FOR AGENDA

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SM/92/227

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December 22, 1992

To: Members of the Executive Board

From: The Acting Secretary

Subject: Italy - Staff Report for the 1992 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation with Italy, which is tentatively scheduled for discussion on Monday, January 11, 1993.

Ms. Atkinson (ext. 34647), Mr. Violi (ext. 36275), or Mr. Krueger (ext. 36854) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 1992 Article IV Consultation

Prepared by the Staff Representatives
for the 1992 Article IV Consultation with Italy

Approved by Massimo Russo and Joaquin Ferrán

December 21, 1992

I. Introduction

A staff team 1/ visited Rome during November 4-16, 1992 to conduct the 1992 Article IV consultation discussions. The mission met with the Minister of the Treasury, the Governor of the Central Bank, the Minister of the Budget, the Minister of Finance, the Minister of Industry, and other government officials, as well as officials of a number of financial institutions, the President and other representatives of the Employer's Association, and officials from the trade unions. Mr. Filosa, Executive Director for Italy, attended most of the meetings as an observer. Italy has accepted the obligations of Article VIII, Sections 2, 3, and 4. 2/

At the conclusion of the last consultation on January 31, 1992 (EBM/92/11), Executive Directors welcomed the commitment of the Italian authorities to participate fully in the process of European economic and monetary integration. However, they warned that convergence would require determined and sustained action to address the financial imbalances and fundamental structural weaknesses in the Italian economy. They were concerned about the stubbornness of inflation, and the possibility of an eventual conflict with the fixed exchange rate policy. They warned that the 1992 budget measures appeared insufficient to meet the deficit target, which they viewed as a minimum to continue the disinflation process.

1/ Mr. Russo, Ms. Atkinson, Messrs. Krueger, Violi and Gleizer, Mrs. Pabst (all EU1), Messrs. Symansky and Lane (RES).

2/ Italy continues to maintain exchange restrictions vis-à-vis Iraq in accordance with U.N. Resolution No. 661, and vis-à-vis Yugoslavia (Serbia and Montenegro) pursuant to U.N. Resolution No. 757, as notified to the Fund under Decision No. 144-(52/51). Italy and Slovenia have a bilateral trade agreement concerning border areas which would appear to give rise to an exchange restriction; however, at this time Slovenia is not a Fund member and therefore any restriction would not be subject to approval under Article VIII.

Following significant losses by the government coalition in the April 1992 general elections, it took 12 weeks to form a government under Prime Minister Amato (Socialist). The government still consists of the former four-party coalition; but it has a reduced parliamentary majority of 16 in the Chamber of Deputies. Recent local election results indicate that the challenge to the majority parties, in particular from the federalist movement in the North, remains very strong.

II. Background

1. Background to financial market tensions

Italy's fiscal and inflation performance remained significantly worse than that of most EC partner countries in recent years. Successive medium-term plans to reduce the budget deficit and curb the growth in public debt failed to correct the structural weaknesses of the public finances; the underlying trend deficit continued on an explosive path and the overall deficit remained above the 10 percent of GDP level first exceeded in 1980 (Chart 1). The rising debt/GDP ratio--which climbed above 100 percent in 1991--meant that an ever-larger adjustment in the primary balance would be needed to offset the growing interest bill and stabilize the public finances. After initial success in reducing inflation in the 1980s, this remained stubbornly higher than in partner countries, averaging over 6 percent a year during 1989-91 (Chart 2).

At the same time, monetary and exchange rate policy was framed increasingly in the European context; capital controls were dismantled, and monetary policy aimed explicitly at the maintenance of the lira within the narrow band of the ERM. This, and the prospect that further EC integration would enforce adjustment in the public finances, contributed to a reduction in interest differentials against low inflation ERM countries. This came despite the poor inflation performance and an erosion of international competitiveness that amounted, by end-1991, to close to 10 percent since the 1987 general ERM realignment. 1/ A weaker trade position was combined with a widening deficit on invisibles. In addition to a deteriorating tourism balance, Italy's growing foreign indebtedness and higher interest rates led to a significant deficit on investment income. By 1991, this accounted for a large part of the external current account deficit, equivalent to 1.8 percent of GDP. Domestic demand continued to grow quite strongly in 1991, bolstered by still-high real wage increases and a further

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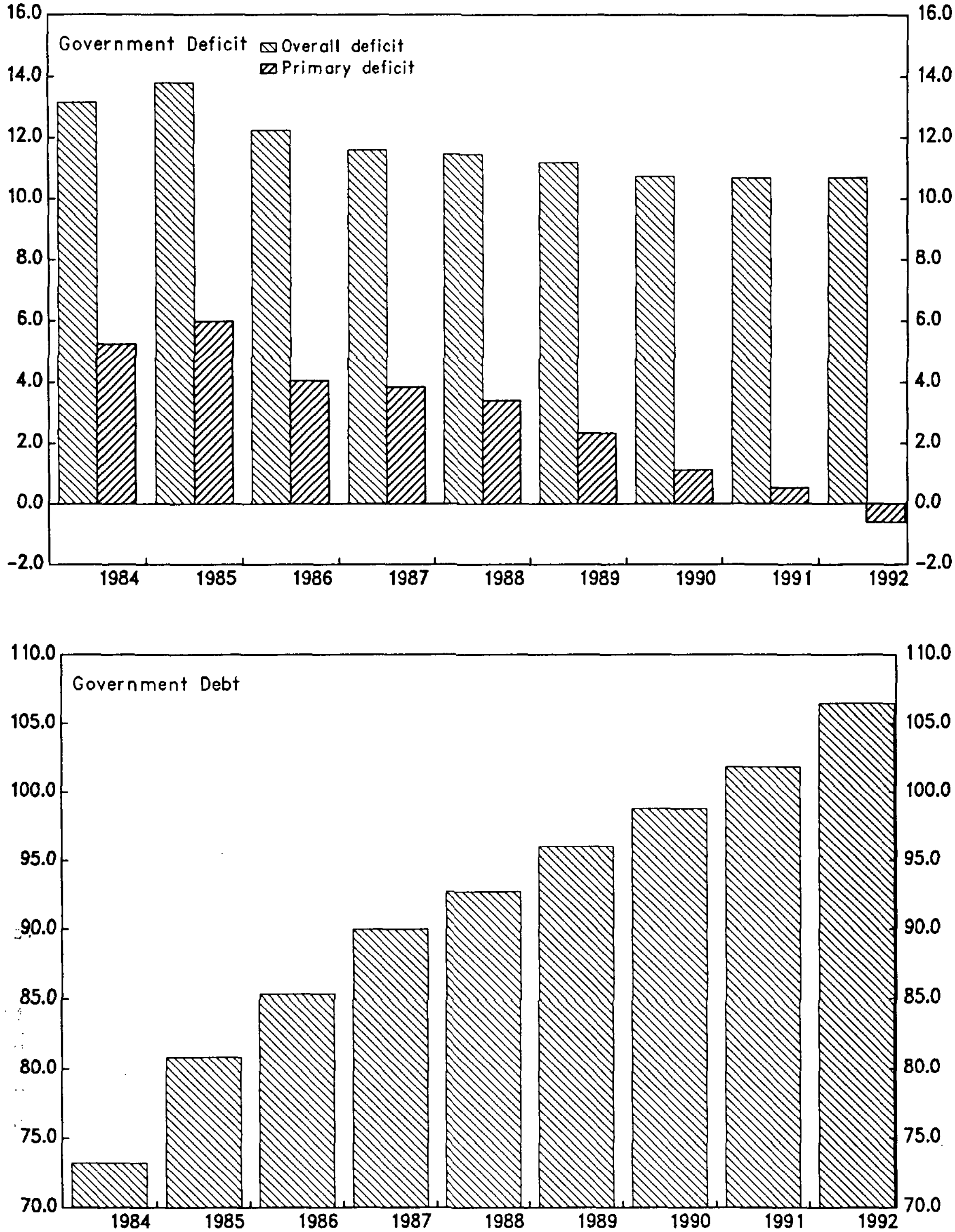
1/ The estimated erosion of competitiveness varies widely according to the measure chosen--from as much as 14 percent in July 1992 relative to 1987, based on the Fund measure using relative unit labor costs in manufacturing, to as little as 6 1/2 percent based on the Bank of Italy measure of relative producer prices. See also Supplement 1 to the forthcoming background document for an analysis of differential price developments, and the implications for competitiveness.

