplus, and a new and larger deficit.

In 1963-64 and again in 1973-74, the Italian monetary authorities used the international credit market to balance the Italian external accounts in the short run. In both instances, foreign newspapers were full of Italy's chaos and impending doom. In what follows, I do no more than attempt to put a decade of Italian balance-of-payments swings into its necessary international economic relations perspective; my point of departure, very firmly, is that in international economic relations the tail cannot wag the dog.

The 1963-64 precedent

Italy's boom (1959-62) was not checked, in time, by fiscal measures. Also, monetary policy remained easy perhaps until too late. The boom-induced balance-of-payments deficit could be financed by ample recourse to the Euro--dollar market.

Community deflationary prescriptions, issued with regard to France and Italy in the early summer of 1963, were disregarded by Italy, applied by France. In the early autumn of 1963, monetary policy had to be relied upon to bring the Italian boom to a halt, and to solve the balance-of-payments crisis. The turn-around in the Italian payments situation was most swift and impressive. It took only six months to change the heavy deficit to a large surplus. Nevertheless, the Community continued to prescribe deflation as the cure for Italy's problems well into 1964, especially as the position of the Lira on the exchange markets continued to be shaky in the spring of 1964, in spite of the realignment in the basic balance. Bilateral aid was sought by Italy and given by the United States in March 1964, and this brought about an avalanche of criticism by the EEC partners; the Community renewed its calls for deflation, in the 'Marjolin letter', and finally got its way, as Mr. Colombo brought about a savage squeeze in public expenditure. The Italian economy, its internal demand depressed for several years, continued to develop mainly thanks to exports: these found their way onto the world's markets, as the continuing Italian squeeze coincided with a remarkable boom in the other major countries, also spurred on, it must not be forgotten, by the Vietnam war boom in the United States. Investment, however, lapsed most miserably, and the 1963 levels were not regained until 1968 (in nominal terms).

The 1968-69 Italian 'boomlet' was brought to a sudden halt by the great American deflation which, beginning in the summer of 1969, caused interest rates all over the world to align themselves to the American levels, through the large capital outflows that the Euro-dollar market made possible.

Summing up, it is not unreasonable to maintain that, by accepting the EEC recipe, the Italian government found itself unable to prevent the economy from falling into a slump as regards internal demand (and especially as regards investment) which lasted certainly four years (1964-68) and, arguably, until 1972. The Italian government, most unfortunately, sought to remedy this situation, in the years following 1964, by injecting funds into private consumption and by swelling the numbers of public and semi-public employees. Investment, or what there was of it, was also delegated to public and semi-public agencies. By 1971, as a result, 50 per cent of total investment was effected by the public sector. This proportion was more than double what it had been in 1963. Moreover, the Italian government deficit was, beginning in this period, structurally transformed: it came more and more to consist of transfers from the public to the private sector, generally designed to keep up internal demand for consumption, particularly for consumer durables.

It is also arguable that, in the years from 1964 to 1969, the unwillingness of the Italian authorities, faced as they were with embarrassing trade surpluses, to revalue the Lira, led them to encourage the massive capital outflow that kept the external accounts of Italy in overall balance.1) From the point of view of the collective economic stability of the West, this was wise, as Italy stuck to the Bretton Woods rules. From the point of view of national interest, it prevented the accumulation of gold and foreign exchange reserves that would have otherwise resulted from the surpluses. The Italian authorities traded off centralised foreign reserve building in favour of private foreign reserve building, and private reserves are hardly mobilisable, if the need arises, in the short or even the medium run. (That this sticking to fixed exchange rates also responded to internal Italian political requirements - the export industry's firm rejection of revaluation - is not an important consideration in the international context.)

Thus, throughout the 1960s, Italy played a very responsible part, vis-à-vis the international economic system: having developed a deficit, she cured it promptly and effectively and, having swung into surplus, she was a 'good credit' country, exporting capital for several years. She also stuck to the Bretton Woods rules and maintained the parity of her currency unchanged. ?

The 1973-74 episode

It is certainly impossible to get a clear idea of the 1973-74 Italian difficulties if we do not study them within the context of international economic relations in the same years. The main events that influenced that context were the two United States devaluations. In addition, a peculiarity of the same context must be noted, namely the lack of synchronisation of the German economic cycle with that of the other Western countries.
The first U.S. devaluation will merely be mentioned: perhaps the recent literature on world inflation has not devoted enough attention to the inflationary impact that devaluing the world trading and reserve currency, the U.S. dollar, had on liquidity preference. The first dollar devaluation put the most faithful creditors of the U.S.A., Germany and Japan, in the unenviable position of counting large capital losses; and of having to think again about a more appropriate mix for their reserves, but with the constraint of being unable to buy gold. Japan reacted very harshly, getting rid of perhaps 10 billion dollars within a very few months, in order to acquire whatever stable-valued liquid capital assets it could get hold of, especially raw materials and primary commodities. Germany 'decided' to absorb the loss with a smile. But it was certainly with very little concern for international equilibrium that the German authorities set about deflating their economy late in 1972 and in early 1973, discarding the fiscal weapon of economic policy until very late, and relying heavily on monetary policy and on a measure - the bardepot - which was in clear contravention of the freedom of capital movements. This disregard for collective economic security on the part of the German authorities can only be understood if one remembers the rudeness

with which the American authorities had enforced the realignment of their international accounts in the second half of 1971. In those six months leading to the Smithsonian Agreement, the American authorities legalised the 'everyone for himself' approach and found very eager pupils in the Japanese and the Germans.

Superficially, the European Community gave the impression of reacting in a concerted fashion to the American challenge. The joint float was launched, and adhered to, for some months. But it could certainly not have lasted without a much higher degree of mutual consistency between the internal economic policies of the countries in the 'snake'. Basically, the decision on the part of the German authorities to deflate their economy at the end of 1972, and to rely only on monetary policy, directly or indirectly induced Italy to leave the 'snake', and caused the dollar to be devalued again early in 1973. One has only to look at the levels to which interest rates had to climb in Germany before the economy began to cool off, to understand the gigantic shift into D-Marks from all other currencies. The existence of the Euro-dollar market undoubtedly made such gigantic shifts possible, and easy. But the Euro-dollar market had been in existence for a decade, continuously growing in size, and the German monetary authorities, who had skilfully used it for years as a substitute for their under-developed internal money market, knew very well what it meant to try to enforce short-term interest rates of up to 15 per cent at a time when the United States, Italy, Britain and France were all intent in reflating their own economies by means of relatively easy money policies.

