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June 2, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Italy - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Italy, which has been tentatively scheduled for discussion on Wednesday, July 2, 1986.

Mrs. Ter-Minassian (ext. 8844) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives  
for the 1986 Consultation

Approved by L. A. Whittome and C. David Finch

May 30, 1986

I. Introduction

A staff team consisting of Mr. L. A. Whittome, Mrs. T. Ter-Minassian, Messrs. A. Leipold and M. Beleza (all EUR), Mrs. P. Alonso-Gamo (EP-FAD) and, as secretary, Ms. C. Nguyen (EUR) visited Rome from March 10-24, 1986 to conduct Article IV consultation discussions. The mission met with the Ministers of the Treasury, Budget, Foreign Trade, Labor, and Industry, with the Undersecretary of State for the Presidency of the Council of Ministers, with the Governor and the Director General of the Bank of Italy, and with officials of those agencies. The mission also met with the Secretary-Generals of two major labor confederations and with the leadership of the Confederation of Italian Industry. Mr. S. Zecchini, Executive Director for Italy, attended the meetings as an observer.

The previous consultation discussions had taken place in March 1985 and the staff report was considered by the Executive Board on May 24, 1985. On that occasion, Executive Directors welcomed the improvement in economic performance recorded in 1984. They regretted, however, that the momentum toward fiscal correction had been allowed to weaken in the course of the year. Executive Directors noted the risks that the main government targets for 1985 might not be achieved, and stressed the need for a prompt implementation of a coordinated adjustment effort, especially in the fiscal and labor market areas.

Italy has accepted the obligations under Article VIII. On April 30, 1986, Fund holdings of Italian lire stood at SDR 1,896 million (65.2 percent of quota) and Italy's holdings of SDRs to SDR 336.2 million (47.9 percent of net cumulative allocations).

Italy's five-party coalition Government, headed by the Socialist leader Mr. B. Craxi, has been in power for over two and a half years. It was strengthened in 1985 by nationwide local elections and by the rejection by a popular referendum of the restoration of the scala mobile points cut by decree in 1984.

## II. Report on the Discussions

### 1. Background

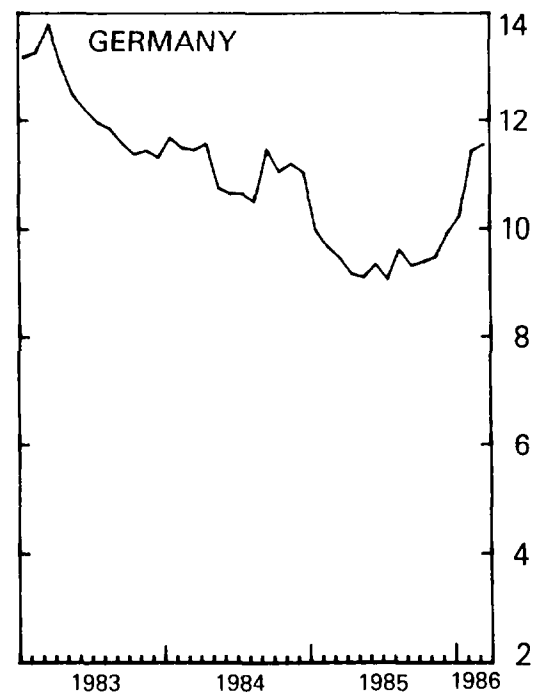
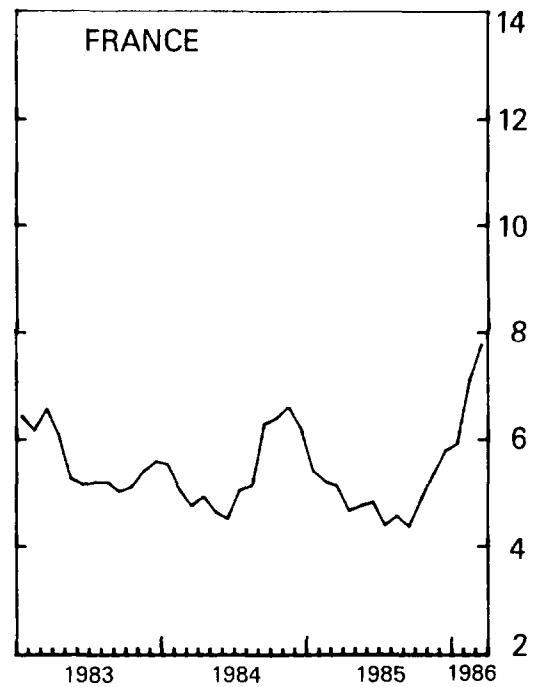
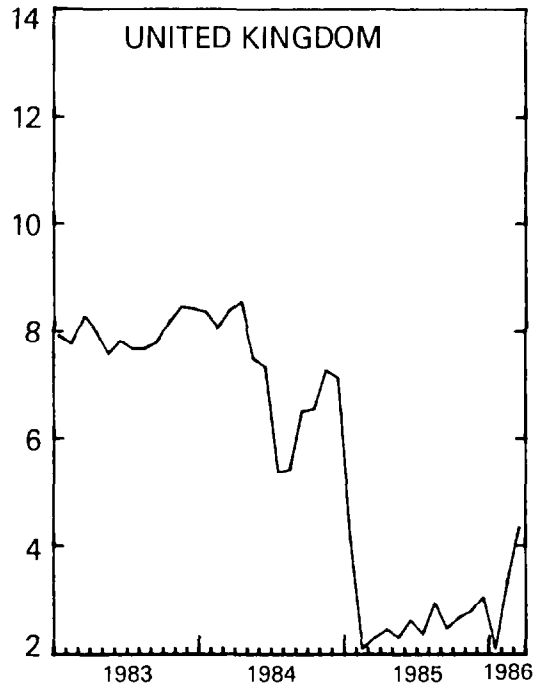
The structural weaknesses of the Italian economy made adjustment to the second oil shock of 1979-80 particularly difficult. The consequences of a relatively high degree of openness of the economy and dependence on imported oil were aggravated by rigidities in the labor market, which hampered a prompt adjustment of real labor costs to the terms of trade loss, and by a rapidly growing fiscal imbalance. The burden of adjustment fell, therefore, largely on monetary policy. The joining of the European Monetary System (EMS) and, after 1981, the ending of the Central Bank's formal role as the Treasury's residual lender set the scene for a nonaccommodating monetary policy. Control over credit expansion and monetary growth was sought through a combination of positive--and rising--real interest rates and, until 1983, strict ceilings on bank credit to the nonstate sector, and the exchange rate was not allowed to compensate fully for the cost and price differentials relative to Italy's main trading partners. The nonaccommodating stance of monetary and exchange rate policies was a major factor behind the progress recorded by the Italian economy in the early 1980s. It fostered a restructuring of Italian industry, partly through a shakeout of labor, a substantial moderation of cost pressures, and a deceleration of the rate of inflation in consumer prices from 21 percent in 1980 to 12.5 percent by end-1983. The current account of the balance of payments shifted from a deficit equivalent to 2 1/2 percent of GDP in 1980 to a small surplus in 1983.