CHART 1
ITALY
Government Deficits and Debt, State Sector, 1984-92
(In percent of GDP)



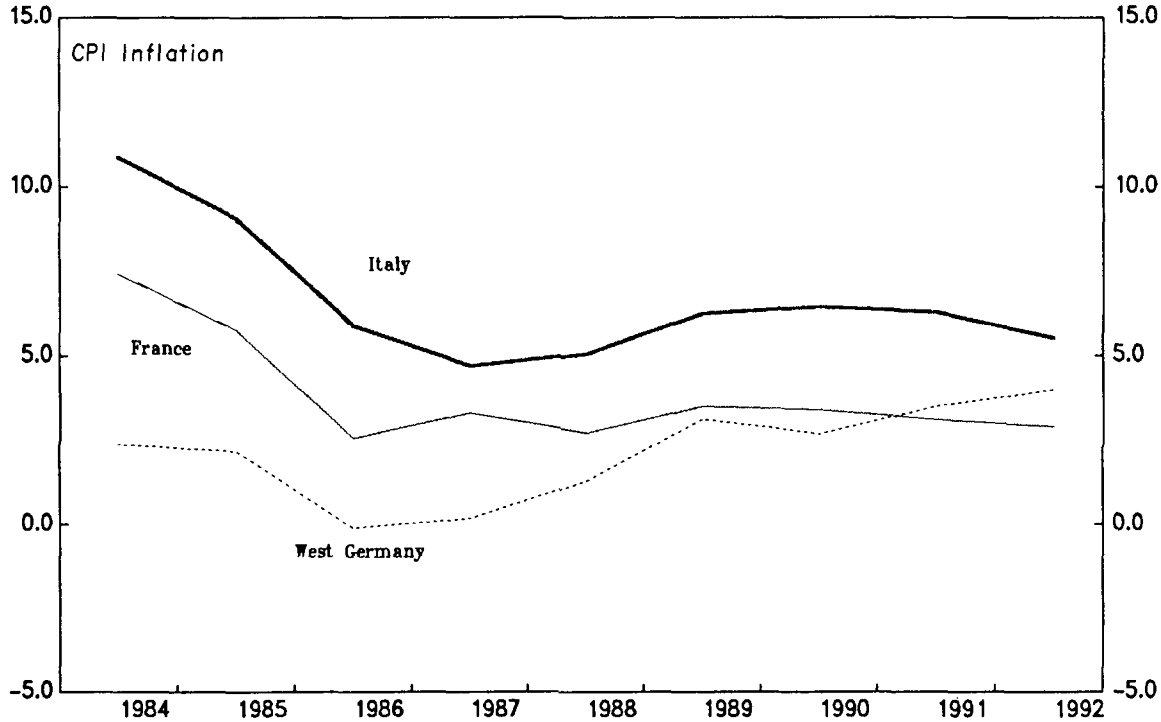
Sources: Data provided by the authorities; and staff estimates.

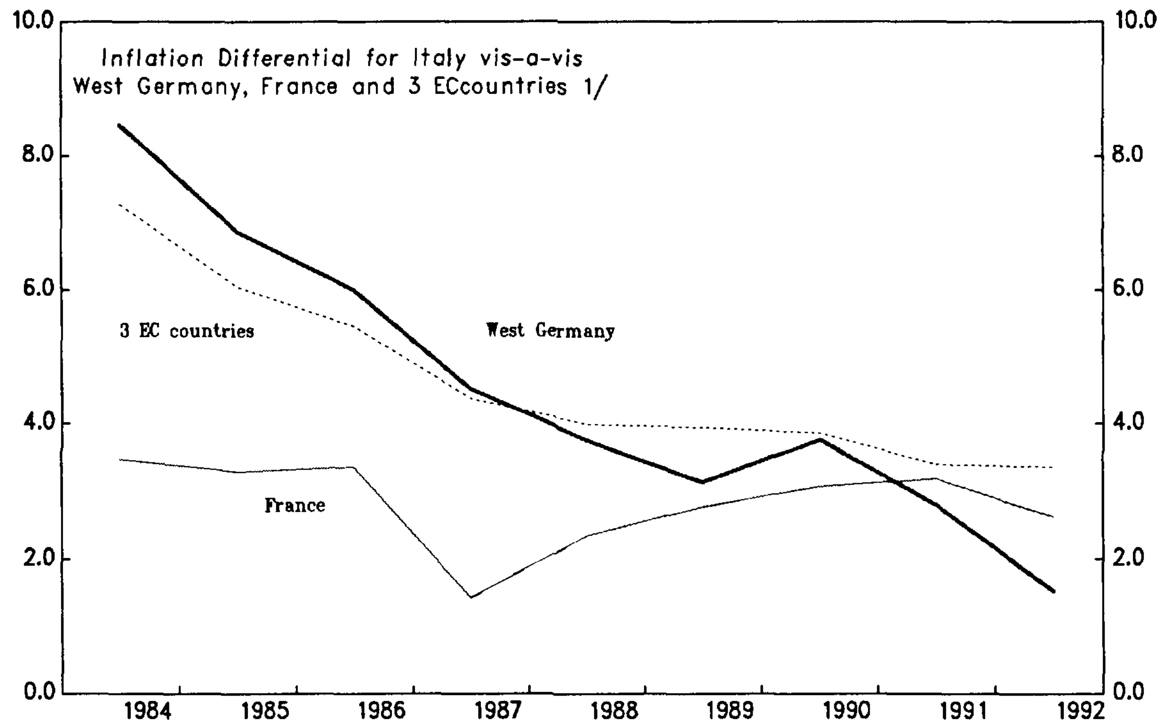
CHART 2

ITALY

Inflation Rates in Italy and Partner Countries, 1984-92

(In percent)





Source: IMF, World Economic Outlook; and staff estimates.

1/ Inflation for the three EC countries refers to the average of the three EC countries with the lowest inflation rate.

decline in household saving. But the worsening foreign balance slowed real GDP growth to just under 1 1/2 percent.

Government policies for 1992, the first year in a three-year convergence program submitted to the EC, were based on a projected recovery in growth, to 2.5 percent, combined with a reduction in inflation, to 4.5 percent. The disinflation effort was again focussed on the maintenance of the nominal exchange rate anchor, to be supported by much-needed fiscal adjustment and incomes policy. The budget deficit was to be reduced to Lit 128 trillion, 8.4 percent of GDP; the planned 1.6 percentage points adjustment in the primary balance was seen as just one step in a major fiscal consolidation, to reach the convergence targets of the Maastricht Treaty by the middle of the decade.

In the event, economic recovery faltered after the spring of 1992. Domestic demand slowed during the second quarter as deteriorating expectations, and actual and prospective tax increases, dampened consumer spending. Investment was inhibited by high and rising real interest rates, increasing uncertainty about demand prospects, and reduced profitability from the steady losses in competitiveness. Exports were almost flat, following an increase toward the end of 1991. By mid-year, industrial production began to decline and the unemployment rate rose above 11 percent. Real growth is now estimated to be lower than in 1991, at about 1 percent for the year on average.

It became clear early in 1992 that the fiscal targets would, once again, be breached without substantial additional measures to curb the deficit. The worse macroeconomic environment--with higher than projected interest rates and lower growth already in prospect--was partly responsible. The budget had also overestimated the trend of tax receipts. But these effects were compounded by slippages in policy implementation. Corrective action was eventually taken by the newly formed government in July, in an attempt to hold the deficit to below 10 percent of GDP. However, the package again relied largely on across-the-board spending cuts of doubtful efficacy and one-off revenue measures that would have no permanent impact on the deficit. Moreover, one of the measures--a 0.6 percent levy on deposits --damaged households' confidence in the safety of their financial assets, and contributed to financial market tensions. A most recent estimate of the 1992 deficit, in December, shows still further slippage from the official target, largely because of the lack of progress in selling off state assets. On this basis, the deficit will be unchanged from 1991, at 10 3/4 percent of GDP in the state sector, and the debt/GDP ratio will exceed 105 percent by year-end.

Monetary policy until September 1992 continued to be guided mostly by the commitment to maintain the lira parity. Thus, official interest rates were raised at the end of 1991, to match the December increase in German official rates, and again (twice) in July, when there was heavy pressure on the lira, and German rates were again raised. However, policy was in part also conditioned by the sensitivity of the fiscal position to movements in short-term interest rates and, to a lesser extent, by concerns about the impact of high real rates on a slowing economy. The lira was allowed to drift down in the band during the period of political uncertainty following the April elections and, even before the crisis in the summer, the central bank engaged in periodically heavy foreign exchange market intervention, that initially was largely sterilized. Rapid expansion in money and credit continued through July, with M2 growth of 8.9 percent--above the 1992 target range of 5 to 7 percent--and private domestic credit expansion of 12.3 percent.

