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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/22

10:00 a.m., February 18, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	C. Enoch
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	
	R. Morales, Temporary
	A. M. Othman
	B. Goos
J. E. Ismael	
	J. E. Zeas, Temporary
M. Massé	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
G. Ortiz	L. Filardo
	M. Fogelholm
	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
G. Salehkhou	
A. K. Sengupta	
K. Yamazaki	S. Yoshikuni
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

European Department: M. Russo, Director; M. Guitian, Deputy Director; A. Lopez-Claros, P. E. Guidotti, L. E. Molho, E. Spitaeller, T. M. Ter-Minassian, S. M. Thakur. Exchange and Trade Relations Department: S. J. Anjaria, A. Leipold. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli, G. F. Kopits. Legal Department: J. M. Ogoola. Research Department: J. P. Horne, M. Mecagni. Western Hemisphere Department: S. T. Beza, Director. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: G. D. Hodgson, K.-H. Kleine, P. D. Péroz, P. Péterfalvy, M. Pétursson, G. Pineau, A. Vasudevan. Assistants to Executive Directors: R. Comotto, F. Di Mauro, S. K. Fayyad, V. J. Fernández, J. Gold, P. Gorjestani, S. Guribye, M. A. Hammoudi, G. K. Hodges, L. Hubloue, A. Iljas, S. King, M. A. Kyhlberg, V. K. Malhotra, T. Morita, S. Rebecchini, D. Saha, G. Schurr.

1. ITALY - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Italy (SM/88/22, 1/19/88; Cor. 1, 1/26/88; and Sup. 1, 2/17/88). They also had before them a background paper on recent economic developments in Italy (SM/88/34, 2/4/88; and Sup. 1, 2/5/88).

Mr. Zecchini made the following statement:

> Since the last Board discussion on Italy, there has been a series of positive developments in the Italian economy on several fronts, although insufficient progress has been made in a few crucial areas, such as in public finances and unemployment, which are characterized by long-standing weaknesses. In 1987, real GDP continued to grow at a healthy pace (almost 3 percent), under the impulse of a lively expansion of domestic demand, which far exceeded that of Italy's major trading partners. To the extent that the contribution of net exports to GDP growth has been negative, one can say that Italy has done its part in fostering international adjustment of the current deficits in the balance of payments.
>
> Both private consumption and fixed investment contributed to the acceleration of domestic demand. The rise in consumption exceeded the increase in households' disposable income resulting from the conclusion of wage negotiations, pointing to the lagged effects of gains from improvements in the terms of trade in the period 1985-86. The pickup in investment in plant and equipment, which was close to 6 percent, reflected the prospects of rising demand, the relatively high level of capacity utilization, and enterprises' enhanced ability of self-financing.
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> Such a revival of economic activity and private initiative was not accompanied by imbalances on the inflation or external account fronts, although the process of reducing inflation came to a halt during the year, and the surplus in the current account of the balance of payments disappeared. Moreover, the rise in the number of those employed was not sufficient to lower the unemployment rate. While inflation decelerated on average with respect to 1986, some tensions emerged in the evolution of input costs more as a result of external factors (i.e., the rebound of oil and commodity prices) than of the increase in labor costs. The increase in labor costs was partly offset by the gains in productivity in the manufacturing sector, estimated at close to 3 percent, which led to a deceleration in unit labor costs. Overall, the surge in input costs was not entirely translated into higher final prices, as enterprises curtailed their profit margins somewhat. Consequently, Italy's inflation

performance, as measured by the change in the consumer price index, came closer to the good inflation performance of its main trading partners.

With regard to labor market conditions, the partial reabsorption of excess labor that had been previously placed in the "wage supplementation regime," and an increase in the participation rate due mainly to demographic factors, are chiefly responsible for the increase by one percentage point in the unemployment rate during the year. A lower increase (1/2 percentage point) is evidenced if workers under the "wage supplementation regime" are included in the unemployment measurement. This is not to deny the gravity of the problem and, in particular, the reduced elasticity of labor demand to changes in levels of economic activity. The current high level of unemployment seems to reflect to a great extent rigidities inherent in the economic system, since it is concentrated among young workers, women, and southern regions of the country, while there are signs of unfilled vacancies in the northern regions. The authorities are striving to reach an agreement with the labor unions on measures aimed at easing some of these rigidities.

The sharp worsening of the trade balance in quantity terms can be attributed mainly to the excess of demand expansion, and particularly investment demand, in Italy, as compared to the rest of Europe. The delayed impact of the loss of competitiveness stemming from the depreciation of the U.S. dollar since 1985 also played a role. The resulting deterioration of external competitiveness has been mitigated by moderation in the export-pricing policies of enterprises. This has to be taken into account when assessing the actual degree of the loss of competitiveness otherwise signaled by various indicators of relative domestic prices or costs. To the extent that demand growth will be sustained in the rest of Europe, as well as in other areas, and that international terms of trade will stabilize, one can expect the trade balance to improve, as the economic system is showing enough flexibility in adapting to the new parameters of international trade. Exports in the second half of 1987 increased by 12 percent over the first half, reflecting the revival of external demand.

As to the prospects for 1988, my authorities intend to maintain the economy on a path of more balanced growth. If this is coupled with faster economic expansion in major industrial countries, as well as in developing countries, the Italian economy should grow at a rate very close to 3 percent, while experiencing a decline in inflation and a very minor deficit in the current account (0.2 percent of GDP). The likelihood of such a scenario is predicated mainly on the containment of Italian price and cost increases within the European averages, and on a significant reduction of the state sector borrowing requirement.

The main conclusions of the medium-term scenario prepared by the staff also point in this direction. Since that scenario only indicates trends, there is no benefit in discussing specific point estimates. Overall, the conclusions of the staff's scenario can be broadly accepted, although the estimation of the impact of interest rate changes on real growth in the baseline scenario seems on the pessimistic side. Apart from the beneficial impact of a fiscal correction, the strengthening of the current, favorable state of the economy requires progress in three areas, namely, improving the cost effectiveness and quality of public services, introducing more flexibility in labor market practices, and advancing innovation and efficiency in the many medium and small enterprises. In the short term, however, attention needs to be focused on three major macroeconomic tools: fiscal, monetary, and external policies.

In the area of fiscal policy, the borrowing requirement of the state sector declined to 11.7 percent of GDP in 1987 (12.3 percent in 1986), but exceeded the original target in spite of the higher than expected increase in revenues and lower interest payment expenditure. This was due mainly to increases in expenses for salaries and wages partly because of a carry over from 1986, and to higher social security transfers. My authorities have repeatedly tried to bring the growth of noninterest expenditure under control, but have been thwarted by the orientation of the Parliament. By contrast, it proved easier to raise additional revenues in 1987, without introducing new taxes, by changing tax exemptions, deductions, tax rates, and excise duties; this was particularly the case during the summer of 1987, when several of these measures were taken to check the excessive buoyancy of domestic demand.

Today, public finance issues are no different from those of previous years, but the room to dodge socially and politically difficult choices for their solution has become very narrow. The stabilization of the public debt/GDP ratio is considered essential to create the preconditions for a durable and faster growth of the economy. To this end, the elimination of the primary deficit is a necessary step, in the opinion of my authorities, to be achieved by curbing the expansion of non-interest current expenditure and by raising the revenue to GDP ratio to the European average. At the same time, improvements in the composition of both expenditures and revenues are needed, particularly by restoring control over the growth of social expenditure and by achieving a better balance between direct and indirect taxes.

The Government's version of the 1988 Finance Bill was in line with this thinking, but the bill was extensively modified by the Chamber of Deputies. The Government was trying to restore the initial thrust of the fiscal package when the coalition of parties supporting the cabinet collapsed. The Government has also been considering ways and means to make for a smoother financing of its borrowing requirement; in this respect, diversification of the financing mix has continued in 1987, with the issuance of financial instruments with price indexation and external debt linkages, and a plan for a more efficient secondary market for government securities is under way through the establishment of a network of institutional dealers and the reform of market mechanisms.

In the face of the rising financing needs of the Treasury, the extent and mechanisms of monetary policy intervention continued to adapt to the need to retain control over liquidity, while supporting economic expansion. In this light, the excess credit growth to the private sector, above the initial target, began to be corrected in early 1987, by reducing incentives to contract external debt, by introducing new reserve requirements, and by tightening central bank refinancing. There were no significant delays in the introduction of these measures. In the second half of the year, speculative pressures on the lira, fueled by an excessive rise in bank credit and by a weakening of disinflationary expectations, led the monetary authorities to impose stringent credit ceilings and some limited exchange controls. My authorities are aware of the distortions that these direct controls bring about, and consequently they regard them as very temporary instruments designed to deal at the least cost with tensions which appear reversible in the short term, or which require more extensive measures, the implementation of which will require a long-term perspective.

In fact, tensions in the financial markets both in Italy and abroad, as well as domestic inflationary expectations, have eased since the last quarter of 1987. As demand for less liquid financial instruments picked up, interest rates declined and the yield curve came closer to a "normal" shape. Accordingly, exchange controls were removed before the scheduled date, and at the moment my authorities do not intend to extend the credit ceilings beyond their scheduled expiration next month.

Overall, credit expansion to the nonpublic sector was just above the initial target in 1987, while the growth of the money supply remained within the targeted range, and the share of Treasury financing of the monetary base was lower than in 1986. Nevertheless, it must be recognized that monetary policy continues to face the challenges of minimizing the Treasury's monetary financing and allowing a smooth turnover of the high stock of accumulated debt, without creating conditions which would hinder the economy's real expansion. In this light, it must also be stressed that the monetary authorities have persevered in their plans to improve the structure of the domestic financial market, by facilitating more diversification in financial instruments, by supporting the development of institutional market participants (marketmakers), and by spurring more efficiency in the banking industry through increased competition.

With respect to external policy, the exchange rate policy continued to be framed in the context of both Italy's participation in the European Monetary System (EMS), and the objective of not accommodating the unfavorable inflation differential with other countries, so as to elicit structural improvements in external competitiveness. In this respect, the response of the business sectors has been positive, as the erosion of export competitiveness has proved much less than what might be expected because of the appreciation of the European currencies.

External policy developments have been dominated by the accelerated pace of liberalization of capital movements. Most, if not all, of the forms of portfolio or real investment abroad have been liberalized, while new liberalization measures for short-term investments will be operational by the end of 1988. This bold move toward liberalization did not create an incentive for capital flight, because it was supported by a consistent macroeconomic policy stance. Overall, the balance of nonbank capital movements was positive in 1987 (1.6 trillion lire) against a deficit in 1986 (-6.3 trillion lire). Furthermore, the system of exchange regulations applying to current transactions was liberalized. In this connection, I must dispel the impression of protectionism which might emerge from the staff presentation of the very few remaining import restrictions; these are temporary, of very limited extent, and are not applied continuously. Furthermore, given current European Community regulations, the staff criticism of Italy's external trade policy applies equally to the other European Community members, and seems too narrowly based, besides. In fact, Italy remains fully committed not only to free international trade, but to fair trade as well.

Finally, I wish to express appreciation, also on behalf of my authorities, for the balanced staff appraisal, as well as for the extensive analysis of economic issues in the report on recent economic developments.

Mr. Goos made the following statement:

I found the staff analysis comprehensive and so well considered that I am going to make only a few points of emphasis. I largely endorse the recommendations contained in the staff appraisal.

Notwithstanding the strong performance of investment and growth last year, I agree with the staff that economic developments in 1987 were disappointing in a number of respects, compared with the progress made in adjustment in recent years. This assessment is underlined by the revised information provided in the supplement to the staff report, notably on public finance and the external current account. In this context, several observers have revised downward their projections for economic growth this year; for example, the latest forecast of the Government's economic research institute is now for a real growth rate of 2.3 percent, compared with the official forecast of 2.8 percent. Similarly, the Commission of the European Communities expects a rate of only 2.2 percent, while the Organization for Economic Cooperation and Development (OECD) and the organization of Italian employers are even more pessimistic, with forecasts of less than 2 percent.

Those forecasts and estimates convey the quite worrisome impression that the developments outlined in the staff's Scenario I are not academic, and they amplify the staff's repeated calls, and the calls of other international organizations, to the Italian authorities to strengthen their efforts to reduce the existing imbalances, most notably the very high fiscal deficit.

There is no doubt that the deficit, combined with the need to refinance ever-growing amounts of public debt, poses the single most important threat to domestic and external stability. Of course, it has to be acknowledged that the revised Finance Bill for 1988 would have prescribed important steps in the right direction, especially as it reflected many of the staff's earlier recommendations, but it appears that an even stronger fiscal deficit reduction effort would have been desirable, so as to give a clear and unambiguous signal to the markets of the Government's resolve to improve the situation. It would also have been desirable in order to meet the staff's concern, which I fully share, about the temporariness of some of the measures envisaged, and the uncertainty of their effectiveness. I recall that at our last Article IV consultation discussion with Italy, several Directors explicitly recommended a more frontloaded adjustment effort in the fiscal area. Against this background, the recent difficulties encountered in the budgetary process are of course most disquieting; I have even heard of forecasts made by Italian academics that the state sector borrowing requirement (SSBR) for this year might again surpass Lit 110 billion.

Such an outcome would have serious negative effects in many respects; it would, inter alia, certainly greatly complicate the task of achieving greater convergence with the economies of Italy's main trading partners, and in particular, of narrowing the existing price and cost differentials. Again, I would like to mention the forecasts of the Italian Economic Research Institute, the Bank of Italy, and the Commission of the European Communities, that the private consumption deflator could well increase by 5 percent or more this year, which would be bound to have a negative impact on Italy's external competitiveness. I found the authorities' rather optimistic assessment of prospects for Italy's competitiveness, in particular vis-à-vis the newly industrialized economies, quite remarkable. The setbacks to be feared in those areas as a result of the increase in the fiscal deficit assume added importance when seen against the background of European financial integration and the concomitant increase in capital mobility, which could also create tensions within the EMS. In order to ward off such potentially serious repercussions, the authorities should give urgent consideration to the staff's fiscal policy recommendations. At the same time, there is a clear need to strengthen monetary policy in order to contain domestic demand expansion. In this regard, I endorse the staff's advice to aim at the lower range of the money and credit targets, and to pursue more flexible interest rate policies.