Against the background of the improvement in the external accounts and in the inflation performance, and of a recovery of demand in Italy's main trading partners, the authorities eased the stance of monetary policy in 1984. This was facilitated by a measure of success in containing the borrowing requirement of the state sector <sup>1/</sup> especially in the first half of the year and by a modification of the scala mobile, which reduced the degree of wage indexation. Administrative controls on commercial bank credit were lifted and credit to the nonstate sector increased strongly (Table 1), despite some rise in real interest rates. Real GDP grew by nearly 3 percent on the strength of a marked pickup in domestic demand (Table 2), which rose significantly faster than abroad. The reversal of the relative cyclical position was the major factor behind a shift of the current account of the balance of payments into a deficit equivalent to 0.8 percent of GDP (Table 3), as the competitive position remained largely unchanged and Italy actually gained export market shares in 1984. However, relatively large net

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<sup>1/</sup> The state sector encompasses the state budget, a number of autonomous government agencies (such as the state monopolies, post and telecommunications and railways), and the Treasury accounts of other public entities (including the local authorities and the social security fund).

CHART 1  
ITALY  
NOMINAL SHORT-TERM INTEREST RATE  
DIFFERENTIALS, JANUARY 1983-MARCH 1986<sup>1</sup>

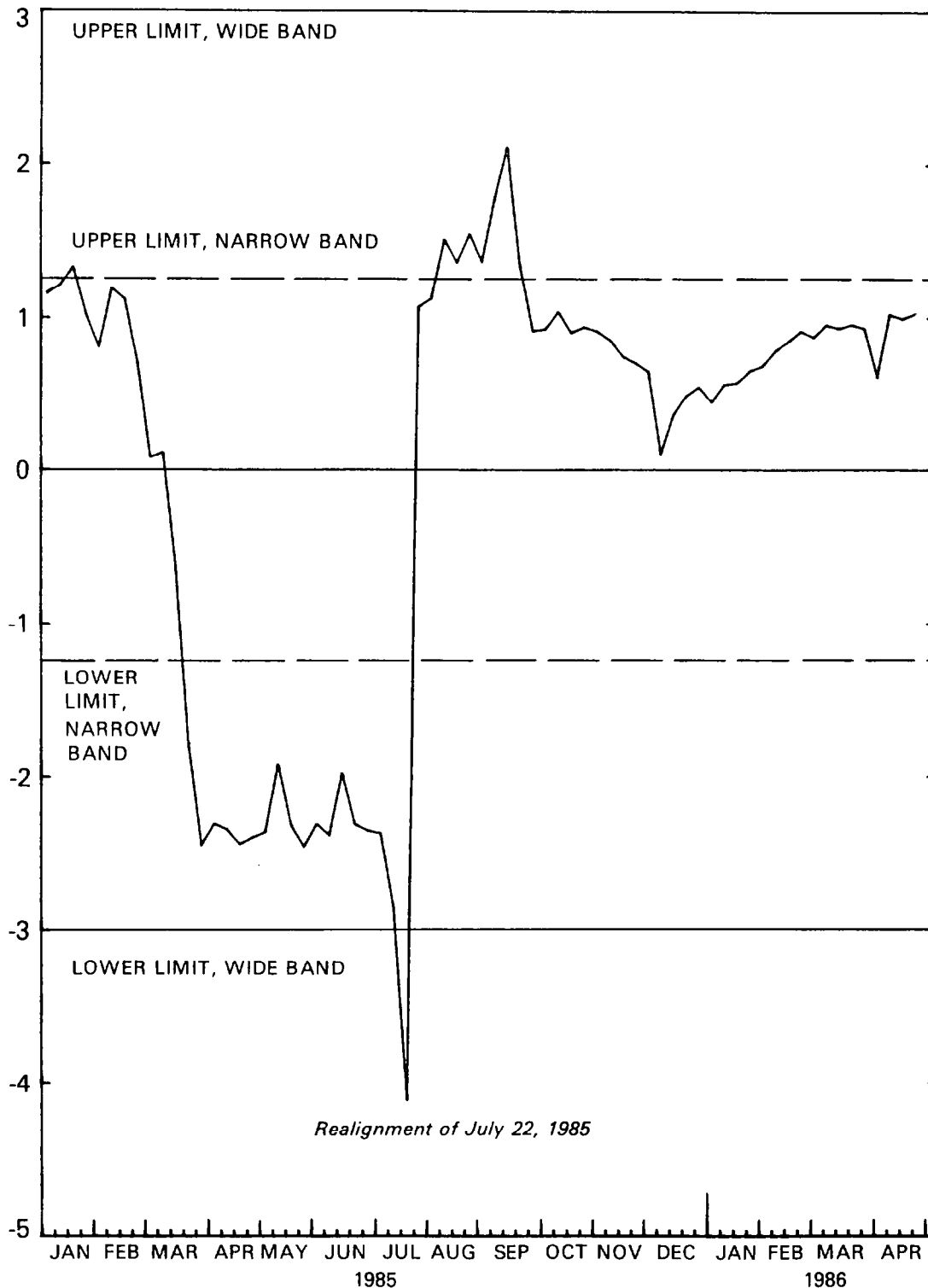


Source: International Monetary Fund, Research department.