For Italy, caught by the international currency storm of early 1973 just as a long-awaited and desperately-needed investment boom was about to take place, there was no alternative but to let the exchange rate go. The devaluation of the Lira was forced upon the Italian authorities by the sheer size of the wave of international short-term capital flows set in motion by the glaring discrepancy between U.S. and German monetary policies.

Devaluation, coupled with the wild rise in raw materials prices, meant for Italy a very high rise in import prices. The deterioration in the Italian balance of trade in 1973 is almost completely explained by the worsening in the terms of trade. Exporters were certainly helped by the devaluation, but it is much less clear that this coincided with a macro-economic benefit. Internal demand being, as it was, buoyant in many important countries, the international market was certainly a sellers' market. Actual availability of exportables was the real limiting factor, as the German export performance in the same period has abundantly shown.

In the course of 1973, the Italian authorities had to face the following policy constraints:

(a) a magnet for capital outflows represented by soaring interest rates in the major countries and especially in Germany;

(b) a radically worsened terms of trade situation caused, as mentioned above, by rising world commodity prices and the devaluation of the Lira;

(c) the near-impossibility of mobilising the gold part of the Italian international reserves. (As a result of American policy, the gold market was frozen and could not absorb large sales.)

The only course left, before it was decided to impose another monetary squeeze on an economy still far below its capacity output and its potential output limits, was that of using the Euro-dollar market once again, as had been done in 1962-63. This course was made easy by the extraordinary amounts of excess liquidity poured into that market since the dollar devaluation of August 1971 induced official and private dollar holders to try to offset capital losses by interest gains. The quadrupling of oil prices and the high rises in raw materials prices, however, made the relevant borrowing needs look enormous, when compared with the equivalent 1963 figures. The Italian authorities, moreover, did not refrain from using all the official borrowing capacity available to them through the various international agreements. The EEC short-term intervention fund was activated, and so were the inter-central bank swap lines and the IMF facilities. In the summer of 1974, a bilateral deal was concluded between the Italian and German central banks, according to which 2000 million dollars were made available to the Banca d'Italia for five years, against a swap transaction in gold. (The Banca d'Italia sold the equivalent of 2000 million dollars of gold to the Bundesbank at the price of $120 an ounce, and the Bundesbank agreed to re-sell the same gold to the Banca d'Italia, on maturity.) With this transaction, the post-1971 rules imposed by the U.S. authorities were clearly shattered: dollars were sold against gold at a market-related price, between central banks. If one remembers the endless debate about the 'means of settlement of official imbalances' in which talks on the reform of the international monetary system were bogged down, perhaps this aspect of the Italo-German transaction has received less attention than it deserves.

When comparing 1973-74 with 1963-64, we immediately notice that, in 1963-64, the unfriendly attitude of the EEC Commission and of the EEC members to the Italian difficulties was coupled with a basically international economic situation which rendered the turn-around in the Italian balance of payments extremely swift and easy; in 1973-74, on the contrary, the relative friendliness of the EEC, the IMF, and the main central banks, has been combined with a basic international economic situation which makes the turn-around in the Italian external accounts much more difficult. 2)

For a country like Italy, a financial readjustment of external accounts is clearly not possible. Italy lacks the financial infrastructure that helps Britain, for instance, to buy time by attracting short-term funds and rolling them over. Whether this infrastructure is going to be of much help in the future is another matter, and one I do not want to examine in this paper. What is certain is that Italy can only effect the readjustment of her own external accounts by a real transfer of resources.

But this is exactly what the international economic system and especially its protagonists, do not seem to want. Both the United States and Britain seem inclined to attempt to solve the basic imbalance in their accounts caused by the oil and non-oil deficits by financial intermediation. At the same time, the German authorities do not seem at all ready to readjust the real side of their international accounts, by reflating the economy and keeping the value of the Mark high, thus generating imports of manufactures into Germany. In recent months, the Mark has lost about 5 per cent of its peak value. In recent weeks, the German government's efforts to induce state and local authorities to borrow on the international market, in order to circumvent the Bundesbank squeeze, have been thwarted by the German monetary authorities. In Washington, talks about re-cycling have more or less aborted into the proposal of an IMF-based solution which everyone knows is acceptable neither to the oil producers nor to the United States.

On looking at the Italian experiences of both 1963-64 and 1973-74, some general lessons can be learnt:

(i) First and foremost, the striking failure, in the two largest Western countries, as well as in the smaller ones, to activate the fiscal arm of short-term economic policy. The last attempt, in the United States, to impose fiscal restrictions on demand, was the ill-fated one of 1968, during the Johnson Administration.

Its failure to gain Congressional approval determined the subsequent over-harsh monetary squeeze, which led to the 'interest-rate war', to the German revaluation, to the subsequent American recession, to the attempt to cure it by monetary release, to the short-term capital outflows that accompanied the enforcement of this policy, and to the dollar devaluations of 1971 and 1973. Appropriate fiscal measures were postponed by the Italian government both in 1963 and 1973, until they were adopted, too late and too harshly, in 1964 and 1974. Necessary fiscal restraint was postponed by the German government until after the 1972 Bundestag elections. In all these cases monetary policy was required to substitute for fiscal policy. The ensuing short-term capital flows, which are to be expected in a world where the short-term capital markets have become highly integrated, have only reflected the basic failure, on the part of governments, to come to grips with the unpleasant task of implementing politically unpalatable fiscal restraint. Economic policy has, in this way, been de-politicised as much as possible, by entrusting it to central banks, thus systematising a highly dangerous form of taxation without representation.

