CABINET.

DISPUTE BETWEEN ITALY AND ABYSSINIA.

IN accordance with the Conclusions of the Cabinet meeting of the 29th May I circulate to my colleagues herewith a memorandum, prepared in the Foreign Office, on the probable effect of maintaining sanctions.

A. E.

Foreign Office, June 3, 1936.

PROBABLE EFFECT OF EXISTING SANCTIONS ON ITALY IF MAINTAINED AFTER JUNE 15 NEXT.

[Note.—£1 sterling is equivalent to about 55 gold lire.]

I.

IT is clear that any opinion on this subject must be speculative. There is both a lack of sufficient direct evidence, owing to the suppression of all public statistics in Italy, and a number of indeterminate factors, such as the extent to which the Italian people will endure privations, the number of soldiers and labourers which will sooner or later have to be withdrawn from Ethiopia, the amount to be expended on matériel, &c., in connexion with the pacification and development of that country, and, above all, the scrupulousness, or the reverse, observed by "sanctionist" countries in administering the present sanctions régime. Assuming, however, that there will, apart perhaps from South America, be no appreciable defections from the "sanctions front" for three months after the 15th June, it is possible to arrive at certain estimates regarding the internal economic situation in Italy on the 15th September next. These estimates will primarily be based on the situation, so far as we know it, in Italy to-day.

II.—THE ECONOMIC SITUATION.

(a) Evidence of League Statistics.

Certain important facts stand out from an examination of the League figures, which, however, only appear in full after considerable delay:—

1. During the first two months of 1936 (i.e., when sanctions began to come into effective operation) the value of Italian trade with the world as a whole was approximately halved, both imports and exports falling in much the same ratio.

The published statistics relating to South and Central America, though very incomplete, suggest that Italy's exports to those areas have not greatly declined during the "sanctions period." Some of the more important South American countries have either not yet applied the import embargo or are applying it only with important reservations.
as compared with the corresponding period of 1935. In the case of the sanction-applying countries, their imports from Italy during this period fell to about one-fifth of what they had been in the first two months of 1935, while their exports to Italy fell to about one-third. If the preliminary figures (nineteen countries only) for March last are a reliable guide, total Italian trade during that month was only about 44 per cent. of total trade during March 1935. Italian exports in that month falling to a much greater extent, proportionately, than imports.

2. An examination of the figures regarding Italian trade with the principal non-sanctionist countries, i.e., Germany, the United States, Hungary and Austria, show that, on balance, their imports from Italy during the period November-February inclusive increased by about 19 million lire, and their exports to Italy by about 170,600,000 lire, as compared with the corresponding period of the previous year. Nevertheless, during the latter part of the period both imports from and exports to these countries showed a marked tendency to decline. For instance, in the case of Germany, imports from Italy, which were up by 9,500,000 lire in December, were down by 13,300,000 in January and by 11,400,000 in February; while exports to Italy, which were up by 28,500,000 in November, and 38,000,000 in December, were only up by 7,600,000 in January, and in February were 3,500,000 less than in February 1935. The same tendency (though to a modified degree) is observable in Hungary and Austria. United States imports from Italy showed a marked increase in November of no less than 21,550,000 lire over November 1934. In December the increase was 17,100,000 lire, in January 3,800,000, and in February 225,000. So far as the United States exports to Italy were concerned, there was an increase of 7,600,000 lire in November, 34,150,000 in December, a decrease of 8,930,000 in January and an increase of 6,080,000 in February. Switzerland (which is only applying sanctions to a limited extent) has during the period November-February taken about 38 million lire worth less of Italian goods and exported almost exactly the same amount less to Italy.

3. Imports from Italy of "sanctionist" countries (i.e., those countries which have refused to accept Italian goods) accounted for about 19 per cent. of the total of the world's imports from Italy in January and about 9 per cent. in February (as against 50 per cent. in each case in January and February 1935). This seems to point to the fact that "sanctionist" countries have on the whole been loyally applying Proposal III. This conclusion is in the main borne out by an examination of the figures regarding individual countries (and also by reports from Rome).