The fixed exchange rate exerted pressure on producers of traded goods to hold down price increases in the first half of 1992, to some 3 percent; with continued productivity growth, increases in manufacturing unit labor costs were held to about 2 percent. Again, traded goods prices rose more slowly than those in the sheltered services sector, where inflation at the consumer level remained at about 7 1/2 percent. On incomes policy, the December 1991 agreement among the social partners to forego the May wage indexation, and to begin talks on a reform of the wage bargaining system, was followed by an interim agreement in July to scrap the *scala mobile*. However, these signs of progress in the disinflation process came after four years during which Italy had suffered a serious loss in international competitiveness.

2. The lira devaluation and recent events

Italy's policy mix in the first half of 1992 was clearly unsustainable, with fiscal policy undermining the commitment to tight money and a firm exchange rate. Policy makers hoped, as markets had seemed also to believe, that fiscal correction and a further reduction in wage and price inflation would come in time to resolve the conflict. However, market doubts were growing about the government's ability to implement sustained fiscal adjustment on the scale required. The "no" result in the Danish referendum on Maastricht in June sparked large-scale capital outflows, despite the tightening of monetary policy, including the two-step increase in the discount rate from 12 to 13.75 percent in July.

Confidence was dealt a further blow in July by the government's initial reluctance to take over and honor in full the debts of EFIM, a bankrupt state holding company. Under pressure from foreign creditor banks, the government subsequently announced that it would stand by the debts of EFIM itself and its wholly owned subsidiaries; talks continue and the issue is not yet fully resolved. The government also clarified that its guarantee extended to all debts--including those contracted in the past--of state enterprises and subsidiaries that were now fully owned by the Treasury (some are only part-owned). A decline in the market's assessment of Italy's creditworthiness was indicated by Moody's decision in August to lower the credit rating of Italy's official foreign-currency-denominated debt to Aa3; it is alone among G-7 countries with such a rating. Still, a temporary respite in exchange market tensions occurred in early August and the central bank lowered the discount rate by 1/2 percentage point, to 13 1/4 percent, in response to the agreement on the *scala mobile*.

Pressures in financial markets were soon exacerbated again, however, by fears of a French no to Maastricht and a subsequent ERM realignment. Gross official reserves of foreign exchange dropped to just over US$20 billion at end-August, half the level at end-1991 (Chart 3). Sharp increases in interest rates in early September--with the discount rate pushed to 15 percent and overnight rates of over 30 percent--failed to lift the lira from the bottom of the ERM band. The absence of convincing action on the budget spurred further massive capital outflows. After heavy borrowing from partner central banks, the authorities agreed to a 7 percent devaluation against all other ERM currencies, effective September 14. Pressures continued in the following days, with the pound sterling also under attack. From September 17, the authorities abandoned the exchange rate peg and left the ERM temporarily; sterling also left the ERM and the Spanish peseta was devalued.

In the aftermath of the departure from the ERM, serious concerns continued about the vulnerability of the financial system and of the public finances. The government met almost all of its third quarter borrowing requirement at the Bank of Italy. During September, Treasury use of its current account facility with the central bank amounted to Lit 17 trillion (over 1 percent of annual GDP), bringing the third quarter recourse to such financing to some Lit 27 trillion and virtually exhausting access to the facility. However, decisive action on the budget--in the form of decree laws implementing tax increases and spending cuts proposed for 1993--was finally taken, in the days immediately following the exchange crisis. The government also used votes of confidence to speed parliamentary approval of its budget measures; pressed for swift passage of four mandate laws setting guidelines for structural reforms in the areas of pensions, local authority taxation, health care and public employment; and strengthened its proposals in some areas, notably pensions.

The 1993 budget, sent formally to Parliament on October 1, called for primary adjustment of some 2 percentage points of GDP from the 1992 estimated outcome, equivalent to 5.8 percentage points relative to the estimated trend. Given the most recent slippage for 1992, a somewhat larger adjustment from 1992 (about 2 1/2 percent) would now be implied by the budgeted Lit 50 trillion primary surplus. The higher level of interest payments meant that this surplus (equivalent to 3 percent of projected GDP) was estimated to be consistent with only a slight reduction in the central government's overall borrowing requirement in 1993, to Lit 150 trillion (9.3 percent of GDP). Real growth was projected at 1.5 percent, with inflation of 4.5 percent.

Despite the fiscal progress, market tensions remained severe for a few weeks after the immediate foreign exchange crisis. Short-term money market rates stayed above 20 percent for several days and the lira weakened substantially, reaching Lit/DM 980, almost 25 percent below the predevaluation central rate. Fears of a government funding crisis deepened with continued poor results in some Treasury bill auctions and, in early October, there was a minor run on the banks. Spreads on government paper over money market rates increased and there was a continued shift away from long-term government securities. The balance of payments remained weak, with no significant return of the earlier capital outflows. Although gross reserves recovered somewhat in September, this reflected heavy official borrowing; net reserves, by end-September, had dropped a further US$24 billion from August. 1/ The government announced that it would seek a large balance of payments support loan from the EC once Parliament had approved the budget. 2/

During October, market tensions began to ease, and interest rates to decline. To reaffirm its commitment to tight money, the Bank of Italy had announced a 5-7 percent target range for M2 growth in 1993. It also imposed informal bank-by-bank guidelines for the expansion of lira bank credit in the six months to March 1993. The latter implied a sharp restriction in this credit, seasonally adjusted, from the peaks reached in July and August. The Bank also began to reduce official interest rates from crisis levels, linked to progress on the budget. The discount rate was cut by 1 percentage point after approval of the mandate laws in October, and by a further 1 percentage point after the decree law was passed in mid-November. As immediate fears receded, the easing of monetary conditions was accompanied by a strengthening of the exchange rate. The lira stabilized in a range of Lit/DM 850-860. Since then, however, it weakened in late November and December to as low as Lit/DM 900, in the context of renewed ERM tensions and domestic political concerns.

III. Policy Discussions

1. The policy setting and medium-term outlook

The mission took place at a time of considerable uncertainty about the macroeconomic and financial environment for policy making. The exchange rate peg, which had been at the heart of the disinflation strategy, had been temporarily abandoned, opening a debate on the appropriate rules for monetary policy in the immediate future. Despite a more serious attempt at fiscal reform than in the past, doubts appeared to remain in financial markets that the public finances would be put on a sound footing; hence most interest rates remained above pre-crisis levels and prospects for a swift further reduction were uncertain. Inflation prospects were worsened by the depreciation, although there was hope that the weakening economy and tight

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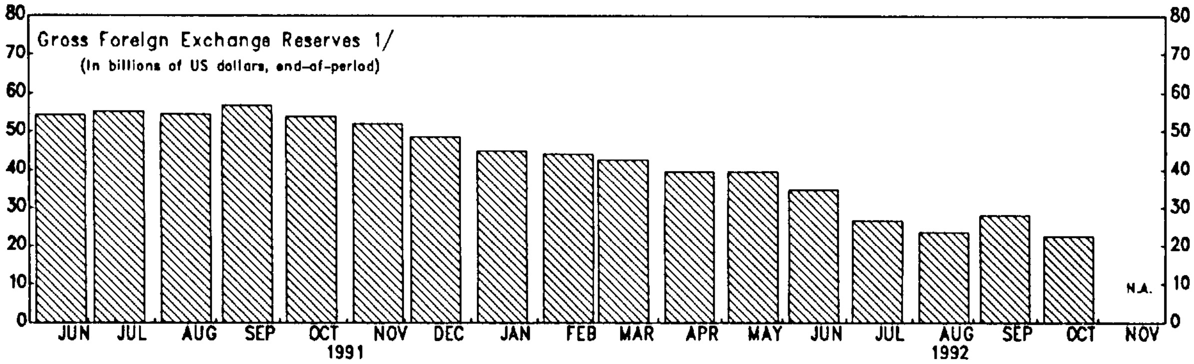
1/ In December, the government repaid ECU 12.2 billion (US$15 billion) to the Bundesbank and the National Bank of Belgium of a total borrowing of some ECU 14.2 billion. The remainder has been rolled over for three months.