(ii) There was little, in such a context, that the international financial community (including central banks) could do to relieve Italy in 1973-74 which it did not actually do. As was said above, all existing borrowing facilities were used by the Italian authorities but, in a world where all relevant governments refrained from doing their duty about fiscal policy, all the burden of adjustment had to fall on interest rates, and thus on debtors. What Italy needed in 1973 and 1974, and will need in 1975, was and still is a German and American reflation. This would make the adjustment much easier, and require Italian interest rates less punitive than the ones that have been imposed in the last nine months. No measure of international financial assistance can be a good substitute for this basic readjustment. In the last fifteen years, German monetary squeezes have been frequent and harsh, but invariably they occurred in coincidence with American monetary ease. It is only in the last year that we have witnessed the coupling of monetary squeeze in the two pivots of the world economy. It was Italy's bad luck that it attempted to revive investment in such an inauspicious international climate. And the situation, in spite of whatever international loans the Italians may manage to get, will become desperate if the German-American monetary squeeze continues in 1975, and world depression necessarily goes with it. No degree of international co-operation can be substituted for such a basic, real readjustment. International assistance must be limited to extending bridging loans to see debtor countries through, while the United States, Germany and the oil producers find an agreement on how the transfer of real resources that the oil-price increases entail can be effected, and while the United States and Germany put their fiscal and monetary houses in order. But bridging loans have a meaning only if these real readjustments take place.

Ironically, however, it will not be the debtors who will have to be particularly concerned about the debts they incur. This is especially true in the case of Italy: the stock of Italian debts is so high that creditors just cannot afford to see Italy go bankrupt. Like Samson, she would go down together with all the Philistines. While she remained virtuous, Italy had no power to ignite the powder keg. Now she does, and it is indeed sad that the international economic system has worked itself into such a situation.

(iii) Both the United States and Germany have been throughout the 1960s and the early 1970s able to export their economic political difficulties abroad. The United States has had the international monetary system at its disposal to get rid of its internal excess demand. Germany, for its part, has extended its labour supply by using a foreign labour force which cannot vote during its residence in Germany but whose contribution to the German social security and pension schemes must not be overlooked. At the same time, the size of the foreign labour force has been tailored to the needs of the German economy. Moreover, both countries have played the free trade game only while it suited them: the United States imposed the burden of readjustment on its creditors after August 1971 by openly and plainly threatening a trade war; Germany, for its part, has closed the immigration window whenever it has felt like doing it, and has not refrained from imposing the <u>bardepot</u>, a measure which, as mentioned earlier, clearly goes against the letter and the spirit of economic liberalism.
At the same time, both countries have emitted a constant stream of virtuous statements about collective international economic security: the United States has come forward with repeated offers to strengthen the Atlantic Alliance by adding an economic wing to it; Germany has been active in fostering a greater degree of European economic and political integration. Seen against the background of their real policies, these pious attempts, on the part of both countries, must be considered more than mildly schizophrenic, and at least could be likened to Penelope's weaving endeavours.

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<u>October, 1974</u>

Tecnica usata dalla Banca tedesca per controllare i movimenti dei capitali da e in Germania (che è quanto predico)

FOOTNOTES

1) (p.2) Capital outflows from a country with a relatively 'strong' currency, as the Lira was, between 1965 and 1969, would be hard to explain; but one has to remember that Italian bank deposit rates were consistently lower than those ruling in other Western financial centres throughout these five years, that a good part of the outflow was motivated by the desire to avoid taxes, and that the Italian monetary authorities repeatedly induced Italian commercial banks to lend foreign exchange on the Euro-dollar market, by giving them the required foreign exchange at attractive swap terms. The extent of the capital outflows can be gauged by looking at the following figures:

<u>Total financial outflows, from Italy to other countries, as a percentage of Italian current GNI</u>

1966	1967	1968	1969	1970	1971	1972
3.5	2.4	3.5	2.9	0.9	1.6	1.2

<u>Source</u>: G. Rota, <u>Struttura ed evoluzione dei flussi finanziari in Italia</u> (Turin, Fondaz. Agnelli, 1974).

2) (p.4) In using the expression 'relative friendliness' I have not lost sight of the fact that, at the same time, 'an assorted set of national and international officials, bankers, politicians and chancellors' - as Luigi Spaventa graphically puts it in a forthcoming paper - stated the following principles of international economic behaviour:

> 'First, let each country find its own way out of the mess. But, second, don't let any country break those rules of gentlemanly behaviour, which, more than preventing a damage from being done, prescribe <u>how</u> the damage should be done. Third, an increase in international liquidity is to be avoided, because of its alleged inflationary effects. Fourth, the market can take care of the problem of finance: provided, however, fifth, that countries do not attempt to live 'beyond their means' and citizens of wealthier countries are not called upon to pay for the excesses of others.'

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Notes for the Conference at Chatham House on 'Italy in the European Community and in the Atlantic Alliance'

1. Concentrating on the EC and on the AA is not only a way of reducing the analysis of ~~the~~ Italian foreign policy to a restricted area and to the most relevant one; it is also a way of focussing ~~the~~ attention on the international environment which, in the present situation, gives aids and constraints to the country, therefore affecting the domestic political scene. [Italy has been part of the Alliance since 1949 and of the EC since 1958. The acceptances of both the Atlantic treaty and the treaty of Rome came out of sharp domestic political fights. In the former case, to the strong opposition of the communists and the socialists one could add the divisions ~~which~~ among the social democrats (Saragat), now the advanced point of ~~the~~ Italian 'Atlanticism', and the reluctance even of a small wing of christian democrats, the ruling party since the war (De Gaspari). The debate over the ratification of the Rome treaty, 8 years after, witnessed a small but important evolution because of the abstention of the socialists, symptom of that approach~~ing to the~~ to their entry into government (the so-called "apertura a sinistra") which implied the acceptance of the Atlantic Alliance as well. Since then the socialists have not only fully accepted the two treaties and their political implications but Nenni, when foreign minister, gave a strong European stamp to his action (~~see the declaration of London~~) (an outstanding example is the joint anglo-Italian declaration in favour of stronger and more democratic Eur. institutions, during the former Wilson government in the late 1960's). A similar path was followed by the Italian Communist Party which, in the late '60s, carried out a thorough revision of its attitude towards the European Community resulting in the entry of its deputies ~~in~~ to the European Parliament and later on in a formal acceptance of NATO. As a consequence there was recently in Italy a situation of no fundamental difference between government and opposition as far as foreign policy is concerned. During this year, after that critical winter ~~that was~~ of 1973/74, a certain tension over the atlantic links and disenchantment about ~~the~~

European integration has shown up, not necessarily along the line of division ~~if any~~, between majority and minority. I do not think that this is going to jeopardise the Italian membership in the two institutions, but I do think that the matter is worth watching in the light of their evolution, and this is why I suggested this subject for our ~~conversation~~ discussion today.

