

# A PLAN FOR MONETARY, FINANCIAL AND ECONOMIC STABILIZATION OF ITALY

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## I. Diagnosis.

1. Italy is suffering from the ill effects of a chronic inflation with cumulative gaps in the economy due to a disproportionate expansion and contraction of official paper-money issued by the Central Bank and private paper-money in the form of monetized credit put into circulation by private banks (domestic and foreign). There is no way in practice to calculate and maintain an equilibrium supply of paper-money in both senses in order to achieve full employment, price stability, a balance of payments in equilibrium and a desirable degree of social justice in the distribution of national income and wealth.

2. The intensity of the inflation is not uniform throughout the country. In the industrial and financial centers the inflation appears stronger than in the agricultural sector. In relative terms, the Italian agriculture, as in other European countries, seems to be affected by a hidden deflation, but in fact it is only a lag, or a different degree of the same inflation. For this reason peasants and farmers are complaining that they do not receive a fair deal when compared with the industrial sector.

3. Under conditions of chronic inflation, it is not the private economy alone which suffers but also the Government, which cannot have order in its finances. The germ of instability induced and propagated through paper-money and monetized bankcredit becomes cancerous and all pervasive throughout the entire economic and social body.

4. Money, when it is 100 per cent covered in the sense of «numeraire», constitutes an objective and reliable instrument to measure exchange values in both national and international markets and to express conclusively decisions of invest-

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ment, capital formation and consumption in a national economy geared toward stable equilibrium. But with a nominal, uncovered monetary unit like the old lira (in internal transactions an abstract unit; in fact, a fiction!) there is absolutely no chance to reach conditions of stable equilibrium.

5. The main lesson from the Italian experience after World War II consists of the fact that in practice it is impossible to successfully manage a monetary and banking system based on inconvertible paper-money and monetized bankcredit. Indeed, there is no formula in theory and there are no practical means to compute and maintain for a given period an equilibrium supply of this type of money consistent with the major goals mentioned under Paragraph 1.

6. The traditional tools of monetary and fiscal policies, including recent income (price and wage) controls, according to the European and American experience, are not adequate to effectively resolve the problem at hand. The Italian Government and the Central Bank of Italy have persistently tried in good faith to manage the issue of paper-money and monetized bankcredit, but without success. The nature and behavior of uncovered and inconvertible money (actually «anti-numeraire») in a national economy is similar to the radio-active elements in the physical universe : Both have inherent instability which cannot be corrected because of their nature.

## II. Basic Problems.

Here are the basic problems which Italy faces in 1973 :

1. How to drain off the existing inflation, because without doing so, no economic, monetary or financial policies can work successfully.
2. How to introduce a framework of stable equilibrium so that inflation will not occur in the short as well as the long run.
3. How to adjust the Government budget and fiscal policies to the new environment of stable equilibrium.
4. How to stop capital flight and have the balance of payments in order, with neither deficits nor surpluses.
5. How to bring more social harmony in Italian society.

## III. Solutions.

### A. How to drain off the existing inflation ?

1. The introduction of a new, heavier Lira is indispensable to accomplish this task.
2. The calculation of the total supply of money composed of central-bank Notes and Deposits, plus monetized bankcredit outstanding on D-day. Let us identify this us :  $s_m$ .

3. The computation of the total amount of gold and convertible currencies included in the Italian reserves on the same day. Let us identify these reserves of «numeraire» in gold as :  $S_g$ .

4. Divide  $S_m$  by  $S_g$  and thus find the degree of intensity of inflation on D-day. This result will provide the basis for the new, heavier Lira which can be used to drain off the existing inflation. Recently, the idea was advanced that 1,000 old liras equal one new lira, but no further information was given on how they arrived at this proportion. The real figure, however, should be derived by dividing  $S_m$  by  $S_g$  with a safety margin for possible errors. For demonstration purposes only, the figure of 1,000 old liras equal one new, heavier lira is retained here because we do not have the real values for  $S_m$  and  $S_g$ .

5. Over a weekend the new lira could be introduced with the stipulation that all prices, incomes, debts and any form of claims (domestic and foreign), including taxes, should be reduced by 1,000 in order to avoid any difficulties with the new reform. The old lira may be allowed to circulate side by side with the new lira within a given period of time, f.i., six months, but prices, incomes and taxes should be expressed after D-day only in new lira.

6. Any issue of old lira should be stopped immediately on D-day. Probably it will be necessary that the new lira be divided into 100 units of the first order (small change) and each one in turn be equal to 100 units of the second order.