4. Italy's absolute unfavourable balance of visible trade seems to have decreased appreciably during the "sanctions period" as compared with the corresponding period a year before.(2) Thus sanctions may not in themselves have directly brought about a positive increase in the rate of outflow of gold from Italy. This is not to say, however, that they have been ineffective in this respect. The decrease in the unfavourable balance is due to the fact that Italy's imports have been cut down to an even greater extent than her exports, and the embargo on her products will, on the one hand, have prevented her from economising gold by the use of foreign exchange derived from her exports, and on the other hand will have compelled her to reduce her imports to an extent even greater than circumstances would otherwise have required, thus further worsening her general economic situation. Moreover, it is practically certain that Italy's invisible exports (tourist expenditure, freights, emigrants' remittances, &c.) have declined heavily of late, so that the real deficit on her balance of payments will have deteriorated in comparison with normal times to a greater extent than the visible trade figures would suggest.

In any case the figures of visible trade fail fully to disclose the position. A number of additions to them fail to be made which go to swell Italy's unfavourable balance of payments. A large item among these is the expenditure of Italy's ships in ports outside Italy, especially on bunker. Suez Canal dues on the basis

(2) So the League figures would suggest. But figures quoted by the Italian Minister of Finance on May 19 last suggest that in the period December 1935 to February 1936 Italy's unfavourable trade balance was practically the same as a year previously.
of the figures for the last half of 1935 and the first quarter of 1936 resulted in an average monthly expenditure of over 13 million lire. Perhaps a rather similar figure should be added for the service of Italy's external loans. In addition to all this, allowance needs to be made for the loss of exchange to the United States for the payment of arrears, which is still continuing.

5. The conclusions drawn from the trade figures and other data relative to the balance of payments should be examined in the light of the League figures showing Italian exports of gold. The latter are not absolutely complete, but they show that, on balance, Italy exported about 1,406 million lire worth of gold between November 1935 and February 1936, as compared with 1,368 million lire worth during the period November 1934 to February 1935 (which, however, included an abnormally large shipment in November-December). During January and February 1936 (i.e., when the import embargo began to become really effective) the net outflow was 850 million lire, as compared with 328 million lire in the same period of 1935. For March the comparative figures are 243·2 million lire (in 1936) and 53·2 (in 1935): for April 375·1 (in 1936) and 18·7 (in 1935).

6. Finally, the League statistics, though incomplete in this respect, tend to show that Italy has to a considerable extent been able to purchase in "non-sanctionist" countries (and principally in the United States) the goods denied her by the "sanctionist" countries under Proposal IV. This particular sanction, therefore, while no doubt adding somewhat to Italy's total external expenditure, can hardly, if maintained, be expected to have any material effect on the general economic situation in Italy during the autumn of the present year.

(b) Evidence from Italy.

(1) Effect on Italian Foreign Trade.

In January Signor Piero Pirelli, one of the best known of Italian industrialists, and who is said to enjoy the confidence of Signor Mussolini, made a speech to the Fascist Confederation of Industrialists, the text of which was given in an Italian periodical on the 23rd January.

"The question of defence against sanctions," he observed, "is in the last analysis no more than a corollary, or in our case an acute extension of the exchange problem"; and he went on to estimate, with remarkable accuracy, that the closing of "sanctionist" countries under Proposal IV. This particular sanction, therefore, while no doubt adding somewhat to Italy's total external expenditure, can hardly, if maintained, be expected to have any material effect on the general economic situation in Italy during the autumn of the present year.

(2) Stocks.