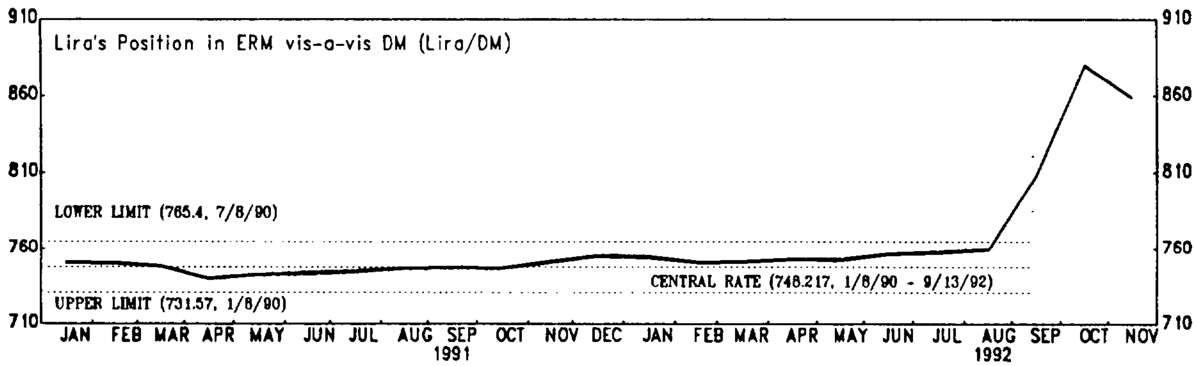
2/ Discussion of the loan in the EC Monetary Committee has now been postponed until early 1993.

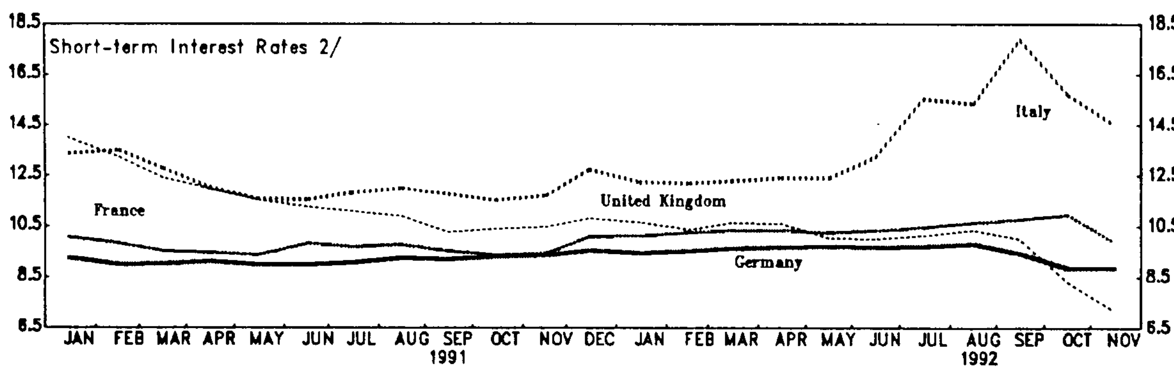
CHART 3

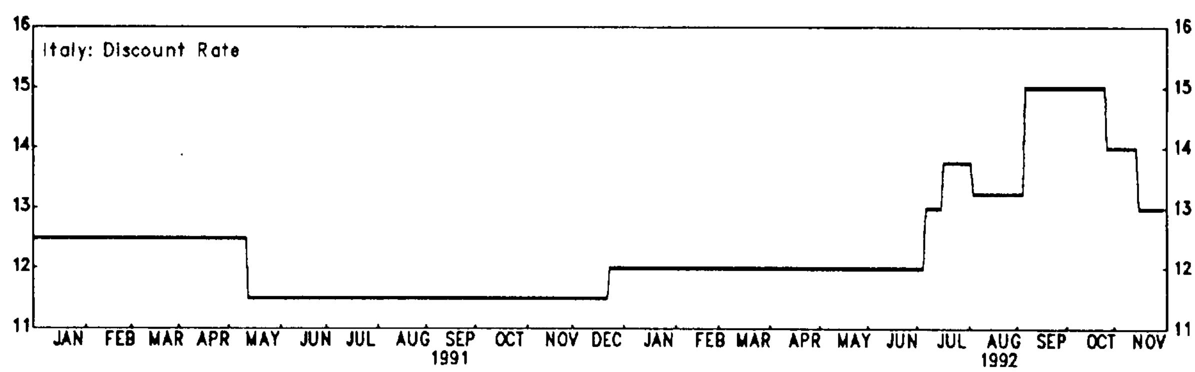
ITALY

External Indicators and Interest Rates
January 1991 - November 1992









Source: Bank of Italy; IMF, International Financial Statistics and Treasurer's Department.
1/ As described in the text, net reserves declined significantly in September 1992.
2/ Three-month interbank loan rates.

financial and incomes policies would limit the pass-through of higher import prices. Preliminary cost of living figures for November were favorable, with an increase of less than 5 percent from a year earlier, for the first time since October 1988. The response of prices and wages would also be critical for maintaining a real depreciation that would support net export growth. But the external environment was clearly weakening, particularly in Europe. With consumer confidence also faltering, there was the possibility of a more marked economic slowdown in 1993.

The authorities described the collapse of confidence in financial markets as more than just a foreign exchange market crisis. They believed that Italy was at a watershed; decisive action to stabilize the public finances and reform the role of the state in the economy was essential to convince markets of the government's ability to continue the disinflation process. The danger of another financial crisis had not yet passed. The authorities' immediate policy focus was clear: to press through with the proposed fiscal reforms and, with wage restraint supported by tight financial policies, try to limit the inflationary impact of the depreciation. A new privatization initiative, intended to have a much wider scope than those of the past, was viewed as a key element in reshaping the economy.

However, there was less clarity than in the previous year about the policy framework and the medium-term perspective within which policies were being formed. Support for Europe had always been very strong in Italy; the Maastricht Treaty was approved overwhelmingly by parliament in late October. The government's broad aims of pursuing convergence with the rest of Europe, and full participation in the next stages of European integration, remained unchanged. Consistently with this, the departure from the ERM was viewed as only temporary; re-entry was to take place as soon as financial market tensions subsided, the budget was passed, and agreement reached with partner countries on a new parity that would command support.

However, as uncertainties about ERM developments continued, the authorities' focus shifted to emphasize more the conditions--both external and domestic--for re-entry than the expected early timing. More broadly, continued turmoil in the ERM, and evidence of political doubts elsewhere in Europe that could impede progress toward EMU, appeared to have lessened somewhat the magnetism of Maastricht as a political rallying point. The authorities had not yet presented a new convergence program to the EC, although they had in July revised their 1993-95 fiscal plan. There was debate among some in the government about the appropriate targets for later years, which would obviously influence the timing of convergence. At the same time, the financial crisis meant that the case for fiscal adjustment was seen as driven by the requirements of domestic stability, quite apart from the specific criteria of Maastricht.

As far as the medium-term outlook in Italy was concerned, the authorities stressed the particularly large uncertainties now surrounding any forecast. A number of possible scenarios, and projections of private forecasters for 1993, were discussed. All of these envisaged limited growth in private consumption, reflecting a drop in real disposable income (partly due to the fiscal consolidation) and lower consumer confidence. Investment was also likely to be depressed, given the high level of real interest rates and weak domestic demand. Weaker external market growth was generally envisaged. However, there was uncertainty regarding other critical assumptions, including the size of the fiscal adjustment, the likely pass-through into prices and wages of the lira devaluation, and thus the size of the real depreciation, and the response of exports to the devaluation and to slower growth in traditional markets.

The prospects for fiscal adjustment were seen as crucial for the medium-term outlook. 1/ Three different scenarios are shown in Table 2; the first outlines the government's three-year plan, announced in July. This provided for a broadly even path of primary adjustment during 1993-95, to reach a surplus of 6 1/2 percent of GDP by the end of the period. While the total primary adjustment planned over the period was more ambitious than that incorporated in the convergence program submitted to the EC in 1991, the reduction in the overall deficit was more gradual than before. 2/ Higher interest payments offset a bigger primary adjustment in the later period, and the overall deficit came down only to 7.3 percent in 1994 and 4.7 percent in 1995. The debt ratio was envisaged to continue rising through 1994, rather than 1993, and to peak at over 112 percent of GDP, rather than 104 percent. Further adjustment would be needed to bring the fiscal deficit to the 3 percent Maastricht target.