7. Foreign exchange rates should be reduced by 1,000 on the same day, assuming that during the two weeks prior to the reform, foreign exchange markets were free in Rome and other Italian centers.

8. The par value of the new, heavier lira could be moved to 1.42187 grams of fine gold, or 703.292 new lira for 1 Kg of fine gold.

9. The available gold stock will be revalued at the new par value.

10. All foreign claims and loans should be adjusted to the new par value.

11. Since all the changes up to this point are technical adjustments to the new, heavier monetary unit and there are neither losses nor gains to foreign creditors or debtors, no additional problems are expected with the International Monetary Fund or the other member countries of the European Community.

12. After D-day the official monetary standard of Italy will be gold-lira. The organization of credit will be separated from the issue of money, as shown below.

#### **B. How to establish and maintain conditions of stable equilibrium.**

1. Unconditional convertibility in gold of the new lira after D-day both at home and abroad is the first and most important requirement. Since the new lira on that day and thereafter will be 100 per cent covered, this requirement can be fulfilled without any difficulty.

2. The Central Bank of Italy shall be the only institution to issue new lira

after D-day at the new official parity against delivery of gold of the same value but retaining a small discount to cover minting and administrative costs.

3. All trading in foreign exchange after D-day shall be free. All existing foreign exchange controls and regulations will be rendered unnecessary and shall be dismantled completely on the same day.

4. The money market on D-day and thereafter shall be clearly separated from the capital markets, since each market has its own specific function, and only in this way is there any chance of developing equilibrium rates of interest on both markets.

5. The proper function of the *money market* is to provide sufficient liquidity in the economy according to that portion of real income (derived from production) which is to be used for consumptive purposes during a given period. Since the liquid funds required in spending for consumption must be immediately available, the money market must be 100 per cent covered at all times in official money. Credit, of course, will play a great role, but it will not be monetized, and therefore it will not change the supply of money. This special framework of the money market will help to achieve two important goals. First, it will make financial crises impossible. Secondly, an equilibrium rate of interest on money markets will insure that the demand for liquid funds in «numeraire» will be equal or very close to the available supply of liquid funds. The volume of credit, on the other hand, will be limited to the amount of real income derived from current production, plus accumulated savings which are not yet invested and eventually may be converted into liquid funds.

It must be further understood that the money market within a framework of stable equilibrium is restricted to the function of pure liquidity in the economy which is satisfied only through official money in form of «numeraire». This represents, however, only a relatively small fraction of the total amount of transactions related to the current consumption of goods and services. The larger balance of transactions is settled through credit facilities which are arranged in such a way that credit is not monetized through the banking system as it is today.

6. The specific function of the *capital markets* is to provide and assemble a sufficient quantity of real capital available in the economy over a longer period of time. This capital is formed of voluntary savings of the people which are entrusted to banks for investment or are invested directly. These savings come from that part of the current income which is reserved for future improvements of consumption, and therefore can be used in the production of capital goods.

The current volume of real income is therefore divided into two parts : One part devoted to immediate consumption during the given period, and the other part saved or committed to future needs. The money market deals with the first part, and the capital markets are concerned with the second part. Here there are two entirely different functions, and therefore, the two types of markets must be kept separate.

Free interest rates on free capital markets will help to create and maintain conditions of stable equilibrium whereby the volume of investments will be equal or very close to the amount of available real capital. In a framework of stable equilibrium with «numeraire» the expressions of «real income», «real capital» or «real wages» have the same connotation as «money income», «money capital» and «money wages», which is an indication that here the business cycle is non-existent.

7. A free and stable banking system. To satisfy the conditions of stable equilibrium mentioned under Paragraphs 5 and 6, a change in today's institutional and legal framework of private and public banking is absolutely necessary. According to the requirement of a complete separation between the money market and capital markets, banking activity must be divided into two independent areas—one dealing with liquid funds, and the other with capital.

(a) Department A will be concerned with transactions on the money market. Here the banks would receive adequate deposits in official money and open current accounts, with the right of deposit holders to use such funds to draw checks or withdraw the funds. The deposit holders in turn would pay a fee for the use of such facilities. Since these would be trust funds deposited with the understanding that they could be withdrawn at any moment on demand, the banks must be required by law to keep such accounts 100 per cent covered in official money at all times. The banks will be prohibited by law to open any such accounts without having adequate deposits in official money. In other words, because it nurtures the social and economic evil of inflation, the creation of nominal bank deposits through monetization of credit is declared illegal.