Early in February the Market Supply Committee circulated a translation of an article by the Rome correspondent of the Frankfurter Zeitung which, after referring to the comparatively privileged position of Rome from an economic point of view, concluded as follows: "The chief reason why Italy seems to be spared the worst effects of sanctions in day-to-day affairs is the existence of considerable stocks. In the course of the last few years stocks of all kinds have been built up largely for military reasons. The interval between the decision in favour of sanctions and their application made it possible for stocks to be considerably extended in both wholesale and retail trade, with the ready help of foreign suppliers, who saw that their market in Italy was threatened. This was rendered easier by the fact that, in the situation which arose before sanctions came
in, it was easier for Italy to pay for foreign goods, both because foreign exchange
was made available and because the rush of foreign importers to stock up with
Italian specialities before imports were stopped facilitated compensation trade.

An article in the Rivista di Politica Economica concludes that this great building
up of stocks has been the "principal element in the resistance" to sanctions. The
newspapers continue to print the number of days that the economic siege has lasted
in heavier print than the date. Mussolini has declared that on the 365th day
Italy will be as inflexible as on the first, but there is no doubt that if the blockade
on Italy really does last as long as that the difficulties will get much worse. The
"principal element of resistance" will be worn down, for sooner or later stocks
will become exhausted.

There is reason to suppose that this is a well-balanced and sound judgment.
Sir E. Drummond has, moreover, called attention to the important point
that the continuation of sanctions must inevitably result in time in a failure
on Italy's part to maintain her exports even at their present reduced level.
During the summer and autumn of last year Italy was laying in heavy stocks of
metallic and textile raw materials; the exhaustion of these stocks could hardly
come to be felt, Sir E. Drummond considers, before June or July of this year at the
earliest. Undoubtedly, however, Italy's increasing financial difficulties and loss
of credit will progressively render it more difficult for her to import even the most
essential raw materials, and since these raw materials are indispensable for her
export trade, this too must, so long as present conditions last, continue to dwindle.

(3) Signor Grandi's Admission.

On the 28th February Signor Grandi, in conversation with Mr. Sargent,
himself admitted that, "notwithstanding the assurance which the Italian Govern­
ment had to make in order to reassure public opinion in Italy, the application of
sanctions had in reality produced very serious effects. These effects were shown
not so much in immediate material shortage, but in the fact that the Italian
Government, having originally laid their plans about Ethiopia for a war lasting
four years, had had, with the imposition of sanctions, to scrap the whole of these
plans and replace them by one which would enable Italy to terminate the war
before her gold supplies were exhausted. For the duration of the war was now
determined by the length of time Italy's gold would hold out. The supply of gold
was larger than we had estimated, and, owing to Italy's low standard of living
and national thrift, it would be made to last longer than we had probably
calculated. But, nevertheless, the time would come when it would be exhausted,
and its exhaustion would make further military operations impossible."

(4) Gold Reserves.

On the 31st March, Signor Azzolini, the governor of the Bank of Italy,
made a statement on the Italian gold reserve which contained the only official
figures on this subject published since October 1935. According to this statement,
the total gold reserve of the bank on the 31st December last was 3,027 million lire
plus a "foreign credit" reserve of 367,400,000—an approximate total of 3-4
milliard or £62 million sterling at 55 lire to the £. This compared with 4-3
milliard lire on the 20th October, the date of the last publication of statistics. On
the other hand, Signor Azzolini explained that his figures for the reserve did
not include "gold offered to the State by voluntary contribution or the sum total
of the means derived from the obligation of all Italians resident in the kingdom
to surrender to the State their mobile foreign credits of every kind." The total
amount already realised from both these sources is unknown; but it is probably
not less than 1 and not more than 2 milliard lire. The amount—which can still
be realised from foreign credits is even more speculative; but perhaps it may be
put down at from one-half to 1 milliard lire.