A second scenario illustrated the fiscal outlook as it was projected before the 1993 budget and accompanying laws. Officials had estimated that growing entitlement expenditures, the loss of revenues from earlier temporary taxes, and rising debt service costs on the growing debt would have driven the deficit to over 18 percent of GDP by 1995. Of course, the projection of an unsustainable position is to some extent inherently misleading. It is also based on judgments about likely future spending that may be wrong or change over time. Nevertheless, the scenarios can be used in an illustrative way to show that while some long-term improvement has taken place, much more needs to be done. Thus, the third scenario incorporated staff estimates of the impact of the new measures in 1993 and the two subsequent years. The underlying "trend" deficit, while improved from scenario B, remained on a path that was clearly unsustainable and incompatible with the desired move toward convergence. The still relatively sharp decline in revenues was noteworthy, while the trend increase in primary expenditures appeared to have been halted. The 1993 budget and recent structural reforms would be enough to forestall some of the deterioration in the trend deficit that would otherwise have taken place. But, as the government recognized, additional fiscal measures would still be

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1/ See also Supplement 1 to the forthcoming background document.
2/ This program was discussed in SM/92/3, 1/3/92, Italy - Staff Report for the 1991 Article IV Consultation.

needed to stop the primary balance from worsening again during 1994-95, pushing up the overall deficit and leading to a sharp increase in the debt/GDP ratio to over 120 percent by 1995. Such a scenario would be likely to result in a further financial crisis, whose impact and timing would be inherently difficult to model and predict.

In connection with the WEO exercise, the staff thus prepared a set of projections that assumed some further fiscal consolidation (Table 3). However, in line with past experience, and in light of the measures adopted so far for 1993, it was assumed that this was not sufficient to achieve the government's targets. Staff estimates of possible slippages in the budget in 1993 (described in more detail below) had some spill-over effects in later years. A weaker macroeconomic environment than that underlying the budget also worsened the deficit and debt dynamics. The debt/GDP ratio would stabilize only in 1996-97. The overall borrowing requirement, although on a clearly declining path, would still be considerably above 3 percent by 1996. Growth would remain well below potential as interest rates would come down only slowly with the more gradual than planned fiscal adjustment. On this basis, Italy would not meet the Maastricht criteria for participation in EMU by 1997. Moreover, there would remain the danger that financial markets would judge the fiscal progress as inadequate. Resulting higher interest rates and exchange market pressures could then undermine the adjustment strategy. Thus, slower than programmed adjustment would hold serious risks.

2. <u>The 1993 budget and fiscal reform</u>

The government's 1993 budget was reviewed in light of the urgent need to stabilize and then reduce the debt/GDP ratio, and to put the deficit on a path to convergence with major EC partner countries. The authorities described the targeted adjustment for 1993, which they measured relative to trend, as very large. The measures already implemented represented a much greater adjustment effort than in the past. Although the overall budget target had been fixed before the financial crisis, officials did not believe that it could be tightened now, given the timing of the budget process. There was concern expressed by some that too much fiscal retrenchment could further damage the weakening economy, and that automatic stabilizers should not be completely offset if the economy were more depressed than foreseen. However, officials generally accepted that measures should be readied in case of a shortfall in the budget savings and stressed the commitment to maintain the projected Lit 50 trillion primary surplus target for 1993.

In commenting on the budget, the staff stressed that focussing on changes relative to the trend deficit exaggerated the impact of the adjustment; the economic impact of the package would depend on the change in the actual fiscal stance from year to year, rather than on the change relative to a hypothetical, trend, outcome. The staff also questioned the even phasing of the planned adjustment in the primary balance--roughly 2 percentage points in each year during 1993-95--and the consequently small reduction in the overall deficit planned for 1993. The severity of the financial market crisis since the deficit target was originally set would have argued for stronger adjustment in 1993. The dynamics of deficits and debt also pointed to the need for greater frontloading of the planned adjustment. The most recent slippages acknowledged for 1992 demonstrated once again the extreme vulnerability of the fiscal position.

Revenue increases, relative to trend, were projected to account for about one-third of the budget measures for the central government, with a particularly marked increase in direct taxes and social security contributions. Proposed tax increases--notably a new minimum tax on the self-employed, increased personal income tax rates, elimination of indexing of higher tax brackets to inflation, and a tax on companies' net assets--would offset the loss to 1993 revenues due to the temporary character of most of the 1992 revenue measures. Higher local taxation was also expected, with local authorities authorized to raise additional taxes to compensate for a reduction in transfers. The staff agreed that the revenue effort was more determined than in the past, when one-off measures had frequently been used to achieve short-term savings. But it was still insufficient to maintain the ratio of taxes to GDP at the 1993 level without further action. This was because receipts from some of the tax measures were (for technical reasons) doubled in the first year, and some specific indirect taxes and other charges were not automatically increased. Although tax pressure had now reached levels observed elsewhere in the EC, there was no room for such a decline at present.

On the expenditure side, the 1993 measures were intended to reduce non-interest outlays by 1 3/4 percent of GDP from 1992 (3 1/4 percent relative to the trend). The planned pension reform was of particular importance. Italy's pension system is one of the most generous among industrialized countries; without reform, pension spending relative to GDP would have risen over the medium- and long-term from 14.5 percent in 1992 to a steady state of over 25 percent. Proposals to increase retirement age, limit early retirement, and switch the indexing system from wages to prices (with the 1993 increase based on the previous target for inflation of 3.5 percent) should produce savings in 1993 and substantially improve the medium-term outlook, although there could be scope for still further measures in this area. As far as other 1993 expenditures were concerned, the staff supported the decision to freeze public employment and nominal wages, and only to increase other current spending in line with the previous inflation target. Provided that no catch-up occurred in later years, the wage policy would also have a longer-term impact on the deficit. The government also planned to cut military expenditures further (already comparatively low at 1.7 percent of GDP) and to reduce foreign aid.

In addition to the concern about the size of the proposed adjustment, the staff expressed doubts that the measures adopted so far would be sufficient to achieve the 1993 target. A shortfall in the primary adjustment of some 1 to 1 1/2 percent of GDP seemed likely, which argued for the immediate preparation of contingency measures. Past experience suggested that savings from across-the-board spending cuts and reduced transfers were likely to be less than projected. The results of the proposed health care reforms would also depend on significant improvements in administration. On the revenue side, projected receipts from the elimination of a number of tax exemptions and tax holidays (which had not yet been fully specified), and from the extension of the tax amnesty (which was less generous than the existing one) appeared likely to be less than projected. Privatization receipts, although scaled back to 0.5 percent of GDP, were another area of risk, as were receipts from the proposed minimum tax. The latter, which represented a welcome step toward more equity in the tax system, would depend for its success on taxpayers expecting swift and effective implementation, despite a possible constitutional challenge. Finally, it appeared likely that the macro-assumptions underlying the budget would tend to understate the deficit (although by less than in the past).

There was agreement that the improved quality of the fiscal measures now being undertaken--in terms of their more permanent impact and the planned structural reforms--represented a break with the past. Previous adjustment efforts had been undermined by the failure to tackle the underlying, structural weaknesses in the fiscal position, with continued rapid growth in entitlement spending and frequent resort to temporary revenue measures. Many of the measures now being implemented would have an impact in curbing the deterioration in the trend primary balance. However, they would not succeed in maintaining even the 1993 improvement, much less in achieving the larger surpluses targeted for later years. The measures were thus only a first step; further significant actions were required both to safeguard the 1993 targets and to achieve the additional adjustment required in 1994 and beyond.

Some of the expenditure savings, including those expected from the structural reforms of local authority financing, health care and public employment, were recognized to depend on improved public spending decision-making and control. In particular, there was limited central control over spending and borrowing of local authorities (chiefly for investment purposes), of health units, and of many other public entities. This, together with the broad scope of such state activities outside the central government, led to substantial future spending commitments and off-budget transactions that would eventually rebound onto the budget. Even in the central government, earlier attempts to restrict public employment growth through apparently strict legislation had been largely unsuccessful.

Given the state's extensive industrial and financial holdings, privatization had for some time been seen as a way of reducing the public debt, while also contributing to enhanced economic efficiency. A number of, mostly limited, initiatives in the past had failed to yield significant results. This partly reflected legal and technical difficulties but also the inherent problems in relinquishing political control over assets that were in many cases profitable and, even where not, could also be used to meet social and political objectives, including preserving employment. The authorities felt that progress in this area would promote real change in the structure of the economy and the role of the state.