(b) Department B will deal with transactions on the capital markets. Here the banks would receive savings committed for different lengths of time and grant loans to businessmen and producers, or anyone in need of capital, with the restriction that the banks may not grant more loans or make more investments than the volume of available savings, including their own capital in the same form. The lending and investment business of banks in this framework must be consistent with the plans and interests of both borrowers and savers. Thus, exactly as the demand for capital in real life is scaled in size and length of time, so also must be the supply of savings. The task of the banks is to match the two sides of demand and supply, and for this service they will earn the differential in interest rates charged to borrowers and paid to savers.

Under a framework of stable equilibrium the banks will truly be intermediary institutions on the capital markets with the additional trust-function in the money market. For this double performance banks will earn a return sufficiently high to keep them in business and grow according to the needs of the economy and society. They may not have as much financial power as today, but certainly they will be doing business in a much healthier environment and on a much more solid foundation with less danger to themselves and the entire economy of inflation-deflation and other negative consequences. The future of banks in a framework of stable.

equilibrium with two separate Departments appears much brighter than under present-day conditions where a conflict of interest between banks and society is inevitable. And this conflict cannot go on indefinitely.

8. Foreign banks located in Italy should be required by the same law to satisfy the same requirements as domestic banks.

9. *The Organization of Credit.* Under conditions of stable equilibrium the organization of credit must be separated from the issue of money. In this framework credit shall no longer be monetized, because it would automatically produce the evil of inflation-deflation. Otherwise «credit», if limited to the existing level of real income in the economy, is a great blessing, since it increases the tempo of economic activity.

With the new stable monetary and banking system, the use of credit will flourish to the maximum permitted by conditions of stable equilibrium. Indeed, producers will no longer hesitate to grant to the business community on a continuous basis as much credit as their capitalization allows. And the business community in turn may grant as much credit to their customers as is safe to be consistent with their obligations toward their suppliers. Since both producers and businessmen have a direct interest to produce and sell as much as possible and as rapidly as possible, it is evident that the largest amount of credit used in the economy is a function of organization of credit facilities. Once the money is «numeraire» and thus perfectly stable, a solid basis is provided for the organization and use of credit on a large scale.

It is conceivable that both producers and business may turn to banks for the organization of credit facilities. But in that case there is one restriction, namely, that credit not be monetized through the banking mechanism. Credit should be limited to the available supply of commodities and services produced in the economy over a given period, a limit which should be established beforehand, not by banks but by producers and the business community participating in the respective credit facilities.

10. *The Comptroller of Currency and Banking.* The most difficult problem with the new reform is to stop monetization of credit in the economy and to be sure that the official money in circulation is only «numeraire»; only then can the economy be spared the calamity of inflation-deflation. A new agency, The Comptroller of Currency and Banking, with professional personnel from the Treasury Department and the Central Bank, would be entrusted with the responsibility of monitoring the application and strict observance of the new monetary and banking law.

11. *The Issue of Additional Commercial Lira on a Regional Basis.* For reasons of full employment and maximum flexibility and uniformity in the distribution of the supply of money throughout the country at all times, each province in Italy should have the privilege of selecting

a representative commodity of that region which, under certain conditions, could be monetized and de-monetized at the discretion of the people of that area.

The Central Bank of Italy shall provide the facilities and the expertise for the monetization of such commodities at the market price minus a discount to cover the cost of warehousing and administration. Banknotes or Bankdeposits created by the Central Bank when accepting such commodities should explicitly carry the information that they are freely convertible only in that particular commodity. These are called «commercial liras» here, which are 100 per cent covered but nevertheless do not represent the official monetary standard—in this case, the new gold-lira. It is the task of the Central Bank to make certain that the value of such regional Banknotes and Bankdeposits is very close, if not equal, to the official standard. Since the commercial liras are 100 per cent covered, this task is not a difficult one. A skilled manipulation of the charges for warehousing and administration costs could easily do the job.

As previously mentioned, the introduction of regional monetization of representative commodities at the discretion of the people will create additional employment and real income in the economy, at the same time decentralizing the issue of money for commercial purposes. Also, this will help to further stabilize the prices for these selected commodities throughout the economy, will stimulate more economic growth without inflation, and thus provide a better standard of living by more efficiently using local human and natural resources. In one word, the old problem of regional development will find an effective solution.