On the basis of Signor Azzolini's figures, there was a drain of gold between
the 20th October and the 31st December, 1935, amounting to 900 million lire,
_t.e., about 385 million lire a month. This was a definite minimum figure, but it
is uncertain whether the total reserve during that period was increased from
further undisclosed sources, such as purchases by the Bank of Italy within the
If so, the real drain would have been *pro tanto* larger. While the average monthly drain was, during the first part of the present year, uncertain, the League figures of gold movements given in paragraph 5 (a) suggest that it was between 350 and 400 million gold lire a month on the average. On the other hand, the rate at which gold is lost may be expected to fall now that the campaign in Ethiopia is virtually over, though the maintenance of a large number of troops in Ethiopia and its development may be expected to constitute a considerable drain on Italy's resources for some time to come.

From these figures, therefore, the following deductions can be drawn, though by the nature of things they are little better than guesses:—

<table>
<thead>
<tr>
<th>Description</th>
<th>Million lire</th>
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<tbody>
<tr>
<td>Reserve on December 31, 1935</td>
<td>3.4</td>
</tr>
<tr>
<td>Expenditure to end of April 1936 (estimated)</td>
<td>1.8</td>
</tr>
<tr>
<td>Add for gold purchases and offerings and for realised securities</td>
<td>1 to 2</td>
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</tbody>
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Thus, the total reserve at the end of April last may have been as low as 2.6 or as high as 3.6 milliard; while there may possibly have been as much as a further milliard still to be realised from foreign securities.

Without examining in further detail the various calculations and speculations which have resulted from Signor Azzolini's statement, it may be said that the general opinion is that, allowing for a considerable reduction in the net outflow of gold and "Devisen" from the 1st June next onwards, there is reason to suppose that the Italian gold stock will be becoming dangerously low at the end of the present year, provided that normal trading relations with other countries are not, in the interval, restored. It should, moreover, be noted that the Italians in any case cannot afford to allow their gold stock to come within measurable distance of exhaustion while they still have hundreds of thousands of men whose maintenance in East Africa (to say nothing of their possible return) involves expenditure in gold or foreign exchange. In these circumstances (to quote His Majesty's Ambassador in Rome) "the loss of every gold piece represents a step nearer to a position of extreme political and military danger."

(5) Local Reports.

A large number of reports dealing with the local economic situation in various parts of Italy have been received from His Majesty's Embassy and from consular officers all over Italy. In the absence of any statistics, such reports can admittedly only show which way the wind is blowing, but the general impression given on reading them is that economic conditions have been rapidly deteriorating in Sicily, the south of Italy and to a certain extent in the centre. In the north the great fillip given to industry by war preparations (financed by the extraordinary expenditure of 11 milliard lire in eleven months or about £600,000 a day) has maintained an artificial prosperity, but even here there is grave anxiety among industrialists and all those in a position to form a reasoned judgment about what will happen when the war boom for one reason or another comes to an end. In Rome itself and the Campagna Roma the position is also exceptional, and this may have deluded certain travellers into thinking that "sanctions have had no real effect." It seems, indeed, that in such districts as Carrara, Genoa, Naples and Palermo distress is acute, while certain industries, notably the textile, are suffering severely. Phrases such as "a marked reduction in activity" and "a steady deterioration in economic activity" appear in reports from such places as Leghorn, and there seems no doubt that in many other districts there has been an actual increase in unemployment in spite of the despatch of hundreds of thousands of men to East Africa and the mobilisation of several classes for service on metropolitan territory. Finally, wholesale prices increased very rapidly during the period January to November 1935 and slightly between November 1935 and April 1936. There was also an increase of from 20 per cent to 30 per cent in retail prices during 1935, this resulting in a substantial fall in the standard of living. Contrary to expectation, the latter does not seem to have fallen appreciably further during the first few months of 1936, but there is little doubt that it will do so on the exhaustion of the present supply of stocks.
(6) Loss of Credit Facilities.