2. Foreign policy was the prerogative of the highest authority of the state ~~top authority:~~ King, government. Now in an interdependent world this is not the case any more: foreign policy is the result of several activities coming from different actors, public and private, not always consistent between each other and with ~~the~~ government policy. Because of the lack of political will and imagination to face this new situation by taking measures, ie by setting up institutions at the supranational level, there is a certain degree of anarchy in ~~the~~ international relations. This is frue for the industrialized world, particularly Western Europe and, particularly, for Italy. In fact, because of the endemic and increasing weakness of the Italian government, one cannot fully understand Italian international policy without taking into account also foreign policy activities and attitudes of political forces, business and trade unions.

Of course transnationalism is stronger in the European Community, a rather new type of state interdependence, than in the Atlantic Alliance, which is not very different from the traditional alliance. But since behind the alliance there has always been, and there is very much today, the US, with connected political, economic and cultural links, the involvement of the entire Italian system is important also in this case.

3. Considering first the Italian political forces, two aspects usually strike ~~usually~~ foreign observers: the little attention given to international issues and their exploitation for domestic goals. This only partly contradicts what I said before about the evolution of the Communist Party and of the Socialist Party. The Communist Party is a rather separate case:

(1) First of all, it has its roots in the world communist movement and has a long-lasting tradition of international relations, not only in terms of interparty relations, but ~~not only~~ since the identification of several parties with their states, also in terms of inter-state relations. The dependence - independence - interdependence issue is for instance very familiar to its leaders;

(2) Then the Italian Communist Party has been always in ~~the~~ opposition (with the exception of a very short time just after the war) and has felt the need to qualify its stand with respect to the majority. Approaching the government area, as it has been also trying to do in the last few years, has meant also that it had to find a new foreign policy line, which takes into account the international environment of the country, namely the European Community and the Atlantic Alliance. These are the reasons for a relatively intense foreign policy activity, which makes the Communist Party, as I said, a separate case.

The ~~international~~ external links of the Socialist Party have been weaker: the the importance of the 'International' is less compared with the communist international institutions. When in ~~the~~ opposition with the Communist Party, the socialists were overshadowed by their colleagues. ~~There was then~~ Then came, as I mentioned, the time of entering the coalition government which required action in the foreign policy field, both as a subject of internal debate and as a line of external activity. Then it gradually joined other coalition parties in their low international profile. Actually the CD and the so-called ~~late~~ "partitini laici" (lay small parties) after the times of 'great choices' - in fact the Atlantic Alliance and the European Community have gradually lost interest in foreign policy matters, assuming that Italy should not have prominent positions in the world scene and that they were dealt with by the government within these limits. As far as the European Community is concerned, this coincided with the shift of the focus from political to economic integration (ac-a study....). Moreover, for practically all parties, there has been a rather common feature: the exploitation of international issues for domestic goals. Two reasons can be found for this: first of all the assumed stability and little relevance ~~reliance~~ of Italy's international position; secondly, as an American scholar ~~student~~ put it (N) 'in an unstable system with stalemating tendencies, frequent governmental crises, and constant political manoeuvres within and among parties, exploitation of foreign policy for internal purposes is almost inevitable'. This is true with respect to ~~for what concerns~~ European integration, but even more for the Atlantic Alliance.

4. The production forces, entrepreneurs and workers, are naturally interested by the economic and social aspects of ~~the~~ international relations. The EC is, thus, in principle, more relevant to them. Business was initially reluctant towards integration, and was forced ~~to it~~ by political decision. Then during the '60s it was able to do ~~make it~~ very well and to take advantage of the Common Market. In the early '70s, more than 40% of ~~the~~ Italian trade was absorbed by the Community partners. Nevertheless ~~the~~ Italian industry, especially in the advanced sectors, has been linked, as all other European industry, to the American matrix. Thus Italian business has become pro-European, but over a permanent rather widespread pro-Atlantic priority.

Unions have become only recently interested in foreign issues other than ~~besides~~ the problem of migrant workers. The opposition of the great majority of ~~the~~ Italian workers to the Atlantic Alliance and, to a lesser degree, to ~~the~~ European integration, was dictated by political parties, in a time of strong dependence of trade unions on them. In ~~the~~ recent years, the situation has changed as the unions have become more independent ~~parallel to the process of autonomization of unions~~ ~~with respect to~~ of the parties. There has been ~~an~~ increasing attention to foreign issues, especially Community ones. The main feature has been the recent entry of the CGIL (communist dominated Trade Union) ~~in~~ to the European Trade Union organization, ~~following the leaving of~~ after its de facto departure from the Russian ~~rumour~~ dominated ~~FSM~~ WFT. World Federation of T.U.

5. In contrast to the good performance, before recent events, of the Italian economy in the Common Market, there are discouraging figures, recently made known, relating to what the Italian government was able to take out of the Community of Six (i.e. until the end of 1972). The agricultural fund supplied to Italy a total of 53 u.a./per capita (as against 93 for France), ie 24.5% of the total yield (while Italy represented 29% of the Community population and 40% of its peasantry). The agricultural fund then comprised ~~means~~ 91% of the total Community expenditure ~~subvention~~. But even of the remaining subvention, Italy has received 78.6% of its share in the form of loans at interest rates similar to the market ones, ~~while~~ but only 16.7% in the form of grants, direct contributions or soft loans, ie the smallest figure in the Community (eg. 37.4% from Holland). This shows on the one hand how insensitive the EEC was towards the Italian case, and on the other hand how ~~much~~ little the Italian government did to defend it. The administration, ~~outside~~ apart from the foreign office, has been almost totally unprepared to deal with Community problems. Even inside the Farnesina, according to an inquiry we made a few years ago, EEC positions come very low in the aspiration priorities of our diplomats or future diplomats. The same can be said about transatlantic relations: sympathy towards ~~militarization~~ bilateralism has always been ~~an~~ dominant — The majority parties relying on government, the government resenting the lack of ~~political thrust~~ interest shown by the parties, the parliament is the ~~heart~~ pivot of this unproductive vicious circle, which can be extended over a large part of foreign policy. Parliamentary debates over international issues are often concentrated on marginal issues - Vietnam has probably taken more time than the EC and broad Atlantic problems.