<sup>1</sup> Monthly averages of daily rates on money market instruments of about 90 days' maturity.



CHART 2  
ITALY  
MARKET EXCHANGE RATE RELATIVE  
TO THE EMS CENTRAL RATE, 1985-86<sup>1</sup>  
(Deviation in percent)



Source: IMF, *Data File*.

<sup>1</sup> Weekly averages; the chart measures deviations of the Italian lira from its bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by hundred.



capital inflows attracted by high interest rate differentials in favor of Italy (Chart 1) and expectations of a stable lira resulted in a significant accumulation of convertible foreign exchange reserves and contributed to the relative strength of the lira within the EMS through most of the year.

The constraints placed on economic policy by the large fiscal imbalance came to the forefront in 1985. The exhaustion of once-over fiscal measures taken in 1984 and the absence of more fundamental corrective efforts contributed to a significant widening of the public sector deficit. Concern about the effects of relatively high real interest rates, especially on the cost of servicing the public debt, led to a more accommodating stance of monetary policy and to a sharp increase in the financing of the Treasury through monetary base creation. The relative ease of financial policies contributed to a disappointing inflation performance, a widening of the current account deficit in the balance of payments and recurrent pressures on the lira during the year.

The initial budget for 1985 targeted a state sector deficit of about Lit 96 trillion, similar to the outcome for 1984, which would have resulted in a fall of about 1 percentage point in the ratio of the deficit to GDP. This was to be achieved through a growth of both fiscal revenues and capital expenditures in line with GDP, and the maintenance of current noninterest expenditures constant in real terms. The initial target for the deficit was revised in February 1985 to just under Lit 100 trillion, but the final outcome is estimated to have reached Lit 108.7 trillion, the equivalent of 16 percent of GDP (Table 1). If the payment of arrears incurred in previous periods is included, the overall deficit amounted to Lit 121.4 trillion (17.7 percent of GDP). The deficit overrun was partly due to a growth of noninterest current spending well in excess of target, largely on account of higher than budgeted social expenditures. Fiscal revenues were also below target, as a faster than projected growth of direct taxes did not fully compensate for the shortfall in the yield of special fiscal measures (including a tax amnesty on illegal construction) included in the budget.

The monetary program for 1985 targeted a significant deceleration in the growth of the monetary and credit aggregates, in line with a projected 3 1/2 percentage point decline in the growth rate of nominal GDP (Table 1). The program was based on the assumption that the Lit 100 trillion target for the state sector deficit would be achieved. During the course of the year, the overshoot of the deficit and the reluctance of the authorities to allow a further rise in real interest rates created growing difficulties for monetary management and contributed to a sizeable loss in foreign exchange reserves. A significant decline in interest rates in the last months of 1984 and the first quarter of 1985 was accompanied by a sharp increase in monetary base financing of the Treasury and by pressures on the lira which, despite sizeable interventions, fell to the bottom of the EMS narrow band by March (Chart 2). A moderate tightening of the monetary policy stance in the second quarter



was followed by a renewed easing after the EMS realignment of July 22, 1985, in which the central rate of the lira was devalued by 6 percent against all other participating currencies, which were in turn revalued by 2 percent, involving an overall increase of 8.5 percent in the central rate of the lira expressed in terms of each of the other EMS currencies. Treasury bill rates fell significantly after August, the discount rate was lowered in early November and the monetary base continued to expand at rates well above target, pushed by credit to the Treasury and despite the large destruction through the balance of payments. In the last months of 1985 monetary developments were dominated by the external sector. The combination of relatively loose domestic financial policies and widespread expectations of another EMS realignment created further intense pressure on the foreign exchange market, in spite of a significant improvement in the trade deficit in the second half of the year. Domestic credit in lire to the nonstate sector accelerated sharply, reflecting a substitution of domestic for external credit. The Bank of Italy had to intervene heavily to support the lira. During the fourth quarter, official reserve losses amounted to over SDR 5 billion, a 26 percent decline from the level of reserves (excluding gold) prevailing at the end of the third quarter.

For the year as a whole, the rates of growth of total domestic credit and of domestic credit to the state sector exceeded the initial targets by 2.0 and 2.7 percentage points, respectively (Table 1). Credit to the nonstate sector decelerated as programmed through most of the year but was boosted to nearly 13 percent (0.8 percentage points above target) by the speculative upturn in domestic credit in lire in the last quarter of the year. Developments in the monetary aggregates followed a somewhat different pattern (Chart 3). The money supply (M2) grew very rapidly in the early part of the year, as new placements of government securities did not keep pace with the expanding budget deficit and the banks were reluctant to sell treasury paper to the public for tax-related reasons, <sup>1/</sup> but began to decelerate by mid-year, as higher interest rates on public debt made government securities more attractive relative to bank deposits. In the last months of 1985, the heavy capital outflows and the corresponding balance of payments deficit resulted in a sharp slowdown in domestic liquidity, and by year-end M2 was growing at an annual rate of 10.7 percent (0.7 percentage points above the initial target).

Against the background of a broadly accommodating stance of financial policies, the growth of domestic demand continued at a relatively rapid pace during the first half of 1985. It decelerated in the third quarter of the year but recovered once again in the fourth quarter, increasing by nearly 2 1/2 percent on average for the year (Table 2). Private consumption rose fairly steadily, averaging a 1.9 percent rate of growth in 1985. The growth of fixed investment exceeded on average