There is no doubt at all that the cutting off of credit facilities for Italy by Great Britain has had a very grave effect on Italian ability to finance her imports of essential raw materials, except on a cash basis. This, however, cannot really be said to be due to sanctions, as owing to the exchange control policy pursued by the Italian authorities during the summer of 1935, Italian credit in London was already practically exhausted (the point was examined at length in Appendix 2 to Rome despatch No. 1213 E of the 12th November last). Moreover, of late owing to the accumulation of indebtedness to “non-sanctionist” countries, e.g., Germany, Switzerland and Austria, the ability of Italy to import goods even from such countries as these, except in return for cash, has been sensibly diminished. It is evident that this state of affairs can only lead to a temporarily increased outflow of gold to the world generally, and to all the accompanying dangers which have been briefly alluded to above.

(7) General.

In conclusion, it may be said that all intelligent and well-informed reports on the existing economic situation and on the effect of sanctions received during recent months contain some reference to the inevitable inflation which must ensue from the internal expenditure of so much money on war preparations, and to the problems to be solved when the troops return from Ethiopia, if, in fact, the bulk of them ever do. Italian exports have, in fact, for long been extremely vulnerable—more especially so since a number of countries suspended the gold standard—and hence only able to compete with those of more powerfully developed countries at a disadvantage. In the absence of some adjustment in the external value of the lira, this disadvantage must necessarily increase as internal inflation develops. Further, unless she can so readapt her industry as to pass over from war production to competitive peace production, it seems (to quote His Majesty’s Ambassador in Rome) inevitable that within a few weeks of demobilisation there will be (a) a return to the unemployment level of January 1935, and (b) the indefinite continuation of a deficit month by month in the international payments balance to be made good willy-nilly from such stocks of gold and “Devisen” as may remain. It follows that, even if a political settlement is arrived at to-morrow, Italy will (in the words of Sir E. Drummond) “re-enter an unsympathetic economic world with a broken exchange, a vanishing gold reserve, a heavy unpaid bill for arrears, a disorganised foreign trade and an unbalanced budget. Her only asset will be the desire of her creditors to maintain her solvency and her power to make use of the inflation weapon, neither of which promise the assurance of immediate support.”

III.—CONCLUSION.

It is now possible to make certain suggestions regarding the effect which sanctions are likely to have if maintained for another three or four months:—

(i) Whatever their political advantage to Italy in unifying the nation, it is quite clear that sanctions have had a serious economic effect and have intensified the already existing deterioration in the economic position of Italy as a whole.

(ii) It is therefore clear that the mere removal of sanctions, while undoubtedly alleviating Italy’s foreign exchange position to a considerable extent, would not of itself remove the inherent weakness in the Italian economy which was partly responsible for the deterioration referred to above.

(iii) If, nevertheless, the “sanctions front” is allowed to crumble and Italy permitted to make the best bargain she can with one country at a time (and we have reason to believe from a recent telegram that this is what she will try to do), the position can probably be held for some time without undue distress, more especially if the Italian authorities are able to secure some form of credits or loan.

(7) According to an unconfirmed report transmitted from Rome in February, Italy had agreed to pay in gold for approximately 35 per cent. of her supplies from Germany.
(iv) If, on the other hand, sanctions are lifted en bloc and at the same time it is found practicable to maintain some sort of "creditors front" (which is most unlikely) with a view to recovering as much as possible of existing Italian indebtedness, and if no loan or credits are forthcoming, the position would be graver, though it would no doubt be wrong to suppose that the Italian Government could not find ways and means of carrying on on the basis of a lower standard of living.

(v) If, finally, existing sanctions are maintained in their entirety (and taking only purely economic considerations into account), the conclusion can hardly be avoided that the position will have undergone a substantial further deterioration by mid-September and be becoming very grave towards the end of the year. The cumulative effect of (a) exhaustion of stocks, (b) depletion of the gold reserve, and (c) the complete breakdown of all credit facilities, coupled perhaps with the return of some soldiers and workmen from East Africa, will present a problem which, as far as one can see at the moment, can only be solved by some thorough-going socialisation and demilitarisation of the country and by heavy reduction in an already low standard of living, or by a war.