In reading the staff report and Mr. Zecchini's statement, I sensed some inclination on the part of the authorities to consider that the root of the existing problems, as well as of their potential resolution, lies at least partially in the external area, notably, in the growth performance of Italy's trading partners and in the level of international interest rates. There is certainly no doubt that the growth differential that emerged last year has contributed to the weakening in the external current account. However, I fail to see how stronger external demand could have mitigated the cost and price pressures arising from the strong expansion of domestic demand, especially as the expansion was accompanied by a record rate of capacity utilization in the domestic economy; quite probably it would have made things even worse. Similarly, it appears that the high level of domestic interest rates can be traced in the first instance to the high state sector borrowing requirement, which I think the staff acknowledges. It therefore appears that a sustainable improvement in Italy's economic situation will have to be sought first and foremost in its own adjustment efforts, notably in the fiscal area. The experience gained in the first half of this decade clearly indicates that the pursuit of appropriate domestic policies can indeed make a big difference in terms of overall economic performance. Such policies would probably be the most important contribution Italy could make toward fostering the international adjustment process, bearing in mind also the prospect that sooner or later the recent pronounced deterioration in the real trade balance will turn into a corresponding deterioration in the nominal balance.

To conclude with some observations on external policies, Italy's participation in the EMS has served the country well in providing an anchor for domestic stability and an incentive to improve external competitiveness. I am therefore pleased to note that the authorities intend to maintain a stable relationship of the lira in that system. Moreover, I welcome the fact that the exchange control measures of last September have been abolished ahead of schedule, and that further important liberalization measures will be implemented in October 1988.

Finally, I note that the last Article IV consultation with Italy took place almost 20 months ago, a considerable delay in the normal consultation cycle. Given Italy's weight in the world economy, it would be appropriate in the future to limit such delays as much as possible.

Mrs. Filardo made the following statement:

As stated in the report on recent economic developments and confirmed by Mr. Zecchini's statement, the most remarkable achievements on the economic front have been the rebound of GNP, which has continued to rise since 1983; the decline in inflation by 69 percent, as measured by the consumer price index in the same period; and the sizable reduction in the trade deficit, as the current and global accounts of the balance of payments turned into surplus during 1986.

To an important extent, these accomplishments were the outcome of a combination of favorable external developments, the execution of adequate structural reforms in the industrial and financial sectors, and more efficient monetary, exchange and incomes policies, all of which contributed to a more appropriate allocation of resources. Despite these positive results, progress has not been made in some crucial areas, such as public finances and unemployment, which could thus jeopardize preservation of the economic achievements made up to 1986, as Mr. Zecchini has rightly recognized. The deterioration of the balance of payments and the increase in inflation during 1987 may be interpreted in this light. In what follows, I will refer to the public sector deficit, the external imbalances, the constraints facing the authorities in sustaining these imbalances, and the dilemma created by the attempt to abide by the commitments within the context of the Group of Seven and the political difficulties of implementing them.

The overall deficit of the public sector has averaged nearly 13 percent of GDP over the last seven years. This is the largest such deficit of the industrial nations, and is considerably greater than many of the deficits of the developing countries. Although on several occasions the authorities have embarked on designing reform programs envisaging the correction of the fiscal imbalances in the medium term, political and social constraints have prevented the programs from being implemented. In this regard, we note the coincidence that at the time of the last Article IV consultation with Italy in July 1986, the country was facing a political crisis, as it does today. The need to form a coalition with different political parties, the long-standing discussion of the Finance Bill in Parliament, and the modifications eliminating or reducing the possibility of a longer-term solution, constitute in themselves structural limitations to the authorities' achievement of deficit correction. Supplement 1 of the staff report emphasizes, and Mr. Zecchini confirms, that the latest data indicate that the deficit reached 11.7 percent of GDP. As the finance law has not been enacted, and as it appears at present that the anticipated expenditure reduction and revenue increase will not materialize, the deficit will remain above 11 percent.

Given the high public debt ratio, equivalent to 90 percent of GDP, and the public sector domestic credit absorption of nearly 73 percent, it is evident not only that the Government is crowding out the private sector, but that the situation cannot be sustained in the medium term. The authorities may thus be facing serious constraints, in view of the stock market deterioration and the high real interest rate necessary to place government paper in the market. Interest cost has become an important component of current expenditure, having increased by 98 percent since 1982.

We understand that, in general, fiscal policy has been managed with the aim of maintaining economic growth, and Mr. Zecchini has emphasized in his statement that GDP grew at a healthy pace under the impetus of domestic demand expansion. Furthermore, Mr. Zecchini stresses that the authorities' intention is to continue growing, taking economic activity in industrialized and developing countries into account. While we attach great importance to this goal, given the rate of population growth in Italy, the high rate of unemployment, and the regional disparity in the labor market, we wonder how sustainable this goal is. Perhaps Mr. Zecchini or the staff would comment on this issue, and how its future evolution is perceived.

In relation to the external imbalances, while several factors contributed to turning the balance of payments into surplus in 1986, the authorities might face serious constraints in maintaining that surplus; the deterioration in the balance of payments evidenced in 1987 is a sign of these constraints. The 1987 outturn is explained not only by the expansion of domestic demand, which affected the trade balance adversely, but also by the appreciation of the lira against the currencies of Italy's main trading partners, especially against the U.S. dollar, and by the increase in unit labor costs in manufacturing. Thus, if trade unions continue demanding salary increases, the narrowing of exporters' profit margins and the authorities' commitment to keep the lira within the EMS may restrain the authorities' margin for maneuver to improve the competitiveness of Italian products. In addition, owing to the expansionary fiscal policy, domestic demand will continue to be strong and, therefore, will create pressure for an increase in imports.

Another problem is the timing of financial liberalization when internal and external imbalances are expected to persist, and probably to deteriorate further, and when trade liberalization has yet to be put fully in place. From the background paper on recent economic developments, it is evident that the degree of volatility of capital movements can be explained largely by the reaction of investors to basic investment principles, namely return, liquidity, and security. The capital account, following the initiation of financial integration and after having been continuously positive during the 1980s, has shifted from a positive amount of Lit 6,200 billion in 1985 to a negative figure of the same order of magnitude in 1986. By the same token, while the authorities moved swiftly to restrain capital movements during 1987, larger capital flows occurred as a consequence of political uncertainty. In addition, the figure for errors and omissions has been negative since 1985. Perhaps the staff or Mr. Zecchini would like to update the information on the final results of the balance of payments for 1987, and comment on how these problems will be corrected in the medium term. It is clear that there will be pressure on monetary management as it aims at a high real interest rate in order to attract foreign savings and to avoid capital outflows.

Finally, I refer to the Italian authorities' commitment in the G-7 communiqué to correct the current account balance and the fiscal deficit in the medium term. The communiqué was issued as a result of international financial instability originating in the stock market crash. One of the main reasons for the outbreak of the crisis was the market perception that the external and internal imbalances of industrialized countries were unsustainable. In view of the political uncertainties surrounding the implementation of sound economic policies, we wonder how the authorities will be able to fulfill their obligations.

Mr. Posthumus made the following statement:

The staff report gives a comprehensive review of the Italian economy, and like Mr. Goos I feel that I have not much to add, other than to make some points of emphasis here and there. I support the staff appraisal.

The market sector of the economy has strengthened considerably over the last years, and many structural improvements have taken place. The authorities' monetary and exchange rate policy should be commended. In this respect, I should like to suggest that, while I agree with Mr. Zecchini's statement that to the extent that the contribution of net exports to GDP growth has been negative, Italy has done its part in fostering international adjustment of current deficits, there is another side of the picture. It cannot be that every country outside the United States with a deficit is fostering international adjustment. The Commission of the European Communities seems to be estimating a deficit of US$5 billion in 1988, and I am not sure that this would be desirable, or welcome to the authorities. Of course, the overall situation should be sustainable; in this case there is a weak spot, the unsustainability of the fiscal situation. We note with satisfaction that the staff accepts Italy's commitment to exchange rate arrangements which do not provide for the use of the exchange rate as an instrument for reduction of a current account deficit, although they do provide for a realignment of currencies.

The scenarios indicate that the noninterest fiscal balance will have to move from -2.6 percent of GDP in 1987 to +3.0 percent of GDP in 1992 to attain a stable relation between government debt and GDP, at a level of 100 percent. Recent developments indicate that the budget for 1988 will not contribute to the attainment of such a target. The Board should express its deep concern about this development. The high level of these deficits, and the required correction, will be a destabilizing factor for Italy itself, which may have effects for other countries closely related to Italy as well, particularly the European Community countries. A structural decrease of expenditure, wage moderation in the public sector, as well as tax increases, are the unwelcome measures needed to prevent an even more unwelcome increase in the destabilizing factors. There may be room for some increase in indirect taxes, in particular.

The size and composition of the public debt will progressively limit the use of indirect instruments in monetary policy. While a flexible interest rate policy is required to support a stable exchange rate, the budgetary costs of any increases in interest rates are a problem. This problem can be alleviated to some extent if public borrowing is being effected on the basis of fixed interest rates, thus shielding the budget from temporary short-term interest rate increases to defend the lira. Do the authorities follow a policy of financing the deficit as much as possible long term? Finally, an improvement in the functioning of the financial markets would also be appropriate, considering the segmentation existing in these markets.

Mr. Ismael made the following statement:

I note that the performance of the Italian economy in 1987 was broadly satisfactory. Both growth and inflation rates were slightly better than in the previous year, while the current account balance, although deteriorating markedly, was still in equilibrium. Nevertheless, as pointed out in the staff appraisal, with which I generally agree, there were disappointing developments in some respects. Inflation stopped declining; unemployment remained high and is, in fact, increasing; and the fiscal deficit, although slightly lower, has nevertheless remained very high.

It is unfortunate that slippages in the implementation of financial policies, together with a relaxed incomes policy, have contributed to a marked deterioration in the current account. At the same time, speculative pressures on the lira have led to a deterioration in the capital account of the balance of payments. Although the imposition of credit ceilings and the tightening of controls over short-term capital flows have been relatively successful in easing the pressure on the external balance, a more lasting solution can only be achieved through a substantial and sustainable reduction in the fiscal deficit. In the absence of significant progress in this area, the burden of adjustment will continue to fall largely on monetary policy. However, its scope and effectiveness has been constrained by the continued increase in the debt burden.

I am encouraged that the authorities have reaffirmed their commitment to a sustained fiscal adjustment effort, with a view to stabilizing the ratio of public debt to GDP over the medium term. To achieve this objective, the authorities would be required to turn the primary deficit into a surplus in the next few years. In light of the limited progress achieved in this area during the past year, much stronger efforts would be needed to obtain the necessary parliamentary support for the introduction of far-reaching corrective measures. In this connection, I welcome the proposed Finance Bill for 1988, which seeks a reduction of the state sector borrowing requirement by 1 1/4 percent of GDP, mainly through revenue-raising measures. While there is some scope to increase revenues, I believe more effort should be made to reduce expenditures, which have continued to stand at more than 50 percent of GDP over the last five years. Moreover, as noted by the staff, some of the revenue measures appear to be temporary and reversible.

It is important to continue a cautious stance for monetary policy, at least until clear progress is achieved in the fiscal area. Like Mr. Goos, I agree with the staff that the authorities should aim at the lower part of the target range for money and credit expansion. In the meantime, I also share the authorities' concern on the distortions brought about by the prolonged use of direct controls on credit and short-term capital flows. As the authorities recognize, however, the abolition of these controls would require an increased flexibility of interest rate policy, with corresponding consequences on government expenditures. This, once again, points to the need for substantial progress in the fiscal area.

The convergence of economic policies and performances of countries within the European Monetary System is very important. In this type of arrangement, the correction of external imbalances cannot rely too much on exchange rate changes alone. Because of the large fiscal deficit and lax incomes policy, it appears that in Italy the burden of external adjustment has fallen too heavily on monetary policy. It is therefore important that a major effort be made to reduce the fiscal deficit and to adopt a tighter incomes policy. I share in particular the staff's view that the public sector should set an example for the private sector in wage settlements.

I support the staff's recommendation on the need for structural measures to improve the functioning of the labor market so as to reduce unemployment. In addition to various measures suggested by the staff, I would also like to urge the authorities to provide a supportive environment for small-scale enterprises, which have been much more successful in creating employment compared to the larger ones. I join the staff in urging the authorities to support an early and comprehensive review of the European Community's Common Agricultural Policy (CAP). As the recent departmental memorandum entitled "The *Common Agricultural Policy of the European Community* - Principles and Consequences" (DM/88/1) confirms, neither the members of the European Community nor the rest of the world benefit from this policy.

Mr. Enoch made the following statement:

Developments in the Italian economy in 1987 seem to represent something of a paradox. Judged by many of the typical indicators, the economy had a very good year. Growth was strong, inflation fell somewhat, thus bringing about a further improvement in Italy's comparative inflation performance, and the current account remained in equilibrium. Important though these achievements were, economic prospects continue to be overshadowed by the very large fiscal imbalance and the associated rise in the stock of domestic debt, which has risen from 54 percent of GDP in 1980 to almost 100 percent last year.

Despite the authorities' continued efforts to cut the deficit, including the package of revenue measures introduced at the end of August 1987, the deficit fell only modestly last year. When account is taken of the relatively strong growth performance, the underlying deficit may actually have widened. Although the conclusions of the staff's medium-term scenarios must be taken with due caution, as Mr. Zecchini points out, they do emphasize that the present position is unsustainable. Resolute fiscal action will be needed, preferably sooner rather than later, if a further sharp rise in the debt burden is to be avoided. There clearly is a risk in present circumstances that the rising debt burden will become self-reinforcing, as the growing debt stock puts upward pressure on interest rates, and hence back on the fiscal deficit.

In tackling the deficit, the staff argues that revenue-raising measures should play an important part. True; but I doubt whether the taxation levels in the other European countries should be regarded too closely as role models. Several of these countries, including my own country, are currently making strenuous efforts to reduce the burden of taxation, in part because they are concerned that the present level may be damaging supply-side performance.

I would therefore place considerable emphasis on the importance of more effective expenditure restraint. One area that might have justified closer examination in this connection was the public enterprise sector. Although this sector's overall financial performance has improved significantly in recent years, on some occasions the Central Government has provided very substantial financial support. I was therefore sorry to see that the authorities' divestiture program has been only modest. I had some sympathy for the staff's view that it would be worth increasing the transparency of policies in this area, by placing greater emphasis on direct budgetary support and less on influencing the pricing and investment decisions of those industries.