In August, the legal status of the major state entities had been changed to bring these under the ownership and control of the Treasury. In November, the government sent to parliament a plan with ambitious goals, which were broadly approved the following month. A more specific timetable of action was to follow. The government's budget constraint argued for speed in increasing possible Treasury receipts from sales of profitable companies and reducing potential budgetary transfers to loss-making companies. Proceeds from asset sales could in future be used for recapitalization of weaker companies, or directed to a newly established "Amortization fund" and used to retire government debt. The view that no sectors (other than defence and basic research) should be considered strategic, and so closed to privatization, was endorsed by the staff, and foreign participation was seen as needed, especially in view of the limited scope of the Italian stock market. Finally, while the need to improve the underlying public finances was now overriding, efficiency considerations would determine the ultimate success of the privatization initiative.

This year's financial market turbulence led to significant changes in debt management. During the past several years, there was an effort to shift the composition of the public debt toward longer-term fixed rate instruments. In the uncertain environment of 1992, however, the authorities depended mainly on short-term and floating rate issues. There had been some discussion of relying more in the future on the issuing of foreign-currency denominated or inflation-indexed debt. The staff argued that such changes in debt management, while they might initially lower budgeted debt servicing costs, would not lighten the task of fiscal adjustment. On the contrary, over the medium-term they would make the fiscal position more vulnerable, strengthening the need for measures that would win and maintain the confidence of the markets. It was possible, however, that a willingness to take on such liabilities and thus limit later room for maneuver could help credibility, if accompanied by some immediate fiscal action.

3. The disinflation strategy: monetary and exchange rate policy

The suspension of the lira from the ERM raised important issues about the conduct of monetary policy. The authorities felt that exchange market pressures could not have been resisted by tighter monetary policy alone. The vulnerability of the fiscal position to higher interest rates meant that markets did not believe in the sustainability of extremely high rates; under these conditions, the authorities argued that rate increases became ineffective beyond a certain point. While the financial system had proved fairly robust in the face of the high rates, there were also concerns about the impact of prolonged high interest rates on economic activity. In this connection, it was agreed that long-term rates on which investment depends would only fall significantly once markets were convinced of the fiscal adjustment, and had adjusted inflation expectations downwards.

The authorities stressed that the temporary withdrawal from the ERM was not intended to signal a departure from the previous anti-inflationary stance. An early return to an exchange rate peg was viewed as desirable, although this had to await a reduction in uncertainties, external and domestic. Views differed about how quickly this could be expected, but there was general agreement, notwithstanding the foreign exchange crisis, that the fixed rate had been an important instrument for spurring disinflation; a return to the ERM was seen as part of the whole process of moving toward EMU.

The period immediately ahead was viewed as critical in determining the prospects for disinflation, especially given the uncertain outlook after the depreciation. In the absence of the exchange rate anchor, the announcements of a restrictive monetary target for 1993 and of tough, albeit informal, guidelines for lira bank credit, had been made in order to signal continued restraint. For the time being, more weight was being placed on the monetary targets, which in the recent past had of course been subsidiary to the exchange rate peg. The M2 target range was unchanged from 1992, despite the lira devaluation. A sharp slowdown in money growth in the second half of 1992--to toward the bottom of the 5-7 percent range--meant that the base for growth during 1993 would also be low. Central bank officials thus saw the monetary targets as being consistent with only fairly limited declines in interest rates, although they expected some further reduction from the crisis levels. The authorities recognized that the guidelines on bank credit were a second-best solution. But they believed that they could play a temporary role in dampening excessive credit expansion while encouraging a reflow of capital from abroad.

It was noted during the discussions that money growth and exchange rate considerations had at that time similar implications for the setting of interest rates. Following the renewal of exchange market tensions and political uncertainties since then, there was a further depreciation of the lira by some 4 1/2 percent against the deutsche mark in the month to mid-December. Money market rates had not risen in response to this, but conditions had been kept tighter than was expected, with the discount rate not lowered again, despite further progress on the budget. Interest rate differentials against Germany remained very high.

The staff argued that, with the authorities intending to return as soon as possible to a fixed exchange rate regime, the lira rate should still serve as a key indicator for the execution of monetary policy during this period. With conditions not present for an immediate repegging, monetary aggregates would in the period before ERM re-entry have to play a somewhat greater role. But the instability in money demand, to be expected at a time of financial market turbulence, and the limited value of money targets as an interim signal to wage and price setters, argued against reliance on the M2 target as the main nominal anchor.

The staff agreed with the authorities that certain conditions for ERM re-entry should be met to ensure that the new parity could withstand any early market test; a second forced exit would be extremely damaging. External conditions included a lessening of foreign exchange market turmoil, and sufficient external support and reserves to deter speculative attack.

The fundamental domestic conditions needed to convince markets that a new peg would be maintained were convincing progress on the fiscal side--including, as a first step, the passage of the 1993 budget--and evidence that the wage/price response to the depreciation that had taken place so far would not reignite inflation. A return to more normal interest rate levels --already underway--would also be needed. This did not mean that all the present interest differentials would soon disappear; as part of the disinflation process, interest rates would probably stay above their long-term equilibrium for a while (although part of the present interest rate differential of some 600 basis points probably represented exchange market uncertainty that could disappear on repegging the rate). But while a premium would persist, markets would be unlikely to find credible an exchange rate that relied for its maintenance on interest rates widely viewed as unsustainable.

As far as the appropriate level of the exchange rate was concerned, it was agreed that this would have to strike a balance between restoring competitiveness, so as to be credible and sustainable, and limiting the depreciation in order to maintain the thrust of the disinflation and convergence effort. Any new parity would also have to command the support of ERM partners. The authorities were unwilling at this stage to commit themselves publicly--outside the framework of ERM support--to a particular rate that could become a focus of speculation. They believed that indicators suggested that the devaluation that had at that time taken place--equivalent to some 13 percent in October 1992 relative to August--was more than enough to offset the loss of competitiveness since the last ERM realignment. The staff broadly concurred, although some of their calculations would indicate a somewhat larger competitiveness loss than the Bank of Italy measures. The widening gap on net investment income also suggested that the equilibrium real exchange rate may have depreciated, with a stronger trade position required to cover interest payments abroad.

4. Labor markets and structural reform

While the immediate policy focus was on financial restraint and the urgent need to restore fiscal balance, structural changes were also seen as important, to reduce the output and unemployment costs of disinflation and to reap full advantage of greater integration in Europe and more widely. 1/ The government's privatization plans, noted above, could be one important vehicle for change. A broader reduction in state subsidies to industry, now among the highest in the EC, would also aid efficiency.

There was agreement on the importance of the present negotiations to reform the wage bargaining system; structural rigidities in the labor market remained severe. Reforms to allow a greater wage response to market conditions would help reduce structural, including regional, unemployment.

1/ These have been discussed in previous consultation reports; see list of past appendices in Supplement 1 to the forthcoming background document.

Real wage increases in recent years, in particular in the public sector, could not be sustained without serious consequences for unemployment, which was already very high. Negotiations should now focus on the immediate need for income restraint. In this context, it was considered important that there should be no re-instatement of the automatic indexing which in the past had contributed significantly to the persistence of inflation. 1/

In discussions with trade unions about 1993 wage increases, it was clear that exchange rate developments were viewed as critical. Unions had reached the July agreement to scrap the *scala mobile* in the expectation that the rate would remain stable. This agreement would only allow for the previously contracted increases and a comparatively small one-time payment in lieu of the wage indexation, together implying 1993 wage increases of some 4 1/2 percent for the industrial sector. Union leaders appeared willing to maintain the agreement, provided that the devaluation and subsequent price increases were contained. The staff welcomed their realism in accepting the need for real wage restraint, in order to ensure a lasting gain in competitiveness and safeguard jobs.

Another aspect of structural policies involved international trade. The authorities noted that recent and planned trade liberalization in some areas would require Italian industry and agriculture to restructure if it was to compete successfully. In 1992, several import restrictions from Japan were lifted and the only remaining exemptions under Article 115--for bananas and Japanese car imports--were expected to be replaced by EC-wide restrictions in 1993. The authorities welcomed the broad reform goals for the Common Agricultural Policy, and they were strongly supportive of the negotiated association agreements between the EC and Czechoslovakia, Hungary, and Poland. With respect to global trade, the authorities agreed that a successful conclusion of the Uruguay Round would improve the overall medium-term prospects, including in Italy. But they were somewhat doubtful about the prospects for swift resolution of outstanding issues, notably in the agricultural sector and, more recently, in the steel sector, where the U.S. anti-dumping duties would apply to imports from several countries, including Italy. Some of the envisaged reforms could affect Italy significantly; in particular the agreement in late November between representatives from the EC and the U.S. to limit output of some products, notably oilseeds, where Italy is a major producer.