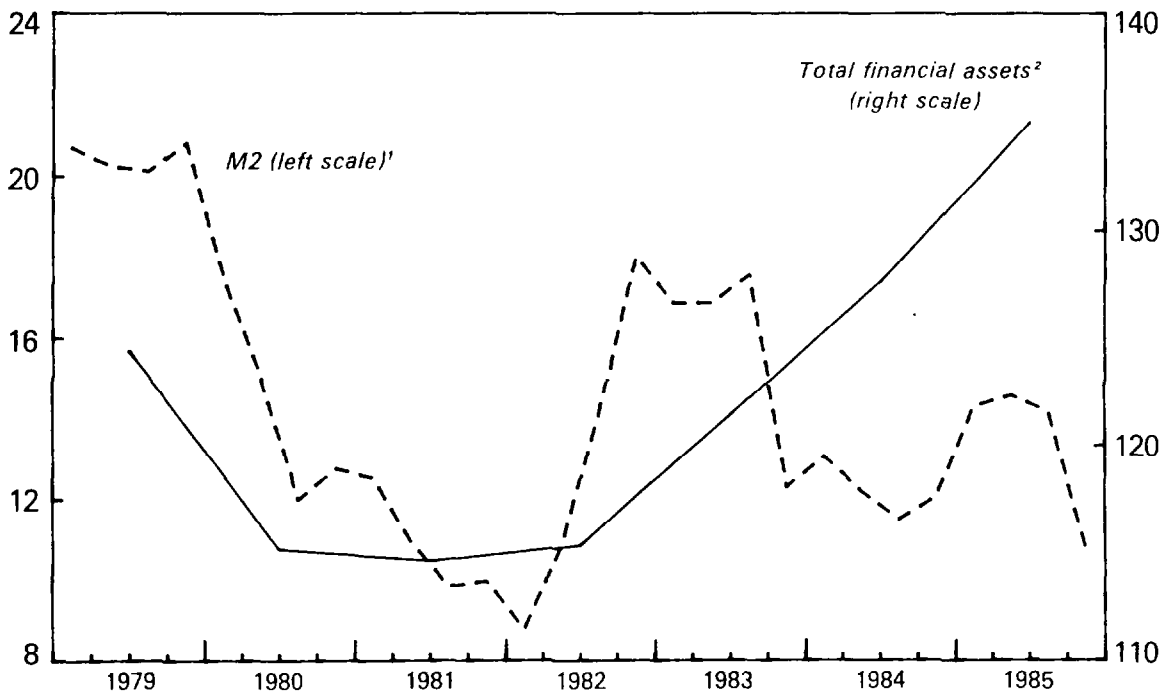
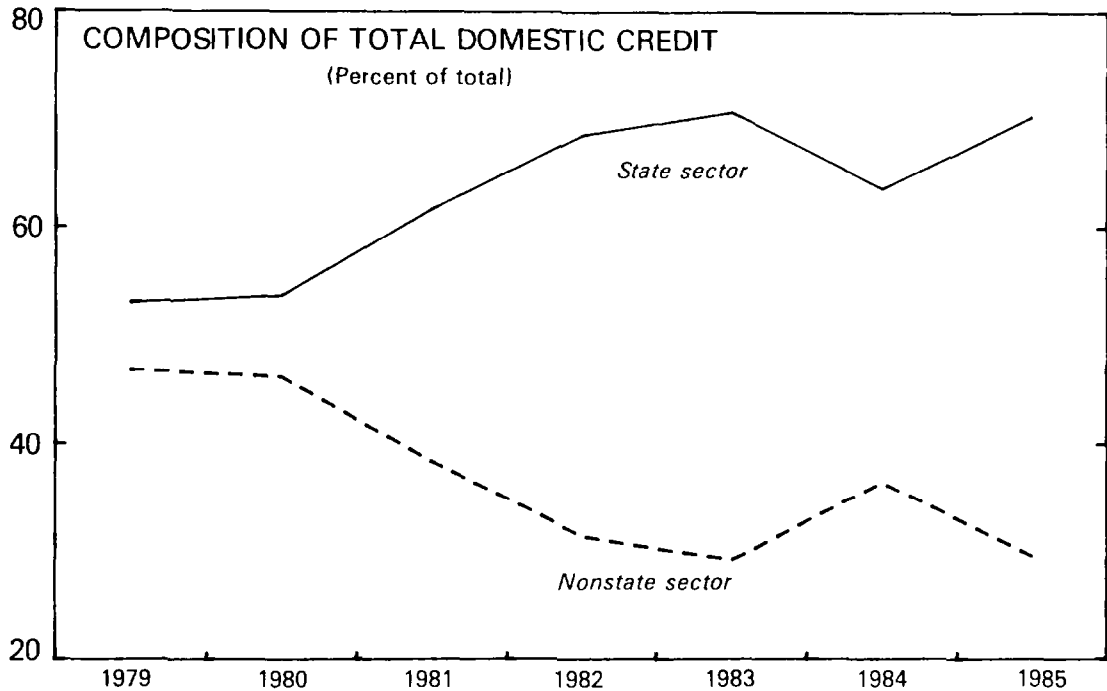
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<sup>1/</sup> See recent economic developments paper, Chapter III (to be issued shortly).

CHART 3

ITALY

SELECTED MONETARY INDICATORS



Source: Bank of Italy.

<sup>1</sup> Growth rates over preceding 12 months.

<sup>2</sup> As a percent of GDP.



4 percent, despite a significant downturn in the second half of the year. It is as yet unclear whether this downturn signals the end of the cyclical upswing in fixed capital formation which began in the second half of 1983. The latest investment cycle has been concentrated on machinery and equipment--investment in construction has declined steadily by a cumulative 7 1/2 percent since 1981--and has taken place against the background of historically high real interest rates and a moderate growth of demand. Between mid-1983 and the third quarter of 1985 investment in machinery and equipment expanded by a cumulative 25 percent, while real GDP rose by around 6 percent. The previous expansionary cycle initiated toward the end of 1977 resulted in a similar expansion of investment in machinery and equipment during a comparable period of time but the expansion of GDP then was almost twice as strong. The bulk of new investment appears to have been directed toward modernization and technological innovation rather than to an increase in capacity. It has been accompanied by significant labor shedding in industry, where employment fell by 6 percent between 1983 and 1985.

The foreign balance largely mirrored developments in domestic demand during 1985. Its contribution to GDP growth was negative in the first half of the year (around 1.8 percent at an annual rate) and strongly positive in the second half (2.8 percent at an annual rate), reflecting the reversal of Italy's relative cyclical position and, in part, the impact of the July 22 devaluation. In the last months of the year, however, imports rebounded strongly, partly reversing the large improvement in the foreign balance of the third quarter. For 1985 as a whole the contribution of the foreign balance in real terms (1970 prices) was approximately zero, leading to an average real rate of growth of GDP similar to that of domestic demand, around 2.3 percent. A large share of the deceleration in GDP in 1985 was due to a marked slowdown in real industrial value added, which rose by 1.2 percent, compared with 2.9 percent in 1984. Employment increased by 0.5 percent as continued strong growth in the services sector more than offset declines in agriculture and industry. However, due to the increase of the labor force, the rate of unemployment rose further to 10.6 percent.