Cautious monetary policies have been largely successful in improving Italy's inflation performance in recent years. It is clear, however, that the fiscal imbalance places an enormous burden on monetary policy. The fact that the monetary authorities will have to issue paper equivalent to about 40 percent of GDP this year is perhaps a measure of the scale of the problem, as is the upward pressure on real interest rates. I note that there was some evidence of "round-tripping" at times last year, and would be interested in any comments from Mr. Zecchini or the staff as to why bank liquidity was allowed to expand until it brought about the structure of interest rates that made such operations possible and profitable. Despite this sometimes difficult background, the monetary authorities are continuing to liberalize the financial system ahead of the further integration of the European market in 1992. We were encouraged to see that they are planning to allow the present system of credit controls to lapse shortly. They are also continuing to ease the capital control regime. But surely the process of liberalizing the financial system would be greatly aided by more rapid progress on the fiscal front. The Italian authorities seem to recognize this clearly enough, but as Mr. Zecchini says in his statement, their efforts to bring the growth of public expenditure under control "have been thwarted by the orientation of Parliament."

Turning briefly to trade issues, I welcome the authorities' restatement of their continued commitment to liberalization of the international trading system, as well as to the reform of the Common Agricultural Policy.

Lastly, on structural policies, I note that there were signs last year of rising demand pressures within the economy, as the level of capacity utilization was higher than at any time since the previous cyclical peak. As in many other European countries, it is worrying that the economy can show signs of at least nearing its capacity constraint while unemployment is so high. I would again agree with the staff, therefore, on the importance of continuing with the process of structural reform by increasing the flexibility and responsiveness of the labor market.

To conclude, the Italian economy continues to perform well in many areas. Despite this performance, it is clear that the continuing fiscal imbalance constitutes a major threat to the future of the economy. It will also make the process of completing the integration of the Italian economy with those of other European countries that much more difficult. The need for action in this area is well known to the authorities, and I hope that the necessary political will can be found to put the required measures in place. In the meantime, monetary policy will face a difficult task in seeking to achieve the orderly financing of the budget deficit while at the same time retaining control over inflation.

Mr. Massé made the following statement:

The Italian authorities have made significant progress during the past few years in reducing the rate of inflation and in eliminating a sizable current account deficit, without sacrificing continuous economic growth. This progress is not only commendable, but also enviable. While it is clear that the improvements were facilitated in large measure by positive external developments, we also recognize the role played by the implementation of a number of appropriate economic measures. Nevertheless, it was hoped that the authorities would take greater advantage of the opportunities afforded by the favorable external developments to set a firm base for a sustained improvement in the domestic economy, particularly with respect to the fiscal deficit and the high unemployment rate.

Although strong growth continued in 1987, developments in a number of other areas were somewhat disappointing. The consumer price index, in part fueled by the overheating economy, began creeping up gradually in the course of the year, and remains significantly above the average for the Group of Seven countries. There was a marked deterioration in the trade balance despite improvements in the terms of trade, although the current account remained almost in balance. The already high unemployment rate rose further, but the most disappointing development during this period was on the fiscal front, with the Government significantly overshooting the fiscal deficit target, despite higher than projected revenue growth.

As both the staff and the authorities have indicated, the fiscal deficit remains the central problem facing the Italian authorities. Some progress has been made in reducing the general government deficit as a percentage of GNP from the high attained in 1985. Nevertheless, there was considerable slippage in the implementation of budgetary policy in 1987. Despite some corrective measures undertaken in the summer, we were disappointed to see the state sector borrowing requirement exceeding the initial target by 1 percent, reaching almost 12 percent of GDP. However, we would like to take this opportunity to commend the authorities on more than doubling official development assistance in the midst of their deficit reduction efforts. This should be an example to a number of us.

In view of the above developments, we are encouraged by the measures that the authorities outlined in their initial 1988 Finance Bill to reduce the state sector borrowing requirement. However, the improvements planned for 1988 appear rather uncertain, as only recently a government crisis threw the passage of the 1988 Finance Bill into doubt. We share the staff's view that further slippages in the implementation of fiscal policy must be avoided, and contingency measures should be made ready in case of expenditure overruns in the course of the year. This is essential in light of the difficulties the authorities have had in the past in reaching the fiscal target, and as a result of the existing high level of uncertainty in the external environment. The authorities could gain some room to maneuver by moderating wage increases in the public sector, the single largest employer in the country.

The constraints placed upon monetary policy by the large fiscal deficit have resulted in the maintenance of high real and nominal interest rates. We agree with the staff that even if the interest rates of Italy's trading partners decline, interest rate policy in Italy will continue to be constrained by the size of the state sector borrowing requirement.

We feel strongly that the conduct of monetary policy will be facilitated by a continuation of the movement toward increased reliance on indirect instruments of monetary control. A great deal of progress has been made in this area since 1983, and it is with some concern that we view the decision to reintroduce direct controls on credit and short-term capital flows in September 1987. While we recognize that the controls are scheduled to be removed in March 1988 and that, in the authorities' view, the pressure for such action was primarily speculative and transitory, it may set back the process of the instrumentation of monetary policy. This process takes on more urgency as the financial system is progressively integrated into the European financial system. We welcome the decision taken by the authorities at the end of January to abolish, two months before the expected date, controls over currency financing of imports and exports and the period of time during which foreign currencies can be held.

The continuous increase in the already high level of unemployment, despite the relatively strong economic growth over the past few years, remains a serious concern. We urge the authorities to adopt measures to alleviate this situation promptly. Such measures would aim at reducing labor market rigidities, as indicated in the staff report, and lower the cost of labor. However, we would caution the authorities about undertaking large public investment programs that would further exacerbate the fiscal deficit.

On the exchange rate, it had been hoped, when the European Monetary System was created in 1979, that Italy's policy and economic performance would converge faster with that of the rest of the European Community, and that the lira band would be readjusted from 6 percent to 2.25 percent, as for most other currencies. Yet it remains 6 percent. We agree with the staff and the authorities that an early resumption of the process of convergence of Italy's economic performance with its main trading partners is essential. However, in light of the most recent data, despite some slowdown in domestic economic activity, economic growth is likely to outpace that in Italy's major trading partners. Perhaps if Mr. Zecchini could comment on whether the relatively high growth in Italy is due to some innate structural advantages in the economy. We would also be interested in hearing of the Italian authorities' plans to help reduce trade impediments inherent in the European Community's Common Agricultural Policy.

Finally, there has been some interesting discussion recently of the size and strength of the parallel economy. Further staff work in this area might be of interest, as would the staff's views on the actual size of the parallel economy.

Mr. Marcel made the following statement:

Had the consultation with Italy taken place as scheduled in mid-1987, the assessment of the economic situation would certainly have been quite favorable. The stabilization policy, which the authorities have carried out steadily since the beginning of the 1980s, led to some very positive developments in 1986 with respect to the level of activity, the deceleration of inflation, and the strengthening of the external position.

However, for various reasons, it was difficult to maintain this policy stance in 1987. The lack of progress was most noticeable in the fiscal and price areas, while the current account position deteriorated. As noted by Mr. Zecchini in his statement, the latter development must be seen as a significant contribution to the correction of external imbalances among G-7 countries. However, Italy will be in a better position to play an active role in the G-7 coordination process if it pursues its stabilization efforts, especially in the fiscal area.

As in some other European countries, the management of public finances is severely limited by prevailing political conditions. Nevertheless, the staff's medium-term scenarios point clearly to the serious risks associated with a steady increase in the public debt to GDP ratio. The authorities should thus make a rapid elimination of the primary deficit their central objective. The budget proposals for 1988 go in this direction, and we hope that the higher value-added tax (VAT) rate and reduced social benefits will result in increased revenues. However, in light of the ongoing government crisis, the staff's suggestion concerning the preparation of contingency measures appears largely warranted. One possibility would be to bring social security contributions more in line with the corresponding social transfers.

The authorities should spare no efforts to avoid the expenditure overruns which occurred last year. Tighter controls over wage settlements in the public sector will be crucial, not only from a fiscal viewpoint but also in order to prevent any slippages in unit labor costs. The authorities should also envisage taking preventive action to forestall any widespread reactivation of indexation mechanisms. This action would be all the more necessary if, as suggested by the staff, increases in public utility rates were to be more in line with price developments. Such an approach would go a long way toward alleviating the amount of transfers from the Central Government to state-owned enterprises. Perhaps Mr. Zecchini or the staff would also like to comment on the feasibility of a privatization program. Appendix III of the background paper on recent economic developments analyzes some of the developments in the public enterprise sector. Recently, various forms of privatization have been introduced on a very limited scale; it would be interesting to have a more precise idea of the potential contribution of public assets sales to the reduction of the public debt stock.

I would like to highlight some of the constraints under which the authorities must formulate monetary policy. Although the monetary stance has been fully satisfactory recently, last year the relative deterioration of public finances and buoyant private demand resulted in a rather strong domestic credit expansion. This led the authorities to temporarily reintroduce direct controls; given the already high real interest rates and the present level of public debt, there were some obvious limits to a flexible interest rate policy.

The prospect of free capital flows within the European Community by 1992, and the increased variability of interest rates which is likely to follow, should prompt the authorities to address a few structural weaknesses which remain, despite the 1981 separation of the Bank of Italy from the Treasury. First, the staff report mentions a central bank overdraft facility which can be used to automatically finance a significant portion of public expenditures. A gradual discontinuation of this facility would allow the central bank to regain a tighter control over the monetary base. Such a change should be greatly facilitated by the measures which the authorities are now envisaging to improve the working of the secondary market for Treasury securities. Actually, a more efficient market, coupled perhaps with a further diversification of public debt instruments, should allow public borrowing requirements to be covered on more competitive terms.

Appendix IV of the background paper on recent economic developments also raises the issue of monetary targeting. It is argued that M3 bears a more stable relationship to income developments and better captures portfolio shifts. This would support the view that the authorities should substitute M3 for M2 as the basis for the target range. To the extent that both the French and German authorities have recently been facing the same problem, I would appreciate any comment Mr. Zecchini may have on this point.

The reference to European partners gives me an opportunity to raise a ritual but very important question about the European Monetary System. Italy still avails itself of wider fluctuation margins for the lira within the exchange mechanism, although it tends not to use them fully. Could Mr. Zecchini clarify his authorities' intentions regarding their eventual full participation in the EMS?

Let me touch briefly on the revision of the Italian national accounts. It appears clear from the description given in

Appendix I to the background paper on recent economic developments, that in terms of demand components, the bulk of the upward revision of GDP figures for 1980-85 is attributable to a much stronger investment rate. On the supply side, the counterpart of this high level of value added is to be found mainly in the service sector, and to a much lesser extent in industrial production. However, the common view holds that industrial activities are generally more capital intensive than services. Therefore, one may wonder whether the supply and demand sides of the revision are consistent. Perhaps Mr. Zecchini or the staff could clarify this point.

I have one additional comment on the various factors responsible for the upward revision of GDP figures. At first glance, the inclusion of the underground economy accounts for only one third of the revision. However, if the activity of small firms is equated with the hidden economy, the overall contribution of the underground economy accounts for more than three quarters of the adjustment. It thus seems that a better assessment of the informal sector is the main factor behind the revision of the national accounts figures.

In conclusion, I have no doubt that the Italian authorities are determined to adhere to a firm policy stance, even if 1988 turns out to be difficult. My authorities are convinced that the Italian authorities will meet the commitments set forth in the last G-7 communiqué. Italy will then contribute to the strengthening of the convergence of the European economies.

Mr. Salehkhou made the following statement:

During the last Article IV consultation with Italy, Directors expressed their concern about the slowdown in the rate of overall improvement in Italy's economic performance during 1985. It was envisaged that implementation of the adjustment program set for 1986 would boost the economy by way of a recovery in GDP growth, restoration of the current account balance, a curbing of inflationary pressures, reduction of the public sector deficit, and a reduction of labor costs through moderation of the wage indexation system, or "scala mobile." The staff papers and Mr. Zecchini's statement convey the impression that the program was well-planned and the implementation was relatively successful, thanks, inter alia, to the then favorable external conditions, including declining oil and commodity prices.

On the positive side, the rate of increase in consumer prices decelerated, the deficit on the current account of the balance of payments turned into surplus, the general government balance as a percent of GDP improved slightly, wage increases and unit labor costs in manufacturing were moderated, the state sector borrowing requirement was reduced by 2 percentage points, to 12 percent of GDP, and the rate of growth of domestic credit to the state and nonstate sectors (21.8 percent and 12.9 percent in 1985, respectively), declined to 17.6 percent and 11.5 percent, respectively, in 1986. Less positively, total domestic demand increased slightly, and the level of outstanding government debt increased from 85.8 percent of GDP to 90.3 percent.

It was hoped that the overall achievements of 1986 would be further consolidated in 1987, and would set the stage for the convergence of Italian economic performance with that of its main industrial country partners. Regrettably, this outcome did not materialize. Constraints in the operation of monetary management appeared, and loosening elements in the projected implementation of financial policy emerged. The decline in oil prices, which in 1986 had contributed to the good performance of the adjustment program, came to an end, causing further deterioration in the external accounts in 1987. Furthermore, a strong increase in the growth of total domestic demand in 1987, clearly aggravated by the authorities' pursuit of an expansionary monetary and financial policy, caused another setback to economic performance. To cope with this, the authorities embarked on a new package of additional corrective measures, including tight control of the flow of funds from the Central Government to public entities and curbs on their expenditure growth, and a tightening of liquidity in the banking system. The timing and effectiveness of these additional measures, however, proved inadequate to improve the economy's performance sufficiently.

Regarding monetary policy, the level of bank deposits and outstanding loans increased, and the Treasury's financing expanded. On incomes policy, domestic demand increased further following the rise in labor costs resulting from wage contract renewals, contributing to inflationary pressures. Export profitability fell, thus leading to a further decline in the level of foreign reserves. These developments showed clearly the distorting forces of excess domestic demand on the economy's performance, and proved that attainment of a full recovery in the current account and the maintenance of a stable general level of competitive prices are conditional upon the alignment of the growth rate of Italy's domestic demand with that of its major industrial partners. Against this background, the Italian economy's performance in 1987 appears, on the whole, rather disappointing.