6. Are there foreign policy alternatives for Italy to West European integration and Atlantic solidarity? Ever since the cold war, the communist world has appealed to the Italian left, first as an opposite model vis-à-vis the West, ~~and~~ then as a prospect for a neutralized Europe, and finally as a partner in a security agreement that would, de facto, annihilate ~~assimilate~~ block confrontation. None of these scenarios has worked: the present trend of the CSCE towards a meaningless conclusion ~~closures~~ is the final disillusion. West European integration is not considered any more as being contradictory to détente policies. As I said before, the Atlantic Alliance is now accepted by both socialists and communists as necessary, until the 'dissolution of blocks' occurs. (?) A recent alternative foreign policy line deriving from early Italian history comes from the Mediterranean. Traditionally power and/or self-assertion policies have looked at the Mediterranean basin. They have usually had audiences on the right of the Italian political spectrum. After the war, nevertheless, there has been the support of ENI (state owned oil agency) and of leftist catholics ~~(Mediterranean conferences organized by La Pira)~~ to a more pro-arab attitude, putting together ~~another~~ a rather heterogneous salad of national interests, ~~christian ecumenicism~~ and aid to development from a point of view of christian ecumenism. The few ~~antiquities~~ ambiguities that remained, as a result of this, in ~~the~~ Italian foreign policy, were not such as to save us from being put by the arabs into the limbo of the neither friendly nor enemy countries, after the Yom-Kippur war.

7. In the present situation, for most ~~other~~ countries and particularly for Italy, making extrapolations out of the recent trends is risky, and making predictions is doubtful. I would only like, in concluding, to come back to my initial point, i.e. the relevance of the European Community and the Atlantic Alliance to ~~the~~ Italian domestic policy and vice-versa.

It is known that the present very acute crisis in Italy results from the ~~emerging of~~ a difficult international situation, due to the drastic increas of our ~~imbalance of~~ payments deficit consequent to the steep energy cost increase, Together with domestic troubles, that mostly come from the end of a political generation that ruled the country for 30 years uninterruptedly. This continuity ~~which was~~ has been often considered a sign of stability but is also a sign of ~~neurosis~~ sclerosis.

To increase stability effectively, three ways have been considered:

(1) The 'rajeunissement' within the present coalition which does not seem a far-reaching change because of the lack of personalities among younger leaders.

(2) Moving to the right, which cannot go ~~behind~~ beyond the small liberal party, after it is clear neo-fascist groups have been almost constantly planning coups d'etat; this move to the right would cause ~~and would likely lose~~ the Socialist Party to leave the government.

(3) Accepting the support of the Italian Communist Party, the so-called 'compromesso storico' which has been polarizing the Italian political debate for the last ~~one or two~~ year or two.

As far as our balance of payments problem is concerned, we have experienced international solidarity to a great extent. Italy's foreign debt is at present as high as 16.6 billion dollars, and likely to increase to about 18 billion dollars if the Community loan presently to be negotiated with oil producing countries should be successful. According to Treasury Minister Colombo, we are likely to need further financial support.

8. The evolution of the financial sources and the associated conditions add, nonetheless, an interesting feature to this substantial economic help. The international financial market (mostly the Eurodollar), the IMF and the EEC were the instances where we applied successfully. But this is not the case any more. At present we have to resort to individual countries, ~~the European ones, and~~ namely Germany, to which the EEC is an increasingly transparent screen, and the US.

On the European side, we have been asked explicitly economic conditions. Traditionally the EEC has suggested macro-economic measures (containment of inflation, reduction of deficits, etc) to the Italian Government (de Cecco). Recently the loan from the German Federal Government was given at rather ~~common~~ normal interest rates, with an additional gold guarantee, which is likely to ~~hide~~ conceal a simple ~~selling à terme~~ sale of the gold when the loan expires. Attempts to give the Community effective micro-economic instruments to enter ~~the~~ Italian economic policy, from the so-called structural policies (regional, industrial, social) to the proposal of including project support facilities in the draft of the present Community loan, have not been successful. I find it very unfortunate, because this, I feel, is what Italy really needs.

Then there is an implicit institutional condition associated with the membership of the EC. The similarity of the institutions of the Nine, the refusal of Southern European authoritarian regimes, verified 'a contrario' by the opening toward Greece and Portugal after their recent evolutions towards democracy, all have been pointing to a European heritage to be saved. If it is kept, this will sound as a warning to my country. If, on the contrary, the Community should become a looser association of states, ~~also~~ this unique feature too is likely to be dropped.

From the Atlantic side, and namely from the US, we receive rather mixed, if not contradictory, pressures. On the one hand there is the plea for discouraging epidemic inflation (e.g. requests for establishing a ceiling to credit facilities) and for ~~better~~ greater efficiency. Nevertheless, political conditions appear ~~easier~~ heavier, substantially if not formally, than economic ones. Kissinger's almost explicit admission of CIA interferences in ~~the~~ Italian ~~democratic~~ domestic politics, contemporary to ~~when he was questioned in the midst~~ ~~of~~ a governmental crisis opened by a political group well known for having strong American connections, is revealing. Political conditions are ~~also~~ likely to be stronger than institutional ones, too, as the history of the Atlantic Alliance and its present situation demonstrate. The increased strategic importance of Italy, because of the growing confrontation in the Mediterranean and of the reduced Greek commitment (even if the need of Italian bases for NATO was highly exaggerated), will only dramatize this.