On the incomes policy front, a popular referendum held in June 1985 rejected the proposal sponsored by the Communist party to restore the scala mobile points cut by Government decree in 1984, but negotiations on further modifications of the wage indexation mechanism were stalemated through most of the year. Nevertheless, economy-wide wages per employee decelerated by about 3 percentage points to around 9 1/2 percent, and the share of dependent labor income in net national income declined further to 68.6 percent in 1985, compared with over 69 percent in 1984. The rate of growth of unit labor costs in manufacturing accelerated by over 3 percentage points in 1985 to 7.5 percent, thereby widening the differential--unadjusted for exchange rate changes--relative to Italy's major trading partners. The acceleration of unit labor costs mainly reflected a marked slowdown in the growth of productivity and an increase in employers' social security contributions.

The steady deceleration of inflation over the last few years came largely to a halt during 1985. The 12-month rate of increase in the CPI declined marginally, from 9.4 percent at the end of 1984 to 8.8 percent by end-1985. In year-average terms, the slowdown was more pronounced, amounting to 1.6 percentage points, to 9.2 percent compared with an initial target of 7 percent. The favorable developments in import prices in the latter part of 1985 contributed to a fall of the rate of inflation in wholesale prices of more than 2 percentage points, to 5.9 percent by year-end.

The trade deficit (f.o.b-c.i.f., customs basis) widened to about Lit 23 trillion in 1985, the equivalent of 3.4 percent of GDP from 3.1 percent in 1984. The rise in the deficit was entirely due to the faster volume growth of imports relative to exports, as the terms of trade are estimated to have improved by 0.8 percent following a 1.5 percent loss in 1984 (Table 3). The competitive position in manufacturing remained unchanged if measured by (exchange rate adjusted) relative export unit values, but it improved if measured by relative unit labor costs or wholesale prices, which on average fell by 2.8 percent and 1.7 percent, respectively (Chart 4). The higher trade deficit accounted for most of the deterioration in the current account deficit, to US\$4.2 billion or 1.2 percent of GDP. Increased net tourism receipts roughly compensated for a higher deficit on interest income and a lower surplus on other invisible payments. Following a near equilibrium in 1984, the balance of payments on nonmonetary operations registered a large deficit, around US\$4.4 billion in 1985. The capital account including errors and omissions moved from a sizeable surplus (US\$2.9 billion) in 1984 to a modest deficit (US\$0.2 billion) in 1985. The lira appreciated relative to the U.S. dollar by 13.3 percent in the course of 1985 (Chart 4). The effective exchange rate (MERM weighted) depreciated on average by 5.7 percent in nominal terms and remained broadly unchanged in real (CPI adjusted) terms.

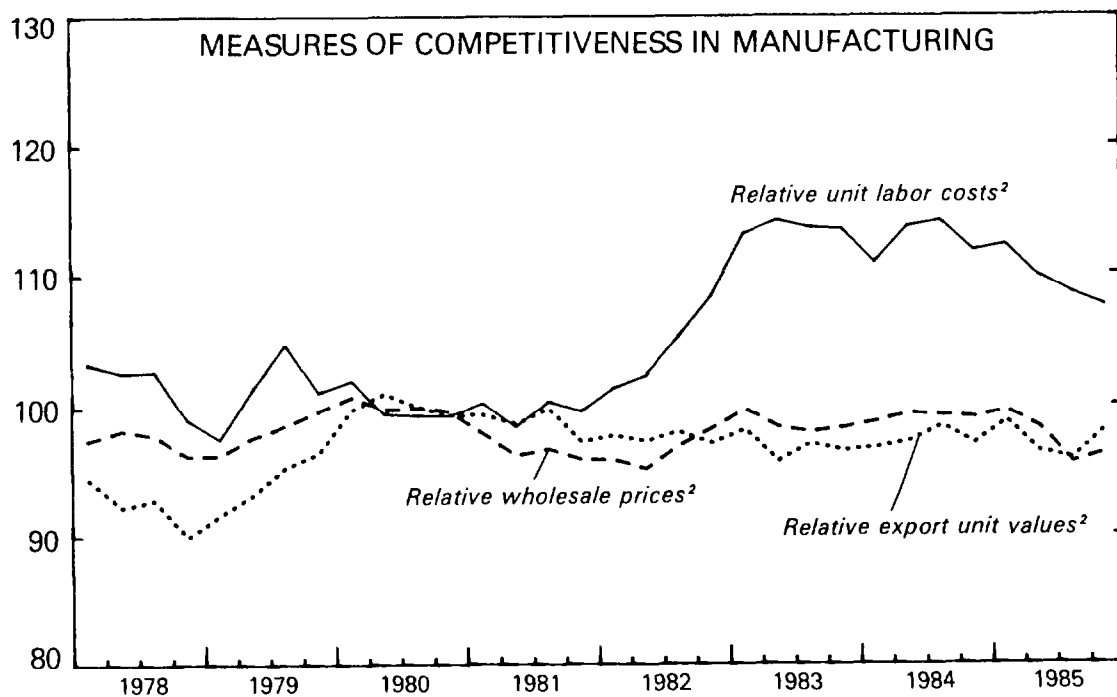
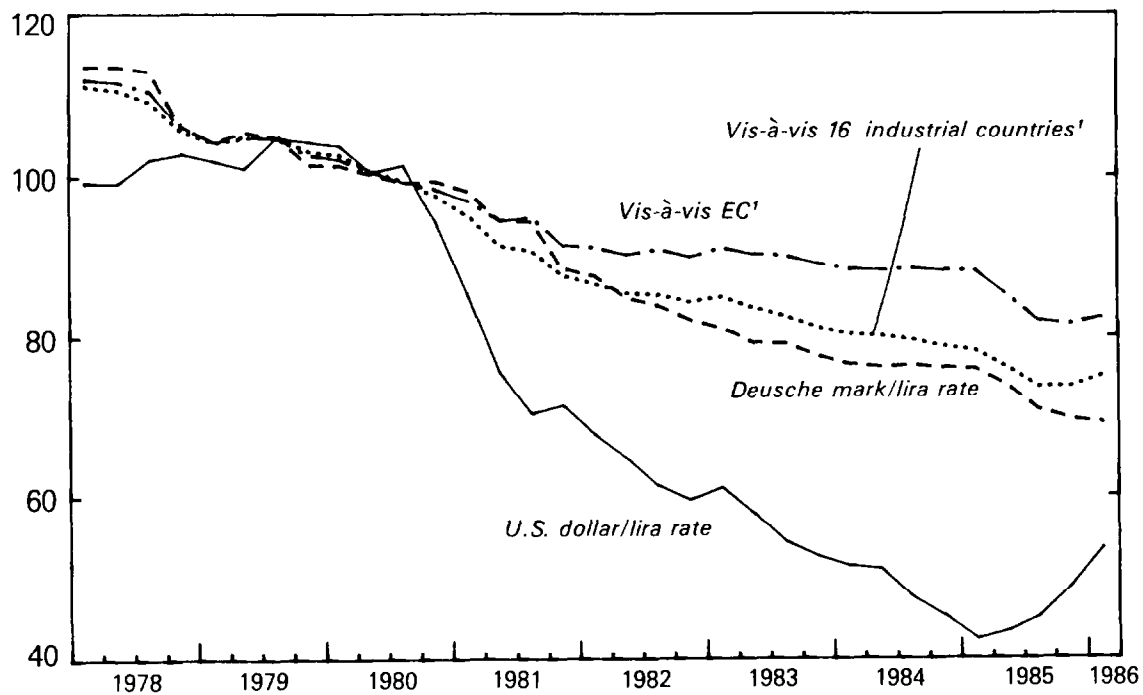
Net disbursements of official development assistance (ODA) amounted to over US\$1.1 billion in 1984, reaching 0.33 percent of GNP, the highest ratio ever achieved by Italy. The aid budget for 1985, including supplemental appropriations for a special emergency program for the relief of hunger and malnutrition in poor countries, amounted to US\$1.8 billion.