The adjustment policy objective set for 1988 is encouraging. On the financial side, the policy initiated in August 1987 is to be continued in 1988. This calls mainly for a further decline in the state sector borrowing requirement and a deceleration in the growth rate of domestic credit. As to incomes policy, the intended ceilings on wage increases of 5-5 1/2 percent will hopefully have the effect of alleviating pressures on labor costs. Regarding the policy of wage determination, I endorse the staff recommendations that a more flexible employment and wage determination policy be pursued, and industrial strike actions be prevented by way of an orderly settlement of labor disputes. In this regard, I note that the authorities are striving to reach agreement with the labor unions on measures aimed at easing some labor market rigidities, as Mr. Zecchini confirms. The gravity of the problem is such that the staff is calling for "legislation" aimed at an orderly settlement of labor disputes and at halting the proliferation of work stoppages, which have plagued Italy in recent months. I wonder if the staff could enlighten us as to the effectiveness of similar legislation in reducing labor disputes and high unemployment rates in Italy's partner countries.

While I commend the authorities' efforts in this respect, they may find it advisable to study seriously the existing and increasingly popular alternatives to the traditional fixed wage system. The rigidities inherent in the traditional system appear to have caused tremendous problems in terms of labor conflicts and high unemployment rates, not only in Italy but in the majority of European Community members. Given the long duration of these problems, to the extent that they are becoming permanent features of these economies, study of viable alternative systems, including what has become known as "the share economy," which is proving most effective in countries where it has been implemented, is indeed called for.

The fiscal policy design for 1988 encompasses a package of corrective measures calling for an increase in revenue and a cut in both noninterest current expenditure and in the state sector borrowing requirement; this package is of utmost importance for overall improvement in the economy.

As to the external position, given the anticipated sustained growth in domestic demand and output during 1988, a deficit in the current account of the balance of payments now seems inevitable. The latest forecast of a deficit on the order of 1/3 percent of GDP in Supplement 1 of the staff report appears reasonable. Also, the authorities' recent drive to relax foreign exchange restrictions and to adopt a more liberalized stance is commendable, and, as the staff has rightly stated, this will place Italy in line with the liberalization requirements of Italy's trade partners.

While a well-managed, direct credit policy, such as direct control on the domestic credit ceiling, has proven to be a very effective tool of monetary management, I am not sure if I can agree with the authorities on their firm intention to abolish the use of a fixed credit ceiling at the end of March 1988, and to rely more on interest rate policy instead. Notwithstanding my own misgivings about the interest rate as a proper monetary instrument, it is universally accepted that monetary policy is best effected when a number of tools, including both direct and indirect instruments of monetary control, are relied on. Given the size of Italy's public debt (on the order of 90 percent of GDP), making direct use of interest rate variations and/or increasing the interest rate and/or yield on Treasury paper in pursuit of a contractionary monetary policy may prove very costly and counterproductive in the long run. It would be helpful to hear the staff's views on that point.

Regarding international trade, while I share the staff's views, it is very disappointing that Italy has not yet lifted all trade barriers. I am heartened by Mr. Zecchini's outright condemnation of protectionist policies in all European Community countries, including Italy. However, by intensifying its restrictions on imports from developing countries, Italy is adhering to the same restrictive policies adopted by other major European Community partners, especially with regard to the Community's Common Agricultural Policy. In this connection, I note once again that the staff mission to Italy is comprised, with one exception, of staff members all from the European Department, with no representative of the Exchange and Trade Relations Department. This seems to be characteristic of missions to other industrial countries, while I can hardly recall any Fund mission to a developing country where the Exchange and Trade Relations Department was not represented. I wonder whether the trade restriction policies of industrial country members have any less impact on world trade than those of developing countries. I would be very interested in hearing exactly what the Fund's policy is in assigning representation of the Exchange and Trade Relations Department in staff missions.

Finally, while I commend the authorities for nearly doubling their official development assistance in 1986 to 0.40 percent of GNP, and maintaining that percentage in 1987 despite their deficit reduction efforts, I note that this still falls far too short of the UN target of 0.7 percent of GNP. Given Italy's trade and other relations with the developing world and its membership in the group of the seven largest industrial countries, one is to expect and hope that its contribution to official development assistance would be compatible with its weight in the international economy.

Mr. El Kogali made the following statement:

The major economic indicators reveal that, compared with the marked improvement that characterized the first half of the 1980s through 1986, the performance of the Italian economy in

1987 was mixed. While output expansion continued at a rate exceeding that of its major trading partners, the process of reducing the rate of inflation came to a halt, and unemployment increased.

The current account position, although virtually in balance, represented a significant decline from its surplus position in 1986, despite some improvement in Italy's terms of trade. While this could have been due to the slow growth of demand in its major trading partners, it could also indicate a loss of competitiveness on the part of Italy's export sector. In this context, the staff has made a number of recommendations, including the need to implement an appropriate incomes policy to effect wage moderation in an effort to enhance the economy's cost competitiveness. The proliferation of work stoppages and the demographic and geographic structure of unemployment suggest an underlying weakness in the functioning of the labor market, and hence the need for further action to strengthen the market and improve labor productivity.

It is unfortunate that fiscal policy was allowed to suffer from prolonged legislative difficulties and government crises, with the result that measures initially announced to restrain public expenditure were not fully implemented in the first half of 1987. This meant that an opportunity was missed to reduce expenditure substantially at a time when revenues were somewhat buoyant. Although the 1988 budget proposal reflected a tight fiscal posture to restore the initial thrust of the measures, the collapse of the Cabinet, another unfortunate incident referred to in Mr. Zecchini's introductory statement, is likely to further delay implementation. Otherwise, the package would have helped to re-establish the 1986 adjustment momentum by reducing the fiscal deficit, thereby restraining inflationary pressure. Much, of course, will depend on strengthened budgetary control and strict adherence to expenditure targets. I agree with the staff that there is a need to complement the fiscal measures with realistic pricing policies to enhance productivity and efficiency, especially in the public enterprises.

I note that the illustrative scenarios provided by the staff for the period ahead imply that there is the need to sustain the fiscal adjustment effort beyond 1988. I share the view that fundamental reforms in the management of public enterprises are necessary, and that, given the relative inflexibility of much of public expenditures, the focus of fiscal policy should be directed mainly at revenue generation. As a member of the EMS, there might not be much room for maneuver to use the exchange rate of the lira to achieve the depreciation required to boost exports and moderate imports. In the event, fiscal policy and structural reforms would, perhaps rightly, continue to bear most of the burden of adjustment.

I commend the Italian authorities for their continued efforts in raising official development assistance that in 1986 witnessed a doubling of net disbursements. The aid budget, which included emergency operations for food relief to some of the countries in my constituency, was expanded further in 1987. It is worth noting that once funds are committed, the Italian authorities attach considerable importance to timely disbursement, as do the authorities in the recipient countries. My authorities wish to express great appreciation for these efforts.

Mr. Santos made the following statement:

It is evident from the staff papers and from Mr. Zecchini's statement that economic and financial developments in Italy were, in some respects, less favorable in 1987 compared with 1986. With some external input costs no longer falling, and an upsurge in domestic demand, inflationary pressures re-emerged. Also, unemployment continued to rise, and the external current account surplus was reduced. Against this background, I share the staff's view that the progress being made toward a convergence of the Italian economy with the economies of the other major European Community industrial countries appears to have slowed.

Concerning fiscal policy, the major issue confronting the Italian authorities is how to achieve a significant reduction of the fiscal deficit and how to moderate its adverse impact on the large and expanding public debt, thereby reducing the burden of interest payments. In this context, I note that the latest information provided by the staff indicates that the positive elements in the 1988 Finance Bill are not likely to be implemented, and as a result the fiscal target for 1988 might not be achieved. There is a need to resolve the present problems confronting the Italian authorities in the public finance area. However, as Mr. Zecchini has stated, "the room to dodge socially and politically difficult choices for their solution has become very narrow." In any event, because of the uncertainties surrounding the execution of the budget, I would endorse the staff's recommendation that contingency measures that could be implemented promptly be put in place, to accommodate possible future expenditure overruns.

With respect to monetary and credit policy, the apparent lack of progress in restraining the growth of the fiscal deficit is bound to make the conduct of monetary policy much more difficult. Again, as indicated in the supplement to the staff report, domestic credit expansion in 1987 exceeded its target, reflecting the impact of budgetary overshooting. Indeed, a strong monetary policy stance is needed to support incomes policy and improve the economy's competitiveness. In the meantime, the institutional changes that are being introduced to improve the structure of the domestic financial market should help in the smooth financing of the public debt.

The efforts that have been made recently to improve the functioning of the labor market are commendable, although additional steps are necessary to ensure further progress, as the staff has indicated. In this regard, the authorities' efforts to reach an agreement with the unions on ways to ease some of the labor market rigidities, as indicated by Mr. Zecchini, are encouraging.

In the external sector, I welcome the abolition, well ahead of schedule, of the exchange control measures introduced *last September to curb speculative capital outflows through* leads and lags. I also welcome the specific measures aimed at the liberalization of the exchange system that are expected to be implemented in 1988.

Finally, I note that despite the problems confronting the Italian authorities in the fiscal area, Italy's official development assistance has increased rapidly in recent years. Italy's efforts in this regard are very much appreciated, and as Mr. Massé has pointed out, they could serve as an example to some other industrial countries.

Mr. Al-Assaf made the following statement:

Italy's economic performance over the last few years has been very impressive, especially when compared with that of its main trading partners. However, the previous years' successes were not repeated in 1987.

Several areas of disappointment can be identified, including an increase in inflationary pressures, a weakened balance of payments, and, most important, progress toward a reduction of the state sector borrowing requirement was less than expected. Thus, the margin of maneuver available to the authorities in 1988 is smaller than a year ago or so. This new situation makes determined action in the fiscal field more urgent. The consequences of insufficient progress on that front are made clear in the first of the staff's two medium-term scenarios. In this respect, it is a matter of some concern that a compromise on an appropriate Finance Bill for 1988 has not yet materialized. The latest indications provide little encouragement about the chances for a full approval of the initially proposed measures. Although it does not seem to be clear at this stage whether the 1988 budget will provide for any significant widening of the tax base, I hope that ways will be found to implement in 1988 the planned increase in rates that had to be canceled last year.

A second area of concern is that a further reduction in the state sector borrowing requirement will depend, in part, on the implementation of a number of measures designed to contain or control expenditures. Mr. Zecchini has confirmed that a number of provisions aimed at a better control of expenditures have been overturned recently by Parliament. I am not sure, however, about the final status of these decisions, and whether a compromise is still considered possible. I would appreciate clarification on this point.

Under these circumstances, and even assuming a favorable outcome for the Finance Bill, one must agree with Mr. Zecchini about the seriousness of the dilemma, and the challenge facing the monetary authorities. One element, of course, is closely tied to the smooth refinancing of the public debt. A further complication results from the ability of a substantial share of business borrowers to meet their financing needs outside the banking system. In this respect, I would be interested to know if the present process of modernization of the financial system, and financial innovation in general, will, on balance, contribute to making the task of the monetary authorities easier. In particular, is it likely to improve the maturity structure of the debt, or make the financing of new debt easier? Also, I would be interested to know to what extent greater competition in the banking industry could translate into lower interest rates.

Another issue of major importance, for the near term at least, is the recently emerging external constraint on growth. It seems that the strength of domestic demand is responsible for a sizable share of the deterioration in the trade balance.

The scope for a substantial improvement on the export side is not very clear. The main obstacle here seems to be the rather subdued economic performance of Italy's main trading partners. Prospects for a pickup in activity in these countries appear limited. In fact, the release of the latest growth estimates of the European Community for its member countries seems to reinforce the views of those who think that growth prospects are not as good as had been expected.

Any assumption of a strong surge in Italian exports would therefore have to rely on the ability of Italian industry to increase its existing market shares and penetrate new markets. The capacity of the Italian industry to do just that should not be underestimated, of course. However, three factors could play a negative role. The first factor is that Italian exporters may have reached a stage at which many of them could find it difficult to maintain or increase market shares through a further compression of their profit margins. The second factor is that the Italian lira, in the recent past, has shown a tendency to trade in the lower half of its fluctuation range in the EMS;

this would seem to imply that the margin of flexibility offered by the arrangement is narrowing. The third and final factor reflects the view that domestic demand will tend to remain quite strong in 1988, a view that was reinforced by the Government's present difficulties in obtaining the necessary support for the Finance Bill.

In the final analysis, that is why improvement in Italy's external accounts in 1988 and beyond may have to depend on sustained increases in external demand. However, this may require a fuller use by those industrial countries in a position to do so of their idle production capacity. It would also imply an intensification of efforts against protectionism, as well as a faster resorption of large trade surpluses where they exist. These are issues to which our Article IV consultation process should make a useful contribution, and I hope it would also benefit the Italian economy, in due course.

Finally, I join Mr. Massé and others in congratulating the Italian authorities for the substantial increase they have made in their official development assistance, despite their domestic financial difficulties.

Mr. Lim made the following statement:

We thank Mr. Zecchini for his very informative statement, and are encouraged by his authorities' resolve to take decisive action to redress the fiscal imbalance and to move toward a more market-oriented monetary policy, and by the reaffirmation of their commitment to a more liberal exchange and trading system. We are in general agreement with the staff assessment that Italy needs to concentrate on demand management policies. We note that the disequilibrium in public finances has worsened sharply in recent years, with public sector debt rising to 90 percent of GDP toward the end of 1986. In 1987, financial and wage policies were loosened and domestic demand grew more rapidly than in Italy's industrial trading partner countries

We recognize that fiscal, monetary, and wage policy restraint holds the key to arresting the possible deterioration of the current account, and would be consistent with the need to address Italy's growing public sector debt. On fiscal policy, we endorse the staff's emphasis on the need for expenditure restraint in the adjustment process. In this regard, we note with concern the persistently high ratio to GDP of state sector expenditure, and the rapid increase in the ratio of the public sector deficit to GDP. These ratios are clearly symptomatic of a structural weakness which needs to be addressed as a matter of urgency. Tax reform could also assist fiscal adjustment. The question is whether there is the necessary political will and whether it can be sustained. In this regard, we view with concern the failure of the 1988 Finance Bill, which incorporates important tax reform and expenditure control measures, to receive parliamentary approval. This may derail not only the immediate objectives for 1988, but the medium-term objectives as well.

We agree with the staff that the authorities' freedom to maneuver on monetary policy has been constrained by Italy's need to finance a large public sector borrowing requirement. While there have been moves to deregulate Italy's financial sector, the monetary policy constraints gave rise to a reintroduction of direct credit controls in 1987. We are therefore encouraged to note in Mr. Zecchini's statement that his authorities do not intend to extend the credit ceilings beyond March, as they are aware of the distortions they create.