Thus, to conclude, there is, as I have tried to demonstrate, a complex interplay between the Italian domestic scene and Italy's membership in the EC and the AA. I do not think, I repeat, that there is a problem of <u>whether</u>, but <u>how</u> to stay in these two institutions. This will depend, more than is commonly understood, on the evolution of integration as well as on that of the Alliance. If the Community will definitely evolve toward a weak intergovernmental structure and, connected with it, the AA will evolve towards a series of bilateral links centred in Washington, this won't help the survival of the Italian institutions. The hierarchy of the European countries will become more evident and more severe. We are well aware of being at the bottom. But the destiny of Europe may be more common than the mould of our ~~national identification~~ conventional national prejudices enable us to perceive.

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The Royal Institute of International Affairs

THE INTERNATIONAL FINANCIAL CONTEXT

by Dr. Kurt Richebächer

Inflation or deflation, inflation or recession, that's the question. Looking around us, we are confronted with a bewildering contrast. Wages, prices are rising more rapidly than ever before, with Germany as the main exception. On the other hand, the current money value of practically every type of property, ranging from shares over real estate to commodities, is suffering enormous declines, compared with price levels of only half a year ago. Where are we -- in the midst of inflation or deflation ?

We are, indeed, confronted with a drastic, a dramatic turn of the economic and monetary climate all over the world. In my opinion, this change is governed by three identifiable influences.

Firstly: Credit restrictions at last produce their effect on our economies.

Secondly: Accelerating inflation absorbs more money and credit. Greater amounts of money and credit are necessary to support a given volume of goods and services.

Thirdly: On top of these two contractive influences now comes a third one: Oil - a four fold increase of oil prices with far reaching consequences. Putting it in a nut-shell: What happens is massive transfer of purchasing power to oil exporting states resulting in a marked shift in the pattern of world income and of world payments.

Altogether, so we agree, we are faced with an unusual and explosive mixture of problems of which no country is spared, leaving alone the oil producers. However, there are wide divergencies in degree. The United States is the country which is far less dependent on oil imports than other continents and countries, far less also than Europe.

Trying to assess the European economic situation in the world-wide context I have to state in the first place the obvious:

There are extreme divergencies from country to country measured by inflation, measured by balance of payments and measured by levels of domestic demand.

To give you a brief sketch of the inflationary picture, Germany, as well known, stands out as the country with the lowest rate of inflation, just about 7 per cent. A group of smaller countries like Switzerland, Austria, Belgium, The Netherlands, has inflation rates around 10 per cent. Well above come countries like France, Great Britain and Italy, in this order with inflation rates ranging from 16 to 20 per cent. Inflation is most rampant in the whole residual group of lesser developed countries at the outer circle of Europe, starting from Finnland over Turkey, Greece, Yugoslavia, Spain, Portugal. Here Inflation is at its highest between 20 and 40 per cent.

With inflation so divergent, it is clear that also balance of payments positions differ extremely. Oil comes now for various countries on top of high existing deficits.

As a heritage of earlier monetary overexpansion practically all countries had and still have quite a lot of reserves and credits in the pipeline. But with these massive deficits most of them should quickly get through them. The danger in this situation arises not only from the magnitude and likely duration of the oil deficits, but from their extremely uneven distribution. Western Germany and The Netherlands together will record this year a current surplus of around $ 10 billion, which squeezes other countries in addition. Among the industrial countries the bulk of the deficits falls on a handful of them: UK $ 9 - 10 billion Italy $ 8 - 9 billion, France $ 6 - 7 billion - and outside Europe Japan with $ 7 - 8 billion.

To understand the meaning of these figures, it may be worth mentioning that in the case of Great Britain and Italy this accounts for about 6 % of the gross national product. By contrast, let me recall that at the height of the dollar crisis in 1969/70 the current account deficit of the United States did not surpass an equivalent of 1 per cent of national product.

Most of a year of higher oil prices now lies behind us. Though payments on the basis these prices did not start before April, the impact is already of staggering proportions. During the first half of this year, OECD countries as a whole have registered a deficit in their current account amounting to $ 22 billion, compared with a $ 3 billion surplus in the first half of last year. Out of these 22 billion roughly two thirds or $ 15 billion was covered by capital imports, and one third or $ 7 billion by drawing on reserves. Again these figures hide wide divergencies between countries. Three European countries - France, Italy, UK - together managed capital imports of $ 12 billion, whilst Germany had a capital outflow of $ 4 billion.

In fact, one may say: The most noteworthy feature of experience so far has been the smoothness with which this financial revolution has been overcome and external deficits have been financed. Individual countries have obtained the capital inflows they each needed to offset their current deficits. The question is in how far this can give us hope for the future. Inspite of this hopeful beginning we mostly agree to-day, I think, that the problem of financing all national oil deficits will be unmanageable for private markets. As experience already amply shows, the access of a country to international finance is strongly ~~affected by~~ its success or failure to cope with domestic stability and external deficits.

The large international banks, which have so far been the main financial channel, will continue their function. Nevertheless, it is impossible for them to lend without end to countries whose international solvency is bound to be questioned. We can only rely to a limited extend on the banks as intermediaries for the recycling of the oil dollars. For Europe, there is an urgent need for alternative financial channels to supplement the banking system.

A second question concerns the direction of the flow of the oil dollars. Contrary to earlier expactations an overproportionate part of the money has gone to the United States. According to official sources (Bank of England) the oil-exporting countries have accumulated from January to July of this year a total surplus of $ 25 billion. The investment of the surplus can be identified only roughly, but so far it would seem that up to one eighth of it corresponds to increased sterling assets, including some euro-sterling deposits held outside London. Most of the rest of the surplus appears to have gone into dollars, a large part directly to the United States, treasury bills for example, and a smaller part into the eurodollar-market.

So much about the oil deficits as far as Europe is concerned. Let me return to the question of the present economic situation in Europe and possible future development. One can say that by now all countries have reinforced their counter-inflationary policy which normally should also help the reduce external deficits. Up till now, however, bpth inflation rates and external deficits seem to escalate further. But the repercussions of the measures taken to restrain inflation are clearly to be seen in a general weakening of demand. What is most significant here is that Western Europe's current cyclical downswing is close to what seems to be evolving in the United States, not only in its origination, but in its time-phasing. The slowdown began at the turn of the year, almost exactly as in the United States, and again like the US was so far relatively moderate through midsummer 1974, the latest date for which sufficient information is available. As in the United States, residential construction, automobile production and financial institutions and markets - share and bond markets - have been hardest hit.