12. The public budget and its execution, as well as the national debt, shall be separated from the issue of money and the Central Bank. In a [frame-work of stable equilibrium, monetization of both private and public debt must be prohibited for the same reason that it initiates the evil of inflation. Of course, the Italian Government may continue to borrow whenever necessary, but not from the Central Bank and not through the machine of monetization of debt or bankcredit. It is advisable to study the possibility of replacing the present taxation system with a single value-added tax to be earned by the Government as a cost element of the current gross national product similar to other cost elements—wages, rent, interest and profit.

13. A reform of the securities market could be added just as a matter of consistency. Pure speculations shall be prohibited on all official markets. Future trading is the most common form of pure speculations. But when the money market will be 100 per cent liquid and the monetization of bankcredit eliminated, the volume of pure speculations will automatically be reduced to a minimum, if not to zero. The securities market will remain the place where capital is directly invested.

14. The «Law of Omenia» in Business. The term «omenia» (an intranlatable Romanian expression) means, among other things, fairness, equity in any human action conducted in such a way that it produces harm to no one. In

business it stands for an equilibrium of ethical type of behavior. A «Law of Omenia in business would require that any transaction shall be concluded at the real cost of production or acquisition, plus a normal rate of profit determined by the opportunity cost of the management function as differentiated from all other cost elements. Under conditions today such a law cannot work, but under conditions of stable equilibrium the application of such a law is possible, and in fact, necessary, especially when we refer to the transitional period.

Seemingly, the law of Omenia, rigorously applied under conditions of stability, can effectively resolve the problem of monopoly. Indeed, in a framework of stable equilibrium with «numeraire» the current prices must be equal or very close to the least cost of production per unit of output, which includes rent, wages, interest, taxes and a normal profit. The extra, monopoly profits do vanish when the Law of Omenia is observed in business.

15. **An enlightened Social Reform.** At this most propitious moment when old lira are exchanged for new lira, an orderly, peaceful but effective social reform may also be undertaken. First some rough indicators should be devised regarding minimum lump sum cash balances and savings that a family of from 2 to 10 members may normally possess as a sign of relative prosperity. On D-day exact information will be available as to those well below that limit and these above. Those who are below the limit constitute the core of that part of Italian society which is exposed to social unrest.

On D-day from the old lira deposited for exchange only 50 per cent shall be delivered immediately in new lira. The rest shall be blocked for five or ten days. In order to avoid social unrest in the future, it is advisable that the Government attach a special «social-peace tax» to be deducted just once from the blocked lira to form a «Social Reconciliation Fund» which would be distributed immediately to those underprivileged who are below the minimum. For purposes of social justice, this tax could be progressive at the higher levels. After five or ten days, the remaining balance of blocked lira shall be returned to the original depositors. Of course, this is a very delicate and controversial issue. But the Italian Government should explain the ultimate purpose of such a social-peace tax which in one sense is productive, besides avoiding possible immediate or future social calamities. This reform would definitely [bring more social harmony to Italian society, and at the same time it would boost the economy by increasing the effective demand of the masses, and thereby production, employment and real income.

16. **The Balance of Payments.** With the realization of this plan, Italy's position in international transactions will become a strong and stable one. As soon as the free convertibility of the new lira at home and abroad has been restored, the various mechanisms of stable equilibrium will go into action so that the Balance of payments will be exposed to the same forces of natural stability as the domestic economy. Certainly under such a framework the internal value of the



lira will tend to be equal or very close to its external value. And this is the best indication that the balance of payments may reach and remain in equilibrium with only minor, temporary fluctuations.

The mechanisms of foreign exchange rates, of gold-points, of the specie-adjustment process and of free capital movements where short term credits are included, all will be working for the purpose of keeping the balance of payments in order, without the need of any direct Government intervention except when one of these mechanisms is faulty and only the Government can restore it.

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The preparation for the institution of the reforms required under the framework of stable equilibrium could be accomplished within a period of one to two months. The execution of the plan can be conducted in 24 hours, over a weekend, once the public has been informed of the impending reforms. Thereafter, within approximately six months, Italy would be a different country-with full employment, price stability, a balance of payments in equilibrium and more social justice in the distribution of national income.

It will be a historic event which may change the course of history not only within the European Community but also in the rest of the world. The spirit of Rome may open a new era where the confrontation between capitalism and socialism-communism can be settled once and for all by mutually beneficial and peaceful means. Beyond both capitalism and socialism-communism there is the potential for a new, better social order here called «Social Liberalism», or the «Great Free, Just and Stable Society». With this plan Italy will be the «Terra Nova» of the new better society of tomorrow.