SM/85/213
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

August 7, 1985

To: Members of the Executive Board

From: The Secretary

Subject: European Monetary System - Realignment of Exchange Rates

The following correction has been made in SM/85/213 (7/29/85):

Page 4, para. 2, line 15: for "to the rate at the fixing on July 19."
read "to the rate on July 19."

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

the last couple of years and the absence of major contractual increases (Table 5). The shift in the relative cyclical position of Italy vis-à-vis other major industrial countries, especially in Europe, is the main factor behind the sharp deterioration in the external accounts in 1984 and so far in 1985. The trade deficit widened from Lit 11.5 trillion (US$5.5 billion) in 1983 to Lit 19.2 trillion (US$7.7 billion) in 1984, reflecting a growth in volume of imports (over 9 percent) significantly in excess of that of exports (6.5 percent), as well as a 1.7 percentage point deterioration in the terms of trade. In the first five months of 1985 the trade deficit was over 60 percent higher than in the same period of 1984, as the growth of imports in value terms (22.4 percent) far outpaced that of exports (15.3 percent) (Table 6). On the basis of preliminary information, it appears that this further deterioration primarily reflected a worsening of the real balance, although the terms of trade probably continued to deteriorate as well. The current account balance shifted from a surplus of Lit 1.2 trillion (US$0.8 billion) in 1983 to a deficit of Lit 5.2 trillion (US$3 billion or 0.9 percent of GDP) in 1984 as the widening of the trade deficit was accompanied by a small decline of the surplus on invisibles. No data are yet available on developments in the current account (on a transactions basis) so far in 1985 but indications are that the deterioration in the trade deficit has been largely reflected in the current account.

It is difficult to assess the impact of developments in competitiveness on Italy's external accounts. Available indicators of competitiveness in manufacturing (Chart 2) point to a slight improvement in relative unit labor costs on average in 1984, following a sharp deterioration in the two previous years. This improvement reflected the moderation in nominal wages and sizable gains in productivity, typical of the early phase of cyclical recovery. On the other hand, the gap between the GDP deflator and export unit values widened in 1983-84, suggesting increased profit margins on the domestic as compared with the export market, a fact which, in conjunction with the increase in domestic demand, reduced the incentive for Italian enterprises to seek outlets abroad. Available indicators point to a slight deterioration in the overall competitive position in the first quarter of 1985.

The weakening of competitiveness is more marked vis-à-vis other EC countries. The Bank of Italy's preferred indicator of competitiveness (relative wholesale prices of non-oil manufactures) indicates that the real exchange rate worsened significantly in 1983 and 1984 vis-à-vis the EC (Tables 7a, b, and c). By January 1985 it stood about 4 percentage points above the level following the previous EMS realignment and over 13 percentage points above the level at the inception of the EMS. The deterioration was significantly more pronounced in relation to Germany. The concern of the Italian authorities over the weakening of competitiveness vis-à-vis the EC was heightened by the slowdown in economic activity in the United States in 1985.

Developments in the capital account of the balance of payments were strongly influenced in 1984 and so far in 1985 by interest rate movements. The maintenance of high nominal interest differentials, in conjunction with stable exchange rate expectations, promoted large capital inflows in 1984 especially in the form of an increase in foreign indebtedness of commercial banks. Following a decision by the monetary authorities to freeze the banks' indebtedness in September 1984, further substantial inflows in the form of commercial credits occurred in the fourth quarter. Provisional information on developments in the balance of payments on a settlement basis for the first half of 1985 suggest that net capital flows remained generally positive so far in the year. The overall balance of payments showed a deficit for the period January-June 1985 of Lit 6.5 trillion, compared with Lit 4.2 trillion in the corresponding period of 1984. A significant further increase in the foreign indebtedness of the commercial banks cushioned the impact of the overall deficit on official foreign exchange reserves, which at the end of June 1985 stood at the equivalent of US$18.7 billion (2.5 months of imports).

The exchange rate of the lira weakened significantly vis-à-vis the U.S. dollar in the course of the first quarter of 1985 but recovered subsequently (Chart 2). On July 19, 1985 it stood (at Lit 1,870) about 3 1/2 percent above the level at the end of 1984. Vis-à-vis the deutsche mark, the lira depreciated by 5 1/2 percent over the same period. The realignment of July 22, 1985 was not preceded by substantial pressures on the exchange rate of the lira or on reserves, with the exception of July 19, 1985 when, with the Bank of Italy abstaining from intervention in the market in anticipation of a realignment over the weekend, a thin market was temporarily upset by a sizable transaction, which pushed the exchange rate vis-à-vis the U.S. dollar to Lit 2,200, at which point the authorities decided to close the market early. During the four days following the realignment, the exchange rate of the lira vis-à-vis the U.S. dollar has averaged Lit 1,918 involving a 2.5 percent depreciation with respect to the rate on July 19. The average exchange rate vis-à-vis the DM during the same period (Lit 668.7) also registered a depreciation of 2.5 percent compared with the prerealignment level and stood 1.6 percent above the bilateral central rate.

On July 20, the Italian authorities announced a package of measures primarily of a revenue raising nature aimed at containing the foreseeable excess of the fiscal deficit over the Lit 100 trillion target. These measures consist of increases in social security contributions--estimated to add about 1 percentage point to labor costs in 1985--and an anticipation to 1985 of part of the receipts from an amnesty on construction that had been illegally undertaken in the past. These measures, together with a recall into the Treasury of bank deposits of peripheral public entities, are expected to reduce the on present trends borrowing requirement of the Central Government by Lit 5-6 trillion in 1985 and by about the same amount in 1986 due to the onceover nature of some of them. It seems unlikely that these measures will suffice to allow the containment of the deficit to the Lit 100 trillion target. Estimates of the state sector deficit before the measures put it at significantly over Lit 110 trillion. At the same time, the Government announced that it had agreed with the