One of the reasons behind this disquieting phenomena, of course, is that other countries, too, are deflating their economies. So the United States, and so Germany. And the question really is who deflates most. In this respect, I dare say, Germany continues to be at the head of the league - the result being the rise of our export surpluses which continues unabashed. Due to slower world demand our exports are slowing down too, but with domestic demand inside Germany contracting faster than abroad, our imports are declining even faster. And projections are that there is no end yet in sight of this contrary movement between exports and imports.

During the first eight months our trade surplus with the rest of the European Community has more than trebled against last year, in figures by more than DM 8 billion to DM 12,5 billion, equal to about $ 5 billion. But 80 per cent of this increase of the surplus has fallen on Italy, France and UK, in this order.

Clearly, German economic and monetary policy will play a central role either to ease or to intensify imbalances between countries within the Community. Trying to assess German policy and future development I do not expect a really worthwhile relaxation of monetary policy before the end of this year. Taking account of the usual time-lags between measures taken and their effect on economic activity, I find it difficult to conceive an upswing of domestic demand before the middle of next year, always provided that expansionary policy will be successful in time.

With the economic key-role of Germany in Europe in mind I would like to make a few remarks about ourselves. Germany has two trump cards at the moment: The one is our relatively low inflation rate, just above 7 per cent, and the immense foreign exchange surpluses. This year, our foreign surplus will reach DM 50 billion, our current surplus around DM 25 billion or roughly $ 9 - 10 billion.

To many foreigners both are symptoms of first class national health. About the causes behind this, there can be no doubt. Practically one and a half years of an extremely stringent monetary policy lie behind these achievements. And this policy had its price. **I shall make a few remarks on that.**

On balance, the German economy is stagnating in real terms, but this is the average of two extremes, of a depressive home market and overheated export markets. With foreign demand so far being very strong, tight monetary policy largely shifted production into exports. A lot of these exports you might more suitably call emergency exports.

To give you an idea of the actual economic situation in Germany, let me present some figures. Unemployment has risen over the year, seasonally adjusted, from 1,6 to 3,4 per cent or nearly 800.000. Capacity utilisation is down from 92 to 81 per cent now. In spite of very high wage settlements, private consumption is down in real terms by a little over 1 per cent. The building volume has fallen by more than 5 per cent. But the brunt of monetary restriction has so far fallen on industrial investment. Gross investment into plant and

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equipment has fallen by 9 per cent in real terms, net by about 30 per cent. Trying to assess these investment figures one should take into account that industrial investment in Germany has been practically flat for more than three years.

The problem of our industry is that the monetary restriction has largely done its job, in respect to sales prices, but by no means in respect to costs, above all not in respect to wages. Monetary policy appears quite effective on the domestic price level, yet totally ineffective at the wage front. Though our inflation rate on the consumer level has stopped at 7 per cent ~~with a clear downward trend~~, wage rates were boosted since the beginning of this year by more than 12 per cent. Relative to the inflation rate this represents one of the steepest increases in the world.

Recently, the OECD has given some figures for various industrial countries about wage rises since 1970. This comparison shows clearly the degree of the wage inflation in Germany which contrasts sharply with the general picture of relative price stability. In order to compare we must, of course, also take into consideration the exchange rate changes, revaluations on the one hand, devaluations on the other hand. On this basis the OECD calculates for the US an increase of unit labour costs, [redacted], since beginning 1970 of 11 per cent, for Germany, calculated on dollar basis, 64 per cent.

This combination of wage inflation and restrained prices has taken its toll from business profits, a very heavy toll whose repercussions we are seeing now in the investment slide. Here again I would like to quote some figures, Germany on the one hand, the United States on the other hand. Whilst retained profits of American companies have been rising year by year since 1971, they have equally continuedy declined in Germany.

Annual changes of retained profits in per cent

	Federal Republic	USA
1971	- 26,6	+ 46,9
1972	- 16,7	+ 42,6
1973	- 26,6	+ 43,0

Looking at financial structures there are some points of importance to which I would like to draw attention. In the first place, private savings are well up. The private savings ratio has climbed to a record level of 14 per cent. At the same time, however, financial savings of companies are way down as the figures of retained earnings tell us. Also, the public sector is running a mounting deficit. In total, budgetary deficits may well double against last year. Drawing the net balance, total financial savings in Germany have so far declined below the level of last year by 20 per cent from DM 58 billion to DM 49 billion.

Yet, even more dramatic changes have taken place on the credit side. With investments so heavily cut back, credit demand of industry is extremely weak in line with credit demand of the building sector and consumers. Drawing here, too, the balance, we find a steep fall of total domestic credit demand by 40 per cent from DM 61 billion to DM 36 billion. In other words, the flow of savings by far exceeds the flow of credit demand.

The monetary and credit figures tell us still more than that. In fact, they give us also the clue for the relative weakening of the Deutschmark. As a matter of fact, there has been a tremendous swing in export financing. It appears that German industry is extending far more export credits than it used to do. During the first half of this year outstanding export credits of the German companies have risen by DM 16 billion compared with an increase of just over DM 2 billion in the same period of last year. Simultaneously foreign indebtedness of German industry has slowed down considerably. Certainly largely due to the cash deposit scheme which penalized foreign borrowing. Altogether, this tremendous swing in export and import financing surpasses the rise in export surplus. In other words, it largely explains why the Deutschmark has been so weak relative to other currencies inspite of its soaring export surplus.

It is an obvious fact that we are in the grip of many and partly quite contradictory pressures. We must give priority attention to the international dimensions both of inflation and the threat of recession. It has been truly said that no country with a highly developed social and economic structure has ever had an inflation rate over 20 per cent and continued with a democratic government. It is sobering and alarming to see social and political unrest escalate in more and more countries.