## 2. Economic policies

### a. Overview

The Italian authorities are keenly aware of the fact that the current favorable international environment provides an opportunity to resume in 1986 the progress in the adjustment of the economy which was largely halted in 1985. Accordingly, they now target a rate of growth of GDP of over 3 percent (spurred by a projected 6 percent growth of fixed investments), some decline in the rate of unemployment and a deceleration in the rate of inflation in consumer prices to around

CHART 4  
ITALY  
SELECTED EXCHANGE RATE INDICES  
(1980 = 100)



Source: IMF, *International Financial Statistics*, and Research department.  
<sup>1</sup> Nominal effective exchange rates, based on 1980 average trade weights.  
<sup>2</sup> Adjusted for exchange rate changes, vis-à-vis 16 industrial countries.



4 percent by year-end. The current account of the balance of payments is expected to revert to a surplus (equivalent to 1/2 percent to 1 percent of GDP) on account of the projected substantial gain in the terms of trade. The policy stance in support of these objectives involves some tightening of fiscal policy and a reduction in nominal interest rates broadly in line with the decline in inflation. Exchange rate policy is to continue to be geared to fostering a convergence of Italy's cost and price performance with its main EMS partners. The fall in international energy prices is being passed on to the enterprise sector to ensure lower production costs, but taxes are being raised on oil products which are primarily used for consumption.

Over the medium term, the authorities hope to consolidate and carry further the improvement expected in 1986. The latest official scenario for 1987-91 envisages a real growth rate of GDP of 3.5 percent a year on average and the stabilization of the rate of inflation at around 4 percent. The maintenance of a rate of GDP growth around 3.5 percent a year is considered necessary to prevent a rise in the unemployment rate, given demographic trends over the next few years. The current account of the balance of payments is seen as remaining in broad equilibrium, on the assumption of the continuation of a sustained growth of world trade, no reversal of the terms of trade gain expected for 1986 and a reduction in the elasticity of imports with respect to demand.

The Italian authorities recognize that a substantial and steady improvement in the public finances is an essential condition for a sustained reduction of real interest rates, expansion of investments and noninflationary growth. Their medium-term fiscal adjustment program targets constancy in real terms of the state sector's noninterest current expenditures, which is projected to lead to a reduction in their ratio to GDP of about 5 1/2 percentage points by 1991 (roughly 1 percentage point a year). Capital expenditures are targeted to remain broadly stable in relation to GDP, and lower interest rates are projected to result in a decline of 3 1/2 percentage points in the ratio of interest payments to GDP. On the basis of an unchanged tax burden, the ratio of the overall state sector deficit to GDP is projected to fall between 1986 and 1991 by over 9 percentage points, to 5.3 percent. 1/

The discussions between the Italian officials and the staff focused on how Italy could best take advantage of the opportunities offered by the improved outlook for 1986. The risk that the expected gains in the areas of inflation and the external accounts might be dissipated even as early as 1987 was highlighted, and the need for a firm stance of financial policies was stressed, in part because of the upcoming wage bargaining round. It was generally agreed that a major effort ought to be made to ensure that, at a minimum, the fiscal target for this year be

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1/ See Appendix IV for scenarios related to the the medium-term adjustment plan.



met, and the possibility that a further reduction in the ratio of the deficit to GDP be achieved through higher taxation of energy products was discussed. The monetary program for 1986 was reviewed, and the dangers of an excessive reduction in interest rates and monetization of the fiscal deficit were stressed. The limits and risks of a policy aimed at lowering interest rates on the public debt through higher investment coefficients on banks' portfolios or the effective resumption of the Central Bank's role as the Treasury's residual lender were highlighted. The discussions also focused on the labor market situation, in particular on the wide variations in unemployment between regions and age groups and on the role that policies aimed at increasing flexibility might have in reducing this dispersion.