We share the staff's regret at Italy's lack of progress in reducing trade barriers, and support the staff in urging an early and meaningful review of the European Community's Common Agricultural Policy. In an environment calling for fiscal restraint and structural adjustment, the lack of progress on the Community's costly and distorting agricultural policies is clearly counter to the members' own economic interests, and is damaging to commodity exporting countries outside Europe as well.

Finally, we agree with the authorities' view that prospects for 1988 and beyond depend to a great extent on the containment of price and cost increases in Italy within the European average, and on a significant and sustained reduction in the state sector borrowing requirement. We reiterate our support for the authorities' commitment to free and fair international trade.

Mr. Fogelholm made the following statement:

Last year Italian economic performance was not as balanced as it had been in previous years. While growth of GDP, at least according to staff statistics, surpassed growth in other G-7 countries, domestic demand grew at an even faster rate. Inflation and unemployment remain high, and it appears that the fiscal deficit did not decrease, if the gains from the lowering of interest rates are taken into account. Escalating wages contributed to the relatively high rate of inflation, which, in turn, weakened the competitiveness of Italian exports. However, increased productivity in the industrial sector counterbalanced some of the negative trend, as did the favorable development in the terms of trade and reduction of interest rates.

An unstable political situation was, no doubt, responsible for the lack of stabilization measures in 1987. In particular, appropriate fiscal measures would have provided a stronger base for the economy in 1988. In general, it is unfortunate that the authorities have not been able adequately to take advantage of the favorable economic conditions during the last four or five years.

I very much endorse the staff's view that the financial integration to be completed within the European Community by 1992 should encourage the authorities to adopt firm economic policy objectives for the medium term, as it is evident that the Italian economy will have to adjust to quite a different and more competitive economic environment. In this context, the inflation differentials and the high public sector deficit, compared with other European Community countries, are of particular concern. In this connection, I join other Directors in welcoming the relaxation of exchange restrictions that are to take effect in October 1988.

We also agree with the staff that public sector management is the major problem area. The authorities have not been able to curtail the persistent fiscal deficit, even though they are undoubtedly aware of the necessity of fiscal realignment, and they should, indeed, be commended for the initiatives taken in the proposed Finance Bill for 1988. However, as we have seen in the supplement to the staff report and in Mr. Zecchini's statement, hardly any of the proposed expenditure cuts were approved. These expenditure reductions themselves were hardly sufficient to bring about a substantial improvement in the fiscal position.

As currently there seem to be major political difficulties in constraining fiscal expenditure, we would like to stress the importance of introducing new revenue measures in order to improve the fiscal stance. Alignment of the tax structure with the tax structures of its European Community partners, and a broadening of the existing tax base, would seem to be appropriate policies upon which to embark.

The restructuring of the state enterprises in Italy has been impressive in recent years. Productivity has increased considerably, and subsidization is today of a minor magnitude compared to earlier years. However, an unrealistic public enterprise tariff policy remains a source of concern. The authorities' attempt to restrain the enterprises' pricing policy can perhaps be seen so far primarily as a counterinflationary measure, rather than as a serious effort to increase productivity and managerial efficiency. For many of these enterprises, gains from increased competition could be exploited in order to achieve productivity and efficiency.

It is pointed out by the staff that the Italian authorities have made little progress in recent years in reducing trade barriers. I believe that the issue needs some further elaboration by the staff, as Mr. Zecchini disputes that assessment.

Finally, a remark on the statistics. I read with interest about the revision of the Italian national accounts in the supplement to the report on recent economic developments. This revision has resulted in major upward corrections of, inter alia, GDP, domestic consumption, and especially, gross fixed capital formation. The authorities claim that the revision has improved the international consistency of Italian statistics. Nevertheless, a question is to what extent these new figures really are comparable and, indeed, compatible with those of other countries, in particular, in view of the fact that they include a part of the so-called "black economy," which certainly is prevalent in many other countries as well. Like Mr. Massé, I would appreciate a comment by the staff on that issue.

Mr. Templeman made the following statement:

At the time of the last Article IV consultation with Italy, we were able to look back on Italian economic performance with admiration, because of the substantial progress which was being made in reaching economic convergence with Italy's major trading partners. Indeed, in some areas performance was better than average. For example, economic growth was quite high, inflation and the inflation differential were coming down, the current account of the balance of payments was strengthening, progress had been made in reducing the rigidities in wage formation and the rate of increase in labor costs, and the industrial structure was being modernized. Some progress was also evident in bringing down the very high fiscal deficit and the very negative public savings rate. Unfortunately, developments in the course of 1987 and into early 1988 indicate that progress in some areas has been slowed, and even reversed.

As noted by some other Directors, part of the problem is due to a faster pace of growth of domestic demand in Italy than in some other parts of Europe, so that economic growth is being constrained by the external environment. But there are also important problems in terms of domestic policies. Given the very high unemployment rate, relatively fast growth is required. Yet, Italy is now faced with a need to contain the growth of domestic demand more in line with that in partner countries, so as to avoid generating an unacceptably high current account deficit and dependence on foreign savings. An alternative would be to generate larger domestic sources of savings to finance investment and growth at a higher level than elsewhere. Given the high rate of household savings in Italy, the latter approach might be a credible one. However, so long as very large public dissavings absorb a major part of private savings, such a scenario is not likely to materialize.

Concerning specifically the fiscal situation, the steady rise in the public debt, the overrunning of the 1987 fiscal target for the state sector borrowing requirement, and continued uncertainty about passage by Parliament of a 1988 budget which would contribute to fiscal adjustment, are particularly disturbing developments. We appreciate the effort made in the fall of last year, both in the fiscal and in the monetary area, to try to correct the too rapid growth of domestic demand. Unfortunately, some of the fiscal measures taken were of a one time or temporary nature, and the current watering down by Parliament of the proposed 1988 budget measures add to our concern. We strongly endorse the staff's urging that every effort be made to avoid erosion of the fiscal adjustment effort this year. Finally, if a consensus is to be formed to correct Italy's grave fiscal problems, it is particularly important that political leaders and the general public be made fully aware of the extent to which the steady growth of the interest payment burden will increasingly limit the authorities' freedom to use fiscal policy for priority economic and social objectives in the future, and of the likely adverse effects on private investment, growth, and job creation arising from the need to maintain high interest rates to permit the financing of such large deficits.

The staff's medium-term fiscal scenarios provide ample evidence of the gravity of the fiscal situation. Even under the sustained adjustment scenario, the stabilization of the public debt ratio would only occur at over 100 percent of GDP, and this would depend upon a further rise in the tax ratio to nearly 40 percent of GDP. While this figure may be close to the European Community average, like Mr. Enoch, I question whether this is a desirable benchmark in terms of its effects on incentives. The staff report also cites a number of areas where structural reforms in the fiscal area are still needed, such as: in the public administration and public enterprises; in the social benefits structure; and with regard to local and regional government finance. While the staff report alludes to plans to present an overall pension reform to Parliament this year, recent action by Parliament to increase pension costs, as cited in the supplement to the staff report, is not a good sign.

The need to facilitate the financing of large fiscal deficits continues to restrict the freedom of the monetary authorities in the exercise of monetary policy. Even the typically prompt, innovative, and flexible employment of monetary instruments by the Bank of Italy will be inadequate in the face of continued large fiscal deficits. The interruption of the general move toward greater use of market-oriented monetary tools last year, in the form of the temporary reimposition of direct credit controls, is an unfortunate example. We hope that efforts to expand and modernize financial markets can proceed, notwithstanding the fiscal constraint.

Before moving on to the external accounts, I would like to endorse the staff's stress on the importance of containing wage rate increases this year in both the public and private sectors. It would be regrettable if past progress in containing the rise in unit labor costs were to be eroded. We also underline the continued need to reduce labor market rigidities, particularly so as to reduce high unemployment rates for youth, women, and workers in the south.

Italy's dynamic export sector and the strength of invisible income have typically played important roles in preserving rough balance in the current account of the balance of payments. This has been possible notwithstanding the constraint on exchange rate policy imposed by the lira's participation in the EMS. Of course, there are limits to exchange rate stability in the absence of sufficient price and cost restraint, and the worsening prospects for the external accounts could again put pressure on the policy of exchange rate stability.

Italy has made some useful progress in the liberalization of capital movements, which is to be commended. Unfortunately, trade liberalization has not been so impressive. For example, restrictions on Japanese autos and electronic goods tend to suppress and divert trade and aggravate the adjustment problems of other countries. Nevertheless, strong Italian support for a successful Uruguay Round, and for reforms of the European Community's Common Agricultural Policy, could make an important contribution to preserving open markets for world trade.

Italy is an active participant in the world economy; it affects, and is affected by, the interactions of economic policies and developments in other countries. Accordingly, we welcome the brief assessment in the staff paper of Italy's role in international economic policy coordination. Italy's membership in the European Community, particularly as the Community increasingly integrates its financial markets in coming years, accentuates the need for further substantial progress in the convergence of Italy's performance and policies with the performance and policies of other major industrial countries. Continued heavy reliance on monetary and exchange rate policy by the Bank of Italy, in the absence of adequate fiscal adjustment, will no longer be possible. This underlines the need for resuming and accelerating progress in the key fiscal area.

Mr. de Groote made the following statement:

The staff rightly puts the main emphasis of its report on the importance of correcting the fiscal deficit, and it is certainly followed by the Board in that interpretation. The latest figures show that the FY 1987 deficit is 14 percent higher than originally targeted. By any standard, this level of public debt lies beyond the limits of sustainability, because it has begun to snowball. This effect is clearly shown in the two medium-term scenarios at the end of the staff report.

Constraints are imposed on the Italian authorities' conduct of domestic policies by the objective of full integration set for the countries of the European Community. Italy still has a long way to go in the areas of adjustment and convergence before being able to lift the restrictions which still protect its financial markets. Currency realignments in recent years have only partly compensated for the inflation differentials, showing that considerable pressure has built up, which can only be countered by large capital inflows at high interest rates. This exposes Italy to the threat that the flows will be reversed. It is conceivable, for instance, that the removal of restrictions on capital movements could trigger a renewal of capital flight, if investors began to perceive the fiscal deficit as too persistent to allow the positive interest rate differential to compensate additional risk taking. If the Italian authorities want to avoid future downward pressures on the lira in the EMS, they will definitely have to take steps toward stabilization of the public debt.

There seems to be room for improvement, first, in the area of debt management. Unlike many other countries, Italy has the advantage that most of its debt is domestic, and therefore lies within its control. The authorities should therefore use all the instruments within reach to reduce the cost of borrowing. Although this avenue has not been explicitly explored by the staff, perhaps they or Mr. Zecchini could explain why the authorities have shortened the maturity of their debt even though long-term interest rates are lower than short-term rates, as shown in Chart 20 on page 86a of the background paper on recent economic developments. The two charts on pages 88b and 88d also show that real interest rate differentials with other European Community countries are highest in the short term, but approach zero, or even become negative, in the long term. It would seem that the Government should put more emphasis on long-term borrowing. This policy could be supported by institutional improvements, such as diversifying the range of long-term debt instruments and developing their liquidity by establishing adequate secondary markets. There seems to be a clear need here for additional innovation.

Second, the authorities will have to improve their primary fiscal balance and even be prepared to generate small surpluses. This should be done mainly through revenue measures. In this connection, we note that although Italy has revised its GDP upward by 17 percent to take account of the underground economy, there is of course no corresponding rise in government revenues. Italy faces here a difficult choice, because attempts to increase the revenues collected on recorded transactions might lead to further increases in the unrecorded economy. Also, efforts to improve tax collection are unlikely to succeed unless they can be combined with simplification of the system governing the taxation of personal and company income, which by its very intricacy favors evasion.

Additional revenues can also certainly be raised through more realistic pricing of public utilities, and through higher indirect taxes. Although we understand the authorities' reluctance to take measures which could rekindle inflation, the issue of adequate utility pricing cannot be indefinitely postponed, because the discrepancies will just keep growing. The Italian authorities face a choice between a large one-time hike in utility prices, or a more gradual approach. The one-time approach certainly seems to be the best way to limit the surge of negative side effects, but may be attended by political difficulties.

In the area of direct taxation, I fail to understand why the tax authorities decided to grant companies the option of revaluing their assets. This not only entails large administrative costs, but will ensure a considerable loss in future revenues at a moment when more revenues will be greatly needed. More explanation from the staff or from Mr. Zecchini on this point would be welcome.

Despite limited room for maneuver on the expenditure side, economies could be obtained by increasing the productivity of public entities and state enterprises, if only by stemming the proliferation of work stoppages, which have unfortunately increased again recently. Legislation aimed at an orderly settlement of these labor disputes should therefore be given a high priority, while the authorities should strive to bring their personnel expenditures under control. Inflationary expectations could be greatly influenced if the wage negotiations in the public sector led to a sustainable result. Once inflationary expectations are reduced and wage increases are under control, there will be room to narrow the interest rate differentials with the other European Community members, helping further to cut expenditures and stop the growth of public debt.

There is much talk these days of the possibility of a "heavy" lira. If such a decision could be the occasion for accompanying decisions in the area of public finances, it would become the symbol of a new policy stance, which is greatly needed, to let the public sector benefit from a dynamic and prosperous private economy.

Mr. Yamazaki made the following statement:

Although the recent real growth of GDP has been a favorable development, the Italian economy in 1987 lost some of the good performance it achieved in 1986 in some key areas. Wage increases accelerated once again. There were slippages in the target for the curtailment of budget expenditure. Subsequently, domestic demand surged, the external balances deteriorated, and pressure on the exchange rate emerged. The authorities took some measures to remedy these unfavorable developments last fall, which have achieved some results. The authorities should be commended for their quick and flexible response to the situation. However, these measures are of a rather temporary nature, and the fundamental adjustment seems to have been left untouched; this adjustment should be dealt with in the 1988 policy package and in future years.

Among the long-lasting problems of the Italian economy, the huge size of the public sector deficit is a major one. The authorities have already made a substantial effort in a difficult political and social situation, and this effort is reflected in the recent steady decline in the level of the primary deficit of the General Government to 2.6 percent of GDP in 1987; it would be unfair if this development were overlooked. Nonetheless, the primary deficit figure is still high when measured against the standards of the other G-7 countries, and if the total government balances are compared, the Italian public sector financial situation appears to be much more serious.

Moreover, the room for maneuver of monetary policy is severely restrained by the large size of the state sector borrowing requirement. In this respect, I support the authorities' intention to continue to give top priority to correcting the fiscal imbalances through the combination of revenue raising measures and expenditure cuts. At the same time, I would stress that these measures should be front-loaded, and that there should be further scope for a more ambitious target in expenditure cuts, especially in personnel expenditures and transfers.

From this viewpoint, the revised 1988 budget proposal seems to be along desirable lines, so it is all the more disappointing that some of the measures in the proposed budget have been voted down by the Parliament, and that now the state sector borrowing requirement in 1988 is expected to be in excess of 11 percent of GDP. The importance of maintaining greater efforts to reduce the state sector borrowing requirement to the initial target level remains. In this context, the administered price policies may be worth reconsideration, and the process of restructuring the public enterprises needs to be intensified further. In the medium term, it might be desirable to seek more drastic measures for deficit retrenchment. I look forward to the updated medium-term fiscal adjustment program, which is to be issued shortly.

On monetary policy, there seems to be some tension between the debt management requirements of minimizing debt servicing costs and monetary policy; debt management considerations call for the maximum feasible reduction in interest rates. The authorities' medium-term plan aims at alleviating unemployment as well as at enhancing productive and infrastructural investments, which, as indicated in the recent G-7 communiqué, also seem to require low interest rates. At the same time, the monetary authorities must pay attention to exchange rate movements. In 1987, the authorities successfully responded to the difficult situation mainly through direct control measures, including the reimposition of a ceiling on commercial bank credit. However, such direct control measures bear with them the cost of inefficient resource allocation, and therefore should not be maintained over a long period of time. The authorities' clear recognition of this point, and their intention to remove these measures next month, as scheduled, are thus welcome. Greater competition in the financial sector should also improve efficiency of that sector, and I note the authorities' plan in this regard, as shown in Mr. Zecchini's most helpful statement.

I fully endorse the staff appraisal of the labor market. The coexistence of the high unemployment rate with the persistent pressure of wage increases seems to show a further scope for improvement in the functioning of the labor markets. Reform in this area would be time consuming, but strong momentum must be preserved.

Finally, on trade issues, I listened with great interest to the statement of Mr. Templeman. We note with hope the Italian authorities' full commitment to the cause of free and fair international trade, as witnessed by Mr. Zecchini's excellent statement.

Mr. Sengupta made the following statement:

During the 1980s until the end of 1986, Italy enjoyed a relatively steady upswing, together with a deceleration in the rate of inflation and a strong improvement in the external payments position. However, the outcomes for 1987 have been disappointing in many respects, although the real growth rate of GDP, at 3 percent, was higher than the 2.5 percent recorded by the rest of the G-7 countries on average. The relatively high growth rate in Italy was facilitated by a strong upsurge in domestic demand, which was far ahead of the average for the other G-7 countries, but if that were fostered by a relatively loose fiscal policy and an increase in wage rates, it will not have been an unmixed blessing. The inflation rate reached a high of 4.6 percent, compared with the average rate of only 2.8 percent in the other G-7 countries. The trade deficit rose sharply, thereby exposing the fragility of the foreign balance and Italy's international competitiveness. Mr. Zecchini makes a point about this, on which I would like to hear the staff's comments. The staff appraisal shows concern about the deterioration of the current account position due to the differential in the growth of domestic demand in Italy and in its partner countries, while Mr. Zecchini refers to the current account position as Italy's contribution to fostering international adjustment. What is the staff's view?

Even though the growth rate has been high, paradoxically enough there has been an increase in the unemployment rate. Unit labor costs have been rising, although as Mr. Zecchini notes there has been a growth in productivity of 3 percent, and recently a deceleration in the rate of employment was noted. Mr. Zecchini notes a reduction in the elasticity of labor demand to increases in economic activity, which would mean a relative rise in the use of capital vis-à-vis labor. A question therefore arises as to how Italy should build up its productive capacity, which is already at its peak, and at the same time reduce the unemployment rate, without giving rise to a resurgence of inflationary pressures.

The unemployment rate, however, is not the centerpiece of the concerns in the staff report; nor is the need to extend the expansion of productive capacity stressed. The staff's main preoccupation is to have Italy's economic performance (obviously not including the unemployment rate) "converge" with that of its main trading partners, and to secure a reduction in domestic costs and prices. This leads the staff to propose discipline in relation to wage settlements, reduction in the fiscal deficit, and in monetary and credit expansion, and improvements in the functioning of the labor market. Indeed, the general framework of the staff appraisal is very similar to the OECD's Economic Survey of Italy released in August 1987.

We would agree that the staff suggestions concerning fiscal deficit reduction for 1988 are extremely useful. It is necessary in particular to ensure that revenue raising measures are not temporary or reversible in nature. As the staff suggested, some contingency planning may be made in case of expenditure overruns.

Such planning should in fact be tried if it is expected that not merely expenditure overruns will occur, but that the targeted fiscal deficit will be exceeded. The debt to GDP ratio has already reached unsustainable levels, and would have to be sharply reduced over the medium term. It is thus essential to develop a fiscal policy strategy for the medium term. Besides exercising expenditure control, emphasis may have to be given to comprehensive budget and tax reforms that would not only help to reduce the deficit, but also promote investments in the private sector. While this may not be easy to implement in the light of Italy's present political situation, it would be in the country's best interests to consider it.

In Italy, it appears that the monetary base moves in line with fiscal developments, and provides a foundation for monetary expansion. Consequently, a reduction in the fiscal deficit would help to bring down the rate of expansion in the monetary aggregates. It would undoubtedly be advisable to aim at the lower range of the money and credit target bands, as the staff suggests, but given the pace and degree of financial innovations and liberalization that have been taking place in recent years, the focus has to be less on direct, and more on indirect, policy instruments, with a view to encouraging and strengthening financial markets and intermediation. This is particularly necessary if private investment is to increase in order to offset the deflationary impulse that may be generated by reduction of the fiscal deficit. We agree with the staff that a flexible interest rate policy would be needed, once the temporary credit ceilings and capital control measures introduced in September 1987 are abolished as scheduled at the end of March 1988.

The success of fiscal policy depends to a large extent on the authorities' restraint in granting wage increases in the public sector. Wages and salaries form as much as 12 percent of GDP, and an important proportion of current expenditures. The staff feels that wage increases within the 5-5 1/2 percent range, as called for in the Government's economic program, should be contained, in order to maintain cost competitiveness. But with this range the wage increase is likely to be higher than the targeted inflation rate of 4.5 percent. It is also doubtful that such a large wage increase would help maintain cost competitiveness in relation to Italy's main trading partners, since the inflation rate in other G-7 countries is estimated to be much lower.

With regard to the external sector, import restrictions still exist on the products of many developing countries, as Appendix VII to the background paper on recent economic developments shows. The staff regrets that Italy has made little progress in reducing trade barriers; Mr. Zecchini says that the staff's criticism of Italy's trade policy applies equally to the rest of the European Community--he is right, but it does not detract from the cause for the regret. However, Italy's progress with respect to its official development assistance in recent years has been impressive, as its official development assistance has risen from 0.26 percent of GNP in 1985 to 0.40 percent in 1986. We urge the authorities to make further progress in this area, and to emerge as the true champion of the international aid effort in support of third world development.

Mr. Dai made the following statement:

The performance of the Italian economy has improved tremendously since the beginning of this decade, with a continuous, relatively high rate of growth in GNP and a deceleration of price inflation from its very high level in the early 1980s. In addition, the current account position improved markedly, from a deficit in the first half of the decade to a moderate surplus in 1986, attributable to both improved external competitiveness and nonaccommodating monetary policies. All this impressive progress is commendable.

In 1987 the Italian economy continued to grow at a rate of 3 percent, due to increased private consumption and fixed investment. This growth had little bearing on the rise in prices and, therefore, was not much cause for concern vis-à-vis the current account position. However, from a longer-term point of view, the potential impact of rapid domestic demand growth on price levels and trade performance needs to be approached cautiously. Large fiscal deficits and rising public debt, which in 1987 were more than 11 percent and 90 percent of GDP, respectively, continue to be the two major problems in the Italian economy. The persistence of a high unemployment rate under the circumstances of a continuously growing economy is another major cause for concern.

Although strong domestic demand brought the Italian economy a relatively high rate of growth and also had a positive effect on international adjustment, the halt in the decline in prices, and a worsening trade balance in 1987, point to the need for the authorities to prevent a resurgence of price inflation and a deterioration of the balance of payments position, taking into account the relatively high level of capacity utilization and the differential of the growth rate of domestic demand in Italy with that of Italy's partner countries.

In the fiscal area, strong measures need to be taken wherever possible to cut spending, so that the state sector borrowing requirement can be substantially reduced. The staff has proposed several areas where spending cuts may be possible, and the authorities may wish to give them careful consideration. In view of the relatively important position of the public sector in the Italian economy, renovation of the public enterprises and improvement in their efficiency are essential for deficit reduction. On the revenue side, expanding the tax base is another necessary step toward strengthening the Government's financial position.

The authorities recognized the importance and the necessity of controlling the growth of fiscal deficits, and corrective measures were announced in 1987. However, the Finance Bill for 1988 failed to include the many corrective measures that had originally been intended, and it would now appear that the state sector borrowing requirement will exceed the authorities' earlier projected target. Lack of fiscal adjustment will cause the public debt to continue to grow, which would be inconsistent with the authorities' medium-term objective of stabilizing the debt to GDP ratio for future years.

Nonaccommodating monetary policy in the past has played an important role in Italy's economic growth and price stability. It seems desirable for the authorities to continue the nonaccommodating stance, so as to control monetary growth and domestic credit effectively. A change in the institutional arrangement with respect to overdrafts by the Government on the Bank of Italy seems to be needed, through the development of secondary markets and greater use of treasury bills.

The incomes policy that led to the moderation of labor costs also contributed to the external competitiveness and balance of payments position in Italy. The slower growth in the world economy after the stock market crash may have had an adverse impact on Italy's export industry. It is projected that the current account will record a deficit of 1/3 percent of GDP in 1988. Because of the authorities' strong commitment to the European Monetary System's exchange rate arrangement, it appears that with respect to exchange rate policy, the authorities do not have much room for maneuver left. Therefore, it is essential that the authorities adopt income and wage policies consistent with labor productivity, so as to consolidate the improvement already made and prevent future deterioration in the current account, and to maintain Italy's competitiveness.

Finally, the Italian authorities should be commended for the substantial increase in official development assistance they have extended to developing countries, despite their existing fiscal constraint.

Mr. Zeas made the following statement:

There were very important improvements in the Italian economy during the period 1980-86, but unfortunately the economy suffered a setback in some areas during 1987, especially a deterioration in the external current account. Several factors contributed to this deterioration, but it would appear that domestic policy slippages, particularly in the fiscal field, played a significant role.

We are in general agreement with the staff appraisal. I will confine my remarks to three of the most important aspects of Italian economic developments, namely, the unsustainability of the fiscal gap at present levels over the medium term, the further improvements needed in the foreign trade system, and lastly, Italy's record of foreign assistance.

With respect to the fiscal gap, we welcome the authorities' recognition that a gradual, but firm, adjustment effort will be needed. As explained in Mr. Zecchini's thorough statement, the overall deficit in 1987, although improving marginally over the previous year, exceeded Lit 113 trillion, equivalent to $88 billion, or 11.7 percent of GDP; and it is envisaged at over 11 percent of GDP for 1988. A deficit of this magnitude is too large in the medium term, given the outstanding stock of public sector debt, which already exceeded 90 percent of GDP at the end of 1987.

Since most of the debt is held by domestic creditors, and the Government must compete with the private sector for resources at fluctuating interest rates, the maintenance of such a large fiscal gap in the future will result in higher interest rates, assuming that nonaccommodating monetary and exchange rate policies will continue to be implemented in the framework of the EMS. Higher interest rates will in turn aggravate the fiscal problem; interest payments already exceeded 8 percent of GDP in 1987. This challenging fiscal adjustment effort will be further complicated because it will have to be carried out at a time when unemployment exceeds 11 percent for the country as a whole, and over 20 percent in the southern provinces, and because the public sector is already the single largest employer in the economy.

As a certain inflexibility of expenditures, including for farm and other subsidies, and the existence of the wage agreement, hinder fiscal adjustment, an alternative route to adjustment could lie in the areas of social security contributions and the rates charged by state enterprises. The authorities will attempt to widen the tax base and to improve tax compliance. We support these efforts, but warn that they may be insufficient to yield the desired deficit reduction during 1988. What is really needed is an adjustment effort like that outlined in Mr. Zecchini's statement.

In order to reduce unemployment in the south (the Mezzogiorno), the authorities may wish to proceed with the proposed reorientation of public investment in infrastructure toward the less developed areas of the country. In addition, fiscal incentives to promote the relocation of certain industries to the Mezzogiorno could be further utilized, so long as these do not raise the public sector deficit. Action to reduce structural rigidities in the labor market should be given priority.

With respect to the foreign trade system, we note that certain trade barriers both within the framework of the European Community and on a unilateral basis have been maintained in recent years. We urge the authorities to support the reform of the European Community's Common Agricultural Policy and to make further progress in the negotiations on agricultural protectionism in the context of the Uruguay Round of Multilateral Trade Negotiations.

In addition to generating growing agricultural commodities surpluses, the European Community's Common Agricultural Policy has imposed a heavy financial burden on the budgets of all of the member countries. I was impressed by a very interesting paper by the staff which has been circulated recently, entitled "The Common Agricultural Policy of the European Community--Principles and Consequences" (DM/88/1), to which Mr. Ismael has already referred, which states that "the Common Agricultural Policy has had a depressing effect on the world market prices of a number of agricultural commodities and its dismantling would turn the European Community into a net importer and the LDCs into net exporters of agricultural products." Furthermore, the paper concludes that "trade frictions caused by export subsidies have underlined the Common Agricultural Policy's international implications. For these reasons, the member states appear more determined than hitherto to bring agricultural expenditure under control." I am glad to learn that multilateral efforts to reform the Common Agricultural Policy are under way, and I hope that these reforms are successful and prompt, so that the welfare of all parties concerned will be improved.

Finally, we would like to commend the Italian authorities for their efforts on official development assistance, which, at $3.1 billion, was equivalent to 0.4 percent of GNP during 1987. We hope that foreign aid for peaceful purposes to the less developed countries will not be reduced, as the authorities struggle to reduce the fiscal gap.

Mr. Othman made the following statement:

I am in agreement with the thrust of the staff appraisal.

Developments in 1987 point to the risks posed particularly to the balance of payments by a rate of growth of domestic demand in Italy significantly higher than the rates prevailing in its main trading partners. Given Italy's commitment to the exchange rate arrangement of the European Monetary System and a relatively high income elasticity of demand for imports, the maintenance of broad equilibrium in the current account would require a fairly close alignment of the rate of growth of demand in Italy with the average of its main trading partners. It is therefore important that, in shaping policies for 1988 and beyond, the authorities strengthen and sustain their fiscal adjustment effort.

We agree with the Italian authorities that the recent developments in international stock and exchange markets, by increasing the downside risks for the world economy, call for a coordinated policy response by the major industrial countries, aimed at reducing the imbalances which contributed to those developments. In Italy's circumstances, the appropriate response lies in a more significant tightening of fiscal policy, which would be essential to Italy's contribution to a concerted moderation of international interest rates. To the extent that concerted effort is successful, it will reduce the risk associated with an increased need for flexibility in interest rate policy in Italy, which will be necessary to safeguard the capital account of the balance of payments as capital controls are liberalized.

As noted by the staff, the prospective financial integration in Europe will require considerable adjustments in the Italian financial system, as banks and other financial institutions will be increasingly exposed to foreign competition, and residents will be provided alternative investment outlets for their savings. At ratios among the highest in the industrial countries, these savings have made possible the financing of substantial fiscal deficits while maintaining the current account in near equilibrium. The challenges which the financial integration in Europe poses to Italy in this regard are quite obvious, and call for a steady progress in the fiscal adjustment effort, as well as a continued strengthening of the securities markets and the banking system.

Finally, I would like to join other speakers in commending the Italian authorities for increasing their official development assistance.

Mr. Morales said that he too concurred with the staff report. He had noted Italy's progress in the 1980s, as shown in many of the economic indicators. Inflation had been curbed and the balance of payments strengthened while the rate of growth of the economy had been maintained or even accelerated; all these were commendable achievements. However, the recent slippages in the fiscal area were a disappointing sign, as the unsustainable fiscal deficit could have the effect of upsetting more positive developments in other areas of the economy. He welcomed Mr. Zecchini's remarks that the authorities intended to maintain the economy on a path of more balanced growth. The authorities' pursuit of a reduction in the fiscal deficit should be encouraged, while the constraints on them and the difficulties involved in such a process needed to be recognized. Finally, he wished to congratulate Italy for the level of its official development assistance.

The Deputy Director of the European Department remarked that comparisons of the staff's projections for 1988 with those of other sources or institutions, though useful in certain respects, were not straightforward, and therefore had to be made with caution. This was particularly the case at present in Italy, where the situation was so fluid that there would be little justification in focusing on any one particular set of projections or forecasts. Broadly speaking, however, downside risks were attached to the staff projections, if only because of prevailing political uncertainties.

On the practice of "round-tripping" by some of the larger enterprises, the Deputy Director went on, as Mr. Enoch had surmised, a number of banks had had ample liquidity positions, which had allowed them to lend to larger enterprises at rates favorable enough to encourage redeposits of the funds with other financial institutions; as a result, it appeared that in effect the large firms had competed with the banks in the process of financial intermediation. Lending by the banks at below prime rates in itself was not necessarily in conflict with the banks' profit maximization, which was based on extensive, long-term commercial and financial relationships between the banks and the firms, rather than on a specific type of transaction. The process of relending through round-tripping would continue to be possible as long as financial markets remained segmented, but the resulting intermediation of funds would tend to reduce and eventually eliminate the extent of segmentation. Also, the temporary re-establishment of credit ceilings might have contributed to round-tripping, as those limits might have induced banks in liquid positions to set their lending rates lower than they would have otherwise.

Questions had also been raised about the scope of the privatization and divestiture programs of public enterprises, the Deputy Director noted. The staff did not have any information other than what appeared in Appendix III of the supplement to the report on recent economic developments. In that Appendix, Lit 5 trillion was calculated as the value of those transactions which had already been completed under the privatization and divestiture programs, with prospects for further transactions of Lit 8-9 trillion for the period 1988-89. With respect to the relationship between asset sales and the public debt management, the Italian authorities had made clear during the discussions that their divestiture programs were aimed at reallocating resources in the economy so as to reorient public sector companies to strategic economic areas; the Government was not interested in privatization for its own sake.

There had been some discussion of the merits and demerits of higher taxes versus expenditure control as the appropriate means to bringing about fiscal adjustment, the Deputy Director continued. The staff had deliberately avoided taking the position that the sole route for deficit reduction would be an increase in taxes; on the contrary, the staff had stressed that expenditure control was required in the Italian context. But the real issue remained the extent to which such control could be established, and its speed, given the structure of expenditure in the Italian public sector. For example, interest on the public debt represented 8 percent of GDP; wage settlements, 12 percent of GDP; transfer payments, 17 percent of GDP. With such a structure of outlays, and given the magnitude of such outlays in relation to GDP, rapid expenditure control would be extremely difficult; therefore, other avenues to curtail the public sector imbalance had to be explored, including tax revenue increases, even if such increases represented only a second-best alternative, from some perspectives. These considerations had led the staff to suggest improvements in tax administration and the expansion of the tax base, rather than increases in tax rates. That notwithstanding, it was clear that expenditure control remained essential, as the scope to continue financing huge government spending with private savings was being progressively limited; from that perspective as well, action on the tax front appeared inevitable.

With respect to the data on the national accounts and the inclusion in them of the underground economy, the Deputy Director said that the new statistical series in Italy had attempted to capture activity in the underground economy, but a definite assessment of the accuracy of those statistics would be difficult; some observers believed that perhaps one third of the underground economy had been covered. Work on the underground economy would continue on the basis of additional information which the Italian authorities would provide, and which would be reported to the Board after subsequent Article IV consultations.

Mr. Fogelholm asked if the staff thought it was appropriate that a measure of the underground economy had been included in the statistics for Italy when it had not necessarily been included in the statistics for other countries, and whether international comparisons might thus be distorted.

The Deputy Director of the European Department replied that in those cases where there was evidence of a relatively large underground economy, the attempt to measure it so as to include it in the statistical base was reasonable. In countries where there were indications that the scope of unofficial economic activity was small or nonexistent, there would be less need to include estimates of it in the national accounts, but that would not mean that the statistics in each case would not be comparable, in his view. In effect, the magnitude of the underground economy in question was determined; if it were judged to be large, it would be more important to measure it and include that measure in the statistical base. Judgments could not be made without reference to specific cases. The Italian authorities judged that the inclusion of the underground economy in the national accounts had made the overall comparison of the Italian economy with that of other industrial countries more accurate.

Mr. Zecchini explained that the revision of the Italian national accounts had been carried out on the basis of extensive studies, and with the advice of an international panel of experts. The panel had been led by Sir Claus Moser, the former Director of the U.K. Statistical Office, with Professors Richard and Nancy Ruggles and Mr. Peter Bjerve, the former Director of the Norwegian National Statistical Institute. The panel had concluded that the corrections were due, as the extent of the underground economy had not previously been entirely captured; other changes to enhance the accuracy and comprehensiveness of statistical data had been made as well. In his view, the end result was that the revised data had been made more comparable to the data of other countries.

The Deputy Director of the European Department, addressing a question about the timing of the financial liberalization in light of the large fiscal imbalance, remarked that the staff position had been to stress the close interaction between the process of reduction in the fiscal deficit and the introduction of liberalization measures. To some extent, the intention to promote liberalization could in itself provide a stimulus to fiscal adjustment, but clearly the two had to go hand in hand.

Mrs. Filardo had also asked about updated statistics concerning the balance of payments, the Deputy Director recalled. It appeared that the Italian balance of payments had ended 1987 quite strongly, which also helped to explain the authorities' decision to advance the liberalization of controls on leads and lags.

He did not have the information that would enable him to comment on Mr. Salehkhou's observation that labor market legislation intended to reduce wildcat strikes and work stoppages had to be seen in the light of similar legislation in other countries, the Deputy Director remarked. Mr. Salehkhou had also commented that the staff's judgment of the inadvisability of direct means of credit control was open to question. As the deepening of financial market spread, indirect means of monetary management tended to become more appropriate than direct credit controls. However, for financial markets with relatively limited breadth and resilience, credit ceilings had proven to be appropriate instruments to guide policy; the judgment depended on the institutional framework of the particular economy.

Despite the constraints placed on fiscal management by the high level of interest payments and the persistent pressure of continued large public sector deficits, in many respects the Italian economy had performed remarkably well, the Deputy Director observed. Over a number of years, the incurrence of large public sector deficits had taken place in the context of a mix of fiscal, public debt, and monetary policies which had made it possible for Italy to stay within the constraints of the European Monetary System, bring inflation down substantially, and also stage a reasonable growth performance. Clearly, an inevitable consequence of this process had been a marked increase in the outstanding public debt to a level where, as already noted, the economy's interest expense on that debt was equivalent to some 8 percent of GDP a year. In that regard, he did not agree with Mr. de Groote's observation that there was an advantage in that debt being domestically held, because as long as monetary policy remained firm--as was required by Italy's participation in the European Monetary System--the debt would represent a significant claim on the economy's resources. Indeed, it could be said that past borrowing had already tightly constrained macroeconomic management for the years ahead, on both the fiscal and monetary policy fronts. The outlook for the coming years was for absorption of a very large proportion of private sector savings by the public debt service requirement, and in that respect the Italian experience was not unlike that of countries with large external debts.

The staff had not wished to convey the impression that Italy was moving toward a particularly protectionist stance on international trade, the Deputy Director remarked. As the staff report had noted, Italy maintained its trade restrictions within the framework of the European Community, but that did not change the fact that there were restrictions, as Mr. Sengupta had observed. The staff would call similar attention to such restrictions in its discussions with other European Community members as well, the Deputy Director added. With respect to the Common Agricultural Policy, a detailed staff study had been issued recently (DM/88/1), and a paper for the information of the Board was also being prepared on the decisions that had been taken recently by the European Council concerning the finances of the European Community and the Common Agricultural Policy.

A question of an institutional nature had been raised by Mr. Salehkhou concerning the participation of staff members from the Exchange and Trade Relations Department in Article IV consultation missions with industrial countries, the Deputy Director recalled. He wished to stress that there was no policy precluding participation by Exchange and Trade Relations Department staff members in missions to those countries. The composition of staff missions was determined by a number of considerations, including the availability of staff in relation to the number of missions. The presence or absence of staff from a particular functional Department, such as the Exchange and Trade Relations Department, was not the factor that determined whether a given subject, such as trade policy, would be discussed with the authorities; on the contrary, he assured Directors that missions endeavored to examine all important policy areas, whatever the staff composition of the team. In the specific area of trade, staff from the Exchange and Trade Relations Department undertook missions to industrial countries to discuss general policy issues from time to time.

Mr. Salehkhou remarked that it was too much of a coincidence that staff members of the Exchange and Trade Relations Department were seldom included in missions to industrial countries; this was especially worrisome at a time the international economy was being threatened by increasing protectionism in these countries. As almost all missions to developing countries included staff members from the Exchange and Trade Relations Department, there should perhaps be some changes in the policy, in his view, for the sake of uniformity of treatment.

The Chairman said that Directors should not draw undue conclusions from the absence or presence of staff members from particular departments in staff missions. Furthermore, there was no policy of "benign neglect" with respect to the trade policies of certain countries. The scope of the discussion of particular policy items was not affected by the representation of a department in a mission.

Mr. Salehkhou said that although he did not doubt the staff's intention, as he saw it there was a problem on trade and liberalization in industrial countries which it appeared was being given less emphasis than the same kinds of problems in developing countries, as recent discussions in the Board had demonstrated.

The Chairman stressed that the Fund was paying increasing attention to the problem of trade and protectionism in all its member countries; therefore, Directors should not draw conclusions from staff departmental representation in it as to the thrust of a mission, and as to the scope of discussions in the field.

Mr. Sengupta asked what the impact on competitiveness of the wage increase target of 5 1/2 percent would be. He remarked that even though he was generally in favor of as large an increase in wages as possible, he feared that in this case the impact on competitiveness might be negative.

The Deputy Director of the European Department replied that in assessing competitiveness, developments in productivity also had to be taken into account. Together with the wage increase to which Mr. Sengupta had referred, developments relating to unit labor cost increases in other countries, which would influence the evolution of competitiveness, also needed to be considered.

Mr. Al-Assaf, returning to the matter of participation by staff members from the Exchange and Trade Relations Department in missions, commented that although he was confident that the exclusion of staff from certain Departments in missions to industrial countries was not management's intention, he agreed with Mr. Salehkhou that the participation of a staff member from the Exchange and Trade Relations Department in them, especially when trade issues were important, surely could not hurt.

The Deputy Director of the European Department replied that the Exchange and Trade Relations Department had been following trade policy developments in member countries for a long time, and a project was under way to discuss trade matters with major industrial countries over the next few months. As the Chairman had noted, the absence of a staff member from a particular department did not imply that an important subject would not be properly covered during the mission.

Mr. de Groote remarked that, in his view, it would be a good idea to consider sending experts from departments other than the regional departments on consultation missions to industrial countries. He had suggested several times before, for example, in the case of Belgium in particular, that it would be useful to have a staff member from the Fiscal Affairs Department assigned to the mission, as fiscal problems constituted an important element in the determination of the overall policy objectives in Belgium. A return to the tradition of sending staff from the Research Department might also be contemplated, he added. Currently, it appeared that the Fund's policy was to move staff from one department to another to expose them to the work of consultation missions; the same end could be attained by leaving staff in the same department, but including them in the consultations.

Concerning the relative advantages of nationally held versus internationally held debt, Mr. de Groote continued, he agreed with the point made by the Deputy Director of the European Department. However, he had another point to make concerning Italy's debt, namely, that it might be advisable for the authorities to change the maturity structure of the debt from mostly short term to mostly long term. This could be accomplished much more easily in Italy's case, as most of the debt was held domestically, and the agreement of foreign creditors for a debt consolidation was therefore unnecessary. He wondered why such a change in the structure of the debt had not been accomplished already, as there was obviously an economic advantage to such a change.

The Chairman said in response to the observations about the composition of staff missions that the management had to take care that missions were not overstaffed. It was necessary to keep the institution lean. There were, in addition, the issues that would arise from too much staff travel, which had implications for the budget.

Mr. de Groote commented that he was not advocating adding staff to a mission, but the replacement of staff from one department with staff from another. For example, in the Belgian case he could think of an excellent mission chief who would undoubtedly write as excellent a report as the staff member who would ordinarily write it. Furthermore, he reminded Executive Directors that in the Fund's early days, even Executive Directors went on consultation missions to countries other than their own, and there were cases of Executive Directors acting as chairmen of consultation missions.

The Deputy Director of the European Department, in response to a question on the maturity structure of Italian debt, explained that, through 1986, the Italian Government had made much progress on lengthening the maturity structure of the debt. In fact, that was one of the reasons that had permitted the large public sector deficits to be sustained. Lengthening the debt maturity profile had become more difficult in 1987, as some revival of inflationary expectations had shifted demand in favor of shorter term, more liquid, assets. Currently, with a more favorable inflation outlook, the Government had been more successful in placing relatively long-term paper in the market, and the yield curve seemed to be returning to a more normal shape. As a postscript to Mr. de Groote's remark about staff participation in missions, the Deputy Director noted that one of the staff members on the mission to Italy was from the Research Department.

Mr. Zecchini observed that one of the basic issues raised by Executive Directors in the discussion appeared in his view to be the judgment as to what constituted satisfactory external account performance for Italy given the current state of the world economy. That judgment needed to be made bearing in mind certain circumstances applying to the Italian case. For example, Italy had certain unexploited economic resources, and had not yet achieved the per capita income levels of other major industrial countries. It was thus doubtful whether Italy's policies should be aimed at preserving systemic or structural excesses of savings over investment, namely, structural surpluses in the current account of the balance of payments. Furthermore, major industrial countries were attempting to reverse large budget deficits while a large number of developing countries were striving to increase their trade and current account surpluses; therefore, the pursuit of domestic demand policies by major industrial countries aimed at retaining a surplus of savings over investment appeared in his view a questionable strategy, unless that strategy was coupled with the appropriate financial mechanisms to recycle the savings on terms and conditions consistent with other countries' need to utilize them.

Italy could not accept the deflationary bias stemming from the recent economic policies of major countries, Mr. Zecchini continued, especially inside Europe. The Italian economy was significantly integrated with those of other European countries. If the outcome of those deflationary policies was the benchmark by which Italian economic performance was to be judged, then that benchmark would be rejected by the Italian authorities. Specifically, the extent of overheating in the Italian economy in 1987 could not be measured on the basis of the rhythm of growth of the other major European economies in the same period.

With respect to the sustainability of the present policy and the results, Mr. Zecchini went on, he would have to be consistent with what had been said in the multilateral surveillance exercise when the Board had used the words "sustainable" and "desirable"; these two words were not synonymous and had different implications, for a policy course might be sustainable without being desirable, and vice versa. The real issue, as he saw it, was whether Italy's economy could continue to grow under the current policies, which would be desirable, but possibly not sustainable, given the external and internal constraints. External and internal conditions would have to be created to make the growth process durable. A faster pace of domestic demand growth in the markets with which the Italian economy was most closely integrated would be required on the external side, as well as a structure of international interest and exchange rates that would create certainty for economic decisions. On the internal side, the major condition would be bold action to redress the fiscal imbalances, which the authorities fully supported, despite their very mixed success so far. Not all Italy's problems lay in the fiscal imbalances; there were labor market problems and problems with the evolution of economic structures in some sectors, which deserved more attention. A faster pace of fixed investment and of capital accumulation in Italy was appropriate.

He disagreed with the projections of rising inflation for 1988 and 1989 that many Executive Directors had alluded to, Mr. Zecchini commented. Given the latest developments, on which the projections in the staff report had been based, as well as Italy's official projections and calculations, there was a likelihood that inflation would stabilize at the current level if the entire set of proposed policies were to be carried out; even a reduction in inflation might occur in the course of the year.

There was undoubtedly a large labor demand component in the current evolution of unemployment, Mr. Zecchini went on, but two other factors needed to be recognized, namely, demographics and the rising participation rate, which tended to blur somewhat the assessment of the unemployment situation, in his view. These two factors explained part of the rise in unemployment. The varying impact of the wage supplementation scheme, which led to slightly different results as to the variations in unemployment, also needed to be borne in mind.

The unsatisfactory trends in employment in the 1980s needed to be interpreted in light of the strong rise in fixed investment in industrial sectors, as noted by Mr. Marcel, and the decline in the relative importance of industry and agriculture in GDP formation. A process of capital deepening had taken place, with the substitution of capital for labor in the industrial sector. At the same time, a lively expansion of employment, together with a moderate rise in fixed investment, had occurred in the services sector, albeit not enough to reduce the overall unemployment rate.

In the fiscal area, Mr. Zecchini continued, he agreed with those who had said that using a European Community revenue ratio average as a benchmark was not a good standard, but it would be a good starting point for fiscal redressment at a time when expenditures tended to be inflexible, thus requiring a greater and more extended effort to compress them. As the Government could not reach a consensus in Parliament to slash some crucial expenditures immediately, the alternative seemed to be to bring the fiscal burden into line with the European Community averages. Finally, he wished to reassure Directors that the Government was considering a set of contingency measures.

The objective of the Government's privatization scheme was not the same as in other major countries, Mr. Zecchini went on. In Italy the overriding criterion was that only those public enterprises not involving the crucial public economic interest could be privatized, including those companies that had been taken over by the State in the 1970s because of their near collapse. As to the latter, certain enterprises which were not currently economically viable could be tested by returning them to the private sector, so that their long-term economic viability could be determined. Privatization in itself was not seen as the goal.

The authorities had attempted to lengthen the maturity structure of the public debt, Mr. Zecchini remarked, and had been quite successful recently, as the yield curve had begun to take on a more normal shape from that of a few months ago. In this connection, the word "consolidation" was considered a very dangerous word in Italy, because of the expectations it might elicit which would affect the demand for government securities at a time when the public deficit was still not fully under control. Consequently, the authorities' efforts to extend the maturity of the debt had to be framed in the context of the expectations and requirements of the market.

He had some doubts about the usefulness of M3 as a leading indicator of the monetary policy stance, Mr. Zecchini stated, given the difficulties some other countries had experienced with it. For instance, when interest rates rose on some less liquid financial instruments, M3 tended to rise; thus, at the time the authorities were trying to tighten policies by raising interest rates, they were confronted with an increasing shift of demand toward instruments included in M3. To a large extent the significance of the M3 indicator as a guideline or monitoring device for monetary policy was thus blurred. In Italy, the monetary authorities had been using an increasing degree of pragmatism in choosing and interpreting credit and money indicators of the monetary policy stance. This had been dictated in large part by the impact of financial innovation on the indicators' significance, specifically, on the behavior of velocity of money and other financial assets. In that connection, the fact that the financial innovations might have been responsible for a change in the behavior of velocity might make the suggestion of some Directors that the Italian authorities aim at the lower ranges of the targeted variables for monetary expansion less valid.

With respect to the round-tripping which had occurred in the financial system last year, Mr. Zecchini said that he concurred with the explanation given by the Deputy Director of the European Department. Mr. Enoch had been absolutely correct when he referred to the evolution of bank liquidity. Those enterprises which had engaged in much of the round-tripping had relatively easy access to foreign financial markets, and the fact that they resorted to Italian banks depended to a large extent on the comparative costs of financing in the domestic market in comparison with external markets.

Although it was clear that financial innovation was having an impact on monetary management, Mr. Zecchini continued, the innovation itself was taking place with the blessing of the monetary authorities, and it was not an uncontrolled process. The monetary authorities were confident that they had the instruments to retain full control of monetary policy, as could be seen from the recent legislation concerning mutual funds, merchant banking, and other financial instruments.

He wished to dispel any incorrect impressions about the degree of protectionism in Italy, Mr. Zecchini remarked, and drew attention to the statement in the staff report that the degree of openness of the Italian economy had increased significantly in the 1980s; the charges of protectionism leveled at Italy were clearly unfounded. In the staff report the few remaining trade barriers had been examined, of course, but their existence did not imply that the Italian market was therefore closed. Italy was committed to free, but fair, trade. Italian trade policy was not in the hands of the Italian authorities, but in the hands of the Commission of the European Communities. Nevertheless, Italy's role in helping to shape that trade policy had to be acknowledged, and in his view Italy's record in that respect had been outstanding. In the agricultural area, Italy was an exporter of Mediterranean products which were generally accorded a lesser degree of protection under the European Community's Common Agricultural Policy than other kinds of agricultural products. Furthermore, Italy was among the few European Community countries with large exemptions for imports from outside the Community, which might be a matter of regret for some of its European Community partner countries. Italy had fully supported the measures taken by the Heads of State a few days ago. These measures included a ceiling on expenditure for agriculture support, and on the amount of Community production that would receive the full price support, such as agricultural products like cereals and oilseeds, where there were significant imports from countries outside of the European Community. A new system of incentives for withdrawing agricultural land from production had also been introduced. The Common Agricultural Policy, he wished to note, was based on an international treaty with several objectives, including self-sufficiency in agriculture, which thus had clear implications for the size of the import market for agricultural products in the European Community.

The Italian authorities were also considering the restrictions on Japanese electronics and automobile exports, Mr. Zecchini continued. He wished to remind the Board that the latter restrictions had been introduced in the 1950s on the basis of a bilateral agreement between Italy and Japan which had not been initiated by Italy.

Concerning the narrowing of the lira's fluctuation band in the European Monetary System, Mr. Zecchini said that a narrower fluctuation band could only be applied at the proper time, and with an appreciation of the impact of new external factors on the lira. Since Italy was liberalizing the regulations on capital movements, rushing into the application of a narrower fluctuation band for the lira might not be advisable. Furthermore, as some other major European currencies were not participating in the exchange rate mechanism of the European Monetary System, or had special exchange regimes, the argument for a change by Italy with respect to the lira in this regard did not appear especially compelling.

In conclusion, Mr. Zecchini said that the liberalization of capital movements in Italy would require that macroeconomic policies be designed and applied more consistently than in the past. So far, the Italian experience had been encouraging, as a large capital flight had not occurred immediately after the liberalization measures. Rather, foreign reserves had increased by Lit 7 trillion in the last quarter of 1987, and the trend appeared to have been maintained into 1988, demonstrating the confidence of markets in the authorities' current policy stance.

The Chairman then made the following summing up:

Executive Directors concurred broadly with the staff appraisal in the report on the 1987 Article IV consultation. They noted that the performance of the Italian economy had improved markedly through 1986: inflation had declined sharply, output had continued to grow, and the current account of the balance of payments had moved into surplus. In 1987 the growth rates of GDP and investment were satisfactory, but Directors regretted the slowdown that had occurred in Italy's fiscal adjustment, which contributed to a sharp relative domestic demand expansion and consequently to a leveling off in the rate of inflation and a weakening in the external current account. They observed that policy shortcomings had contributed to the deteriorating economic performance.

Directors drew particular attention to the important slippages in the budgetary area, illustrated by the larger than projected borrowing requirement of the state sector, and consequent further growth in public sector indebtedness. An important factor behind these developments was an accommodating attitude to wage demands in the public sector, which also contributed to an acceleration in labor costs in the economy as a whole. Directors stressed the severe burden that the large borrowing requirement of the public sector, together with the management of a large stock of public debt, imposed on monetary policy, which was already constrained by the requirements of the exchange rate arrangements of the EMS. Indeed, the authorities had found it necessary to let interest rates rise from midyear and to resort to the temporary introduction of direct credit ceilings and tighter controls on leads and lags.

Directors expressed concern over the outlook for 1988 and the years thereafter. There was general agreement that Italy's commitment to the EMS exchange rate arrangements and the progressive financial integration in Europe required a determined resumption of convergence of Italy's economic performance with that of its main trading partners, which left little, if any, room for slippages. Directors stressed the need for a restrained stance of monetary policy, not only for purposes of continued progress on the price front, but also as a necessary underpinning for wage moderation. They noted that continued interest rate flexibility will be required to permit the lifting of credit controls on schedule, while keeping the expansion of money and credit aggregates within the announced target bands; in this regard, several Directors agreed with the staff that it would be advisable to aim at the lower ranges of those bands. However, it was pointed out that the targets themselves might have become a less reliable gauge for monetary policy, because of the changing behavior of velocity stemming from the broadening and deepening of the financial system.

In the view of Directors, the effectiveness of restrained monetary and wage policies is likely to be impaired if they are not supported by a determined effort to reduce the fiscal imbalance and rein in the growth of public indebtedness, which many speakers regarded as unsustainable. Directors stressed that the delay in the approval, and the weakening in the quality, of the 1988 Finance Bill pose a serious threat to Italy's adjustment effort. In this context, they expressed the hope that the final version of the Bill to be approved by Parliament would be consistent with a significant reduction of the state sector borrowing requirement adequately frontloaded. A number of Directors referred to the emphasis on revenue increases in the budget, and the temporary or reversible nature of some of these measures, and they urged greater restraint on budget expenditure, including, in particular, the wage bill and on subsidies, and urged market pricing of public services and improvements in the financial position and operational efficiency of state enterprises.

Directors commended Italy's ability to live up to its commitments within the EMS in difficult domestic circumstances. Looking beyond 1988, they also welcomed the authorities' intention to proceed toward financial integration within Europe, and in this context they noted the recent elimination of the controls on leads and lags, and the further liberalization measures scheduled to take effect later this year. The need to adjust to a more open and competitive external environment underscores the importance of consistent and adequately restrained financial and incomes policies, and of adjustment in policy areas of a structural nature, including foreign trade, agriculture, energy, labor and industrial policies. Directors urged the authorities to ease remaining unilateral import restrictions and to press, within the European Community, for greater trade liberalization and for a comprehensive review of the common agricultural policy, in order to enhance efficiency in this area. Actions to increase flexibility in the labor market, and to reduce regional disparities, would also contribute to improve the performance of economy and ease the process of its international integration.

Finally, Directors welcomed the steady increase in Italy's official development assistance, and hoped that this trend would continue in years to come.

It is expected that the next Article IV consultation with Italy will take place on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/21 (2/17/88) and EBM/88/22 (2/19/88).

2. EXECUTIVE BOARD - TRAVEL ALLOWANCES

The Executive Board approves the recommendations concerning travel allowances for Executive Directors as set forth in EBAP/88/39 (2/12/88).

Adopted February 17, 1988

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/88/45 (2/17/88) and by an Advisor to Executive Director as set forth in EBAP/88/43 (2/16/88) is approved.

APPROVED: October 26, 1988

LEO VAN HOUTVEN
Secretary