IV. Staff Appraisal

As Italy's Prime Minister has commented, the country reached the brink of financial collapse during September-October 1992. The government's early actions in response to the crisis still fall short of what is needed to resolve the fundamental disequilibria; the major adjustment effort lies

1/ SM/92/6/, Supplement 1, 1/24/92, Italy - Recent Economic Developments, Appendices II and III.

ahead. But the response also holds some promise. Permanent and structural measures that would begin to correct the massive fiscal imbalances and to reduce the role of the state have been proposed, and in some cases already implemented; resort to extraordinary measures and controls has been avoided, even in the midst of crisis; and the monetary authorities have reaffirmed their commitment to fight inflation. Interest rates have declined significantly, although they are still generally above pre-crisis levels and the premium against other countries remains very high. A lasting solution to the crisis will depend on the government now pressing ahead with a long over-due restructuring of the economy and permanent measures to improve the public finances. Only thus will Italy's credibility, in financial markets and more broadly, be rebuilt. The further recent slippage in the 1992 deficit is regrettable.

As the government recognizes, the main policy focus must be on the fiscal side, since this has been at the root of the financial crisis. Some steps have been taken in this area, with the 1993 budget and accompanying reform laws. The improved quality of the measures now being implemented is a welcome sign of change, with some action being taken to address long-standing structural weaknesses in the public finances. Proposed reforms in four key areas of the public finances, notably pensions, are of particular importance if the underlying trend of the deficit is to be curbed. Proposals to improve tax equity are also welcome.

But the public finances are still far from being on a sustainable path. In 1993, greater frontloading would have been desirable; comparisons with the underlying trend tend to exaggerate the adjustment. It is now critical that the government ensure that at least these targets are met. Failure to do so would be costly in terms of lost credibility. It could precipitate further serious funding difficulties for the government, which would ultimately force a more rigorous, and painful, pace of adjustment. Staff estimates suggest that without further action there could be a shortfall of some 1-1 1/2 percent of GDP, relative to the government's target. Measures must be quickly identified and implemented to offset this, and, if possible, to do more. Possible areas for action include reductions in state subsidies, further restrictions on transfers to local authorities and public agencies, and tighter limits on health spending. Revenue shortfalls could be offset by additional tax measures, perhaps focussing on consumption taxes. Faster progress in privatization would also help to reduce the debt burden.

To secure financial market confidence, it will also be essential to move swiftly to ensure lasting deficit reduction beyond 1993. Without further measures, the deficit would swell still further and the fiscal position would quickly become unsustainable. As a start, policies should aim at a further improvement in the primary balance of at least 2 percentage points of GDP for 1994, on top of the additional action still needed in 1993. Future budget measures should be focussed as far as possible on expenditure control, including the maintenance of firm limits on public sector wages and employment. Improvements in the system of public spending and borrowing control are also urgently needed. But revenues cannot be allowed to decline, as they would do with unchanged policies.

Credibility in the government's ability to achieve change would also be enhanced by privatization. The extent of the state's involvement in the economy--including in many market activities typically left for the private sector in other countries--means that there is considerable scope for sales of state assets. This should improve economic efficiency, as well as help to reduce government debt and limit the incurring of future Treasury liabilities by loss-making companies controlled by the state. The government's proposals will inevitably arouse opposition among those whose interests are presently served by the public control of the assets to be sold or, where rehabilitation and sale is impossible, liquidated. The commitment to press ahead nevertheless is welcome; progress on the sales already proposed is now overdue and the lack of results in 1992 is disappointing. An early announcement, as promised, of a clear and speedy timetable for action under the new plan, with specific companies and activities identified for sale, would provide an important signal of change. For this to be credible, the government may need to demonstrate further its willingness to take difficult decisions, including by withdrawing support for some loss-making companies. Moreover, it should aim clearly at a withdrawal of the state from activities that can be carried out efficiently by the private sector, and should insist on the sale of assets into private hands. The process will also have to be open to foreign participation, and should respect competition rules.

The conduct of monetary policy has been complicated by the lira's temporary exit from the ERM. The authorities' intention to maintain a monetary policy geared to fight inflation, and to return as soon as circumstances permit to a fixed exchange rate regime, is welcome. The exchange rate should remain a key policy guide in the interim. As a better-known signal to wage and price setters than the monetary targets, it can guide inflationary expectations and help the disinflation process. Exchange rate pressures also can be a good indicator of how supportive financial policies are of disinflation. The authorities' concerns about excessive credit expansion, that could fuel speculation and inflation, are understandable. But the use of ad hoc administrative guidelines to control some bank credit, albeit on a temporary basis, could introduce unwelcome distortions. On the other hand, the avoidance of capital controls even during the crisis has helped credibility.

Persistent tensions in international markets and questions about ERM developments have delayed immediate ERM re-entry. Given also the continuing uncertainties about fiscal and inflation developments in Italy, it is appropriate for the decision on the timing and level of re-entry to be approached with prudence. A successful re-entry will depend both on external support and reserves, and, most importantly, on the government's ability to press ahead with fiscal consolidation and disinflation policies more generally. In determining the rate for re-entry in conjunction with ERM partners, the authorities must balance their inflation objectives against considerations of competitiveness and credibility. An excessive depreciation would undo the chance of wage moderation and could create difficulties for ERM partners. But domestic and external objectives must be consistent; it would not be credible to re-enter the ERM at an exchange rate that could only be maintained, from the outset, by unsustainably high interest rates.

The foreign exchange market crisis showed the limits of monetary policy acting alone to fight inflation. Although interest rates were eventually raised very sharply, there were clearly perceived limits to the use of this instrument to defend the exchange rate, given the swift impact on the budget of higher debt-servicing costs. Monetary policy would be helped by greater independence from fiscal policy. In 1992, the extensive use of the Treasury current account facility was a step away from this. The bill to eliminate monetary financing of the deficit should be revived and passed, in line with the EC commitments in this area. However, effective monetary independence will only be possible if the problem is addressed at its roots, with a reduction in the large stock of public debt, much of it of short maturity.

The process of disinflation and convergence will also require incomes restraint. The trade unions' readiness to abide by the July agreement, even in face of the lira depreciation that had occurred, shows their willingness to share the costs of adjustment and avoid a devaluation/inflation spiral. The scrapping of the *scala mobile* opens the opportunity for a long-needed and permanent reform of the wage determination mechanism. Progress in other areas of labor market flexibility has remained inadequate.

The Italian economy has benefitted in the past from the closer integration of world markets. The further integration envisaged in the Uruguay Round negotiations could again provide a welcome impetus to growth and efficiency; renewed efforts are called for to bring the negotiations to a timely conclusion, and the authorities are encouraged to play an active role in these efforts. Care should also be taken to ensure an adequate level of development assistance, despite the overall budget constraint.

It is recommended that the next Article IV Consultation with Italy be held on the standard 12-month cycle. A staff visit before then to monitor progress under the fiscal adjustment program has been requested by the authorities.

Table 1. Italy: Selected Economic Indicators, 1985-92

(Percentage changes, except as otherwise indicated)

	1985	1986	1987	1988	1989	1990	1991	1992 1/
Domestic economy								
Real domestic demand	2.8	3.0	4.1	4.4	2.8	2.4	2.3	1.4
Foreign sector contribution	-0.2	-0.1	-1.1	-0.5	--	-0.3	-1.0	-0.4
Real GDP	2.6	2.9	3.1	4.1	2.9	2.2	1.4	1.0
Employment	0.5	0.6	-0.1	0.7	-0.1	1.4	1.4	0.1
Unemployment rate 2/	10.3	11.1	12.0	12.0	12.0	11.0	10.9	11.1
Industrial production	1.1	3.6	3.9	6.0	3.1	0.1	-2.0	0.6
Average cost per worker 3/	11.4	6.8	7.6	7.9	10.2	8.2	8.4	5.5
Unit labor costs in manufacturing	6.4	3.7	2.1	1.7	6.7	6.4	6.6	2.3
CPI (annual average)	9.1	5.9	4.7	5.0	6.3	6.5	6.4	5.5 4/
GDP deflator	8.9	7.9	6.0	6.6	6.2	7.5	7.3	5.7
External accounts								
Export volume 5/	3.2	3.8	3.3	4.9	9.0	3.5	0.1	2.8
Import volume 5/	4.1	7.6	11.3	6.4	8.3	4.5	4.5	2.8
Export unit value 5/	12.4	-7.1	1.1	5.1	6.3	2.1	2.9	4.5
Import unit value 5/	7.4	-17.7	-1.5	4.2	7.6	-0.7	-0.8	1.2
Trade balance (In Lit billions, f.o.b. - f.o.b.) 6/	-11,928	6,283	-392	-1,501	-2,956	431	-923	6,037
Net invisibles 6/	5,082	-2,655	-1,486	-5,964	-11,855	-18,056	-25,303	-27,274
Current account 6/	-6,846	3,628	-1,878	-7,465	-14,811	-17,625	-26,226	-21,237
In percent of GDP	-0.8	0.4	-0.2	-0.7	-1.2	-1.3	-1.8	-1.4
U.S. dollar/Lit rate (period average)	-8.0	28.1	15.0	-0.4	-5.1	14.5	-3.4	-2.3 7/
Effective exchange rate (MERM)	-5.8	3.9	1.6	-3.6	-0.2	4.7	-2.4	-1.7 7/
Real effective exchange rate in manufacturing								
Normalized unit labor costs	-1.8	0.5	1.4	-2.5	5.0	7.0	2.2	2.1 8/
Financial variables								
General government								
Total balance (In percent of GDP)	-12.5	-11.6	-11.0	-10.7	-9.9	-10.9	-10.2	-10.4
Primary balance (In percent of GDP)	-4.5	-3.1	-3.0	-2.6	-1.0	-1.3	--	1.1
State sector								
Borrowing requirement								
In Lit billions	112,210	110,159	113,829	124,911	133,400	140,680	152,322	164,000
In percent of GDP	13.8	12.2	11.6	11.4	11.2	10.7	10.7	10.7
State sector revenues 9/ (in percent of GDP)	29.4	30.7	30.4	30.8	32.3	32.9	33.8	35.0
State sector expenditures 9/ (in percent of GDP)	43.2	42.9	42.0	42.3	43.5	43.6	44.5	45.7
Primary balance (in percent of GDP)	-6.0	-4.0	-3.8	-3.4	-2.4	-1.1	-0.5	0.6
M2 11/	11.1	10.6	7.1	7.7	9.9	8.2	9.0	7.2 10/
Total domestic credit 12/	18.6	14.9	13.1	14.7	14.8	13.2	12.8	12.6
Of which: To nonstate sector	11.3	10.9	10.2	15.7	18.0	14.7	13.9	13.2
Interest rate on six-month treasury bills (gross of taxes, in percent per year) 13/	13.7	11.5	10.7	11.1	12.6	12.3	12.5	14.4
Minimum lending rate (in percent per year) 14/	16.4	14.1	12.1	12.1	12.9	12.7	12.3	13.5

Sources: Data provided by the Italian authorities, and Fund staff estimates.

1/ Staff projections.
2/ Excluding workers under the Wage Supplementation Fund.
3/ Average cost per standard unit of dependent labor in manufacturing.
4/ The official target for 1992 is 4.5 percent.
5/ Trade (customs basis).
6/ Transactions basis.
7/ January-November.
8/ January-October.
9/ Includes gross financial operations, net of depreciation.
10/ October 1992. The official target range is based on quarterly averages and is 5 to 7 percent for 1992.
11/ Based on monthly averages of end-of-year data.
12/ End-of-period; 1992: September.
13/ Period average; 1992: January-November.
14/ Period average; 1992: January-September.

Table 2. Italy: Fiscal Scenarios - State Sector, 1992-95

(In percent of GDP)

	1992 1/	1993	1994	1995
Scenario A				
Government medium-term plan 2/				
Revenues	34.2	34.5	34.7	35.9
Of which: Taxes	26.1	26.2	26.4	27.6
Expenditures 3/	44.8	44.2	42.9	41.3
Of which: Primary	33.6	31.8	31.1	30.2
Privatization proceeds	0.5	0.4	0.9	0.7
Overall balance	-10.2	-9.3	-7.3	-4.7
Primary balance	1.1	3.1	4.5	6.4
Debt/GDP	106.2	110.6	112.5	112.4
Scenario B				
Before the 1993 budget and accompanying laws 2/				
Revenues	34.2	32.4	31.7	31.2
Of which: Taxes	26.1	24.1	23.4	22.9
Expenditures 3/	44.8	47.6	49.0	49.5
Of which: Primary	33.6	35.0	35.8	36.2
Privatization proceeds	0.5	0.0	0.0	0.0
Overall balance	-10.2	-15.3	-17.3	-18.3
Primary balance	1.1	-2.7	-4.1	-5.0
Debt/GDP	106.2	116.8	128.3	143.9
Scenario C				
Without any further measures 4/				
Revenues	34.0	34.0	32.4	31.9
Of which: Taxes	26.0	25.8	24.5	24.2
Expenditures 3/	44.7	44.8	43.8	43.7
Of which: Primary	33.4	32.4	32.0	32.3
Privatization proceeds	0.0	0.2	0.3	0.3
Overall balance	-10.7	-10.5	-11.2	-11.5
Primary balance	0.6	1.9	0.7	-0.1
Debt/GDP	106.7	112.2	117.5	123.3

1/ The 1992 deficit has been revised upwards since the government plan was announced, largely reflecting the lack of receipts from privatization.
2/ Source: September 1992 revised 1993-95 Plan (Documento di Programmazione Economica). The 1992 deficit has since been revised upwards.
3/ Including net financial operations.
4/ Staff estimates.

Table 3. Italy: Medium-Term Projections, 1992-97

	1992	1993	1994	1995	1996	1997
<u>Government program</u> 1/						
			(<u>Percent changes</u>)			
Real GDP	1.2	1.5	2.4	2.6	3.0	...
Domestic demand	1.3	1.0	1.9	2.3	2.6	...
CPI	5.3	4.5	3.5	2.5	2.0	...
			(<u>In percent of GDP</u>)			
Fiscal balance 2/	-10.2	-9.3	-7.3	-4.7	-3.5	...
Debt/GDP 2/	106.2	110.6	112.5	112.4	111.3	...
External current account balance	-1.8	-1.3	-0.8	-0.4	-0.1	...
<u>Staff scenario</u> 3/						
			(<u>Percent changes</u>)			
Real GDP	1.0	0.5	1.0	1.7	2.0	2.3
Domestic demand	1.4	-0.4	0.3	1.2	1.5	2.0
CPI	5.5	6.5	5.3	4.1	3.4	2.7
			(<u>In percent of GDP</u>)			
Fiscal balance 2/	-10.7	-10.5	-9.3	-7.4	-5.9	-4.4
Debt/GDP 2/	106.7	112.2	116.1	117.9	118.3	117.7
External current account balance	-1.4	-1.9	-1.8	-1.5	-1.0	-0.8

Sources: *Relazione Previsionale e Programmatica, September 1992; and* staff estimates.

1/ Macroeconomic projections underlying government three-year fiscal plan.
2/ State sector.
3/ December 1992, WEO scenario.

Italy: Fund Relations
(As of November 30, 1992)

I. Membership status:

Italy became a member of the Fund on March 27, 1947. Italy has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement.

II. General Resources Account:	SDR Million	% Quota
Quota	4,590.70	100.0
Fund holdings of currency	2,637.37	57.5
Reserve position in the Fund	1,953.33	42.5
Operational budget transfers (net)	-303.50	

III. SDR Department:	SDR Million	% Allocation
New cumulative allocation	702.40	100.0
Holdings	170.53	24.3

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: (SDR Million; Based on Existing Use of Resources Only):

	Overdue	Forthcoming				
	11/30/92	1992	1993	1994	1995	1996
Charges			3.8	3.8	3.8	3.8
Total			3.8	3.8	3.8	3.8

VII. Exchange Rate Arrangement:

Italy left the exchange rate mechanism (ERM) of the European Monetary System (EMS) temporarily on September 16, 1992 and maintains a floating exchange rate regime. Since March 13, 1979, Italy had participated in the ERM, initially with a 6 percent margin, and, with effect from January 8, 1990, within the narrow EMS band which allows fluctuation margins of 2.25 percent around bilateral central rates. The last adjustments of the central rate occurred when Italy joined the narrow band of the ERM, and again on September 14, 1992, when the lira was devalued by 7 percent against ERM partner countries.

VIII. Article IV Consultations:

Italy is on the standard 12-month consultation cycle. The last consultation discussions took place during November 5-18, 1991, and the staff report (SM/92/3) was discussed on January 31, 1992 (EBM/92/11).

IX. Technical Assistance: None

X. Resident Representative: None