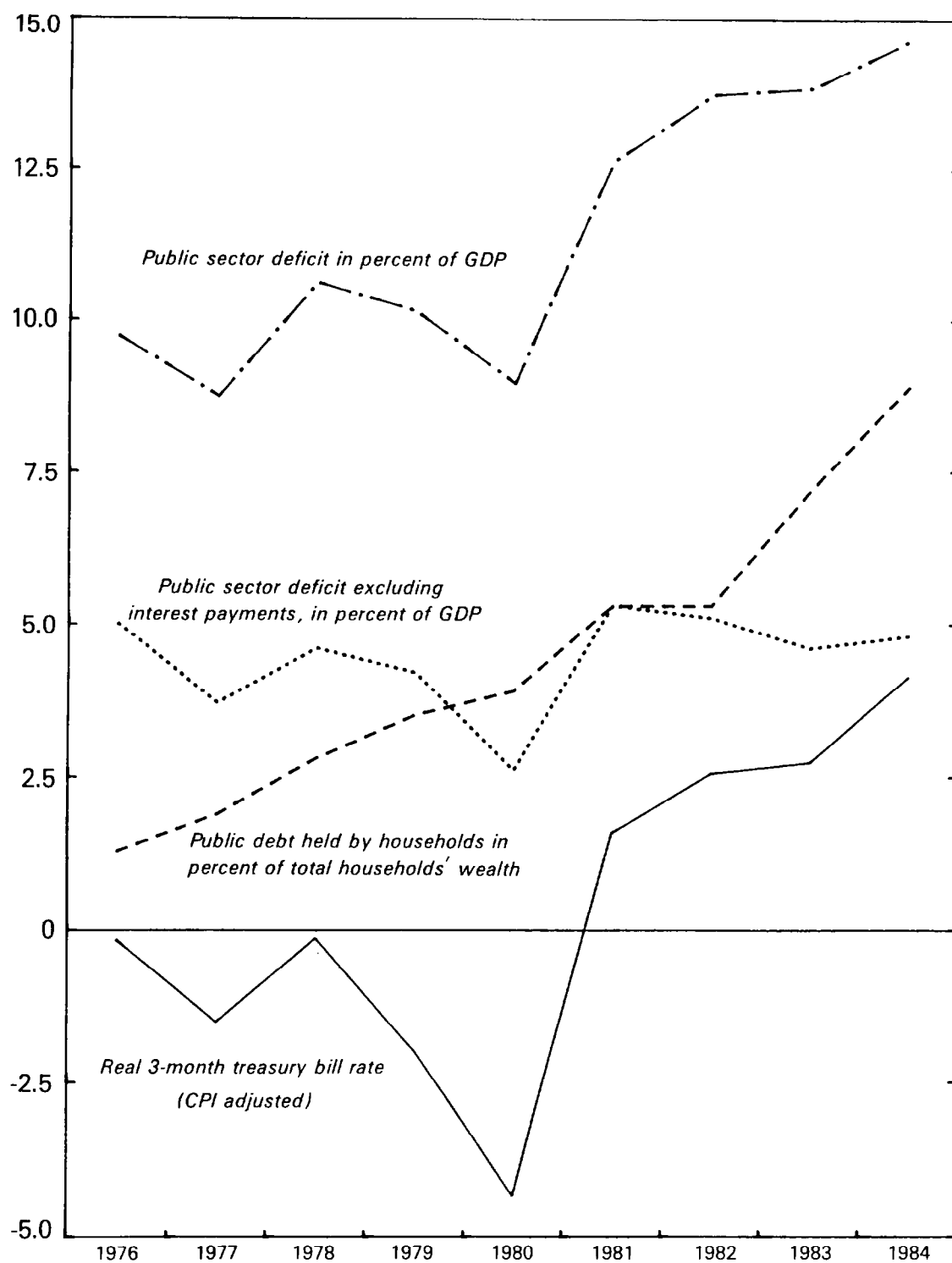
b. Fiscal policy

The steady deterioration of the public finances over the medium term has been a major weakness of the Italian economy. While a measure of adjustment to the second oil shock was achieved in other areas, the overall deficit of the General Government has continued to widen, from the equivalent of 8 percent of GDP in 1980 to 14 percent in 1985. The need to ensure the absorption of very large amounts of government debt in the public's portfolios has required high and generally rising real interest rates (Chart 5), which in recent years have largely exceeded the real growth rate of the economy. This has contributed to a very rapid growth of the public debt--as a ratio to GDP it rose from around 66 percent in 1980 to roughly 100 percent in 1985, the highest ratio among industrial countries with the exception of Belgium--which largely feeds on itself through rising interest payments.

Despite the fact that revenues have grown relatively faster than in other industrial countries--as a ratio to GDP current revenues of the General Government have risen from 38 percent in 1980 to 44.8 percent in 1985, compared with an increase of 1 percentage point to 45.6 percent in Germany and of 3 percentage points to 45.4 percent in France over the same period--the deficit excluding interest payments has risen steadily in recent years, from the equivalent of 1.8 percent of GDP in 1980 to 4.7 percent in 1985 (Table 1). The high savings rates of the private sector have allowed the fiscal deficits to be financed without unsustainable external current account imbalances, but at the expense of a large and growing preemption of domestic savings by the public sector. From around 31 percent in 1980 the ratio of the general government deficit to gross private savings has risen steadily to an estimated 57 percent by 1985, close to three times the average for the major industrial countries.

The initial budget proposal for 1986 targeted a reduction of the state sector deficit equivalent to about 1 1/2 percent of GDP, to Lit 110 trillion (14.6 percent of GDP). The authorities estimated that in the absence of measures the deficit would reach Lit 124 trillion (16 1/2 percent of GDP). The measures proposed in the budget to cut back the projected deficit to the targeted level consisted, on the one

CHART 5  
ITALY  
PUBLIC SECTOR DEFICIT,  
PUBLIC DEBT AND REAL INTEREST RATES



Sources: Data provided by the Italian authorities; and staff calculations.



hand, of increases in revenues (social security contributions, charges for public utilities and fees for health and other public services, including a local tax) and, on the other hand, of cuts in expenditures, especially social benefits. The projected budget savings from these measures were, however, partly offset by reductions in rates of the personal income tax. The budget proposal was approved by Parliament with various amendments, the total cost of which can be estimated at around Lit 3 trillion. The Italian authorities expressed, nevertheless, confidence that the outturn for the state sector deficit in 1986 would be broadly in line with the initial target, mainly on account of a stronger than projected growth of tax receipts and social security contributions.