One of the puzzling features is the erosion of wealth, caused by steep declines of market values of all those things which for years had been considered and used as full-proof hedges against inflation: real estate, shares, and even gold is not doing too well. Losses must now be running into hundreds of billions of dollars world-wide. Though this collaps of market values of financial and real assets is by no means particular to Europe I would like to give you some of my considerations, as it is a problem of such wide importance.

To begin with, we have to keep in mind one fact of central importance -- market values of real as well as financial assets are always determined by transactions of minimal and marginal volume relative to the totality of existing assets. Nonetheless, these prices "at the edge" serve as the bell-wether and as the yardstick for the valuation of equal or similar assets as a whole. People, companies invest on the basis of these marginal market prices. Hoping for the next round of higher prices, they tend to become insensitive to the relation between current profits and current interest rate costs. At the same time, banks lend on these rising prices.

In time, however, and that's what we are painfully witnessing, speculations get out of touch with real markets. Outlay on capital goods, on inventories is swollen far over and above current savings, far over and above normal demand -- being financed by a massive inflationary expansion of credits.

The cycle of events whereby the fringe of the market pushes total values takes its course: market values of all assets favored by speculation are thrown out of balance to the general price level and also out of balance to the current return on these invest-ments. They simply become overpriced.

My point is easiest to see when you look at building markets where, at present cost and interest rate levels new investors are no longer making profits but instead sustaining losses.

As long as owners hoped for relatively big capital gains, compared with which the interest burden seemed light, they continued to feel happy in spite of waning current yields. Now, however, with tight money and credit, there suddenly are more sellers than buyers. Even if there is no wave of selling, the crucial thing is that the fringe of the market has gone into reverse gear. Some hard-pressed owners try to sell and soon the gigantic edifice, which was honeycombed with speculative credit, begins to break under its own weight. What was considered most secure, turns out to be the least so, while the banks are faced with the choice between taking over the ailing assets or running the risk of precipitating the crisis.

Let me try to draw a few general conclusions from what I have said. Market values of capital assets of all kinds are determined by the following factors:

First, by the general monetary influences.

Second, by expectations about future capital gains by rising prices.

Third, by expected current profits.

Fourth, by interest rates, in particular the long-term interest rate.

Monetary in influences which were very expansive during the last years, have turned contractive. Money is no longer in favor of markets, it is against them, and as I said, marginal changes from buyers to sellers are enough to turn a bull market into bear market.

As capital gains expectations disappear, now suddenly- that is my conclusion - markets quickly become highly interest rate sensitive. Without prospects for bigger capital gains investors look more criticallyat expected current profits relative to the income offered on riskless bonds. And our bond yields - I need not tell you - are atrociously high, nominally and above all in relation to current and expected profits. More and more markets begin to feel the full weight of these long-term interest rates.

Conclusion

With economies sagging, we all shall be confronted one day with growing internal pressure to resort to unilateral beggar-thy-neighbor actions - competitive devaluations, dumping, import and exchange controls. Though inflation remains our public enemy Nr. 1, we must pay greater attention than hitherto to the danger of a world-wide slump. In this respect, trying to weigh both dangers against each other, I found a passage in a speech of the Managing Director of the IMF, H.J. Witteveen, most balanced:

"To a certain extent, deflationary effects have to be accepted, as some reduction in demand is required to fight inflation. But the necessary elimination of excess demand must not be allowed to generate international repercussions resulting in severe and prolonged recession. The emergence of severely recessionary conditions not only would be harmful in itself, but also could be expected to have a counterproductive effect in the fight against inflation. For such conditions would inevitably lead to widespread pressures for a shift to sharply expansionary policies, and this could easily exacerbate inflationary pressures and psychology. In the uncertain international environment that prevails, it will be of crucial importance for national authorities to conduct their demand policies with a close eye on changes in the underlying economic situation and, in this process, to take into account both the time lags in the effects of policy instruments and the interdependence of developments in different countries."

In the face of this ocean of problems we ask ourselves, where is Europe? For many years our efforts to create the European Community were favoured by steady economic growth. Even then we suffered painful setbacks, but on the whole we made some progress. Our present problems are of unprecedented proportions. We have unprecedented inflation, an unprecedented threat and potential of recession, and unprecedented external imbalances due to the higher oil prices. For the European Community the cost of imported oil will treble from $ 16 billion last year to $ 48 billion this year. That compares with an increase in the import bill for the United States by about $ 10 billion. All this is putting and will continue to put enormous strain on our Community, considering in particular the extreme differences in the domestic and external position of member countries. The Common agricultural market seems to be falling apart, and the monetary picture looks even more gloomy.

Altogether, it is easy to become very pessimistic about Europe. When the oil crisis broke out, at first any Community spirit seemed to have gone to the winds. For some months sauve qui peut became the order of the day. At the same time the Turkish-Greek war painfully demonstrated to us what we knew before: The political weakness or should I say the political non -existence of Europe. Political unity seems so far beyond our present horizon that we have practically stopped to speak or even to think about it. At the same time even economic union seems on the retreat. In view of the urgency and the huge dimension of the energy problem, one should think that this would give a stimulus to tackle it in European cooperation. I am afraid to say that there is little evidence in this direction.

Still, some rays of hope, one may say so, begin to emerge. With the main countries having adopted flexible exchange rates we all feared that we would finally move apart. While the system has worked well in some respects, experience has meanwhile given the lesson that the possibility of countries to follow their independent monetary and fiscal policies has been widerly overrated. The need to coordinate policies is hardly less pressing than under a system of fixed rates - and I think that governments are making this again the basis for their decisions. Remember the recent plegde of Giscard d'Estaing to join Germany in its ~~policies and~~ anti-inflation targets. The sense of interdependence is returning.

Also witness the German loan to Italy and the planned venture of a joint European loan issue. There is some scepticism about the meetings of the heads of Government, of the conferences on ministerial level which have produced little concrete measures. To retain or to create mutual understanding among leading politicians is still important. Although all these new trends and efforts cannot give rise to euphoria, they seem at least to justify a moderate optimism about the coherence of the Group. For a some time to come, however, we shall certainly have to live with flexible rates on the one hand, and the "little snake" on the other. As to this snake, I am rather optimistic that this monetary nucleus of Europe will hold together, as the positions and the policies of the countries in it are not far apart.