The authorities stressed that the 1986 budget marked some progress in the effort to contain the growth of noninterest spending. Steps, including a modification of the scala mobile, had been taken to curb the growth of personnel expenditures. The granting of certain social benefits--e.g. family allowances--had been linked more closely to need through income tests, and the contribution of beneficiaries to the cost of medical care had been increased. Steps had also been taken to reduce transfers to public enterprises, especially those with state participation, given that their finances had registered a significant improvement in the last couple of years, and a beginning had been made in restoring a measure of taxing capacity to the local authorities.

Nevertheless, the authorities recognize that more fundamental adjustments in the mechanisms of expenditure determination will be necessary to ensure adherence to the guidelines of the medium-term fiscal adjustment plan. This is especially true for pensions, which are expected to grow by significantly more than GDP over the medium term (see recent economic developments paper, Appendix III, to be issued shortly). Plans for a reform of the pension system have been under discussion for several years but no decisions have been taken so far, and the official proposals put forward to date appear to fall short of the degree of adjustment required. As a first step toward a reform of the budgetary process, which should allow for a better implementation of the medium-term fiscal adjustment program, a series of initial guidelines for the preparation of the 1987 state sector budget has been issued earlier than in previous years. According to those guidelines the growth of current spending by the state sector net of interest payments cannot exceed 4 percent, the medium-term inflation target.

#### c. Monetary policy

Monetary developments over the last few years bear out vividly the limitations under which monetary policy has to function in Italy. The targets of a steady deceleration in inflation, the maintenance of external balance and of broad stability of the lira within the EMS require a degree of control over the growth of the monetary aggregates which may simply be inconsistent with the extremely high public sector borrowing requirement. Consistency might be achieved in the short run

if real interest rates were allowed to rise to sufficiently high levels, or if rationing devices such as credit ceilings or higher reserve requirements could be used with a sufficient degree of tightness. But it is unlikely that a clearly restrictive monetary policy could be sustained over the medium term. On the one hand, political and institutional factors favor such a stance only in near-crisis situations. On the other hand, higher interest rates may themselves be destabilizing, as they entail a higher real cost of financing the public debt and thus, ceteris paribus, a higher deficit, and because the capital inflows they may induce make monetary control more difficult. In the absence of a sustained effort of adjustment of the public finances, it would be virtually impossible to implement a steady, medium-term focused monetary policy in Italy. The experience of recent years would in all likelihood repeat itself, with periods of tightness alternating with periods of accommodation, and convergence with Italy's main partners might remain an unrealized aim.

The steady move toward increased reliance on indirect, market-oriented mechanisms of monetary control came to a temporary halt early in 1986, when heavy losses of foreign exchange reserves led the authorities to reintroduce the ceilings on commercial bank credit in lire which had been abolished in 1984. Credit expansion in each of the first six months of 1986 was limited to between 6 percent and 8 percent of the average level of loans outstanding at the end of September and October 1985. At the same time, short-term interest rates on the public debt were raised by about 1 percentage point, and some previously abolished capital controls were reintroduced. The authorities chose to resort to direct controls, rather than to let interest rates rise further or to allow the lira to depreciate, because they believed that the pressures on the exchange rate were largely of a temporary nature, relating to the slide of the U.S. dollar and corresponding upward pressure on the traditionally stronger EMS currencies. In these circumstances, the authorities felt that the interest rate increase that would have been required to halt the hemorrhage of reserves would not have been appropriate in the light of the expected downward trend of inflation, and would have made the containment of the fiscal deficit to the targeted level more difficult. However, the authorities are well aware of the distortions engendered by a prolonged use of administrative controls on bank credit, and are determined to abolish the credit ceilings as scheduled by mid-year.

The monetary program for 1986 targets a significant slowdown in the growth of credit and liquidity, consistent with the objectives for growth, inflation and the state sector deficit. The growth of total domestic credit is projected to decelerate by nearly 4 percentage points, to around 14 percent by year-end, and the growth of credit to the nonstate sector to decline by about 6 percentage points to around 7 percent (Table 1). These targets are designed to ensure the reabsorption of the exceptional growth of domestic bank credit in lire during the last quarter of 1985. The credit ceilings announced in mid-January are consistent with the programmed deceleration of credit. For M2 a

central target rate of growth of 9 percent has been set, with a band of 1.5-2 percentage points on either side. The growth of total financial assets--excluding shares--of the private sector is projected to decelerate by 3 percentage points to 15 percent, on the assumption of a surplus in the overall balance of payments of the order of 1 percent of GDP.

The Italian authorities believe that room for a significant reduction in nominal interest rates should be provided by the downward trend in domestic inflation and in interest rates abroad. They feel that, given the size of the prospective fall of inflation and the viscosity of bank rates in Italy, some guidance by the monetary authorities may be necessary to ensure an adequate reduction in market rates. On the strength of the marked easing of pressures in the foreign exchange market in recent months, the authorities have moved to lower the discount rate in two steps by a cumulative 2 percentage points since March 1986, to 13 percent, a move which has been only partly followed by market rates so far.

The scope for further reductions in interest rates will, of course, depend crucially on the development of the borrowing requirement of the state sector. The growing concern regarding the high level of real interest rates in general, and the cost of servicing the public debt in particular, has led to proposals for a significant change in public debt management. In particular, the introduction of additional coefficients for mandatory purchases of government securities by commercial banks or the partial repeal of the so-called "divorce" between the Bank of Italy and the Treasury have been proposed. The monetary authorities recognize that such measures could only achieve a temporary reduction of the burden of the public debt through either an excessive expansion of the money supply or increased crowding out of the private sector. It should also be noted that, if the growth of M2 in 1986 is to be contained to the targeted 9 percent, the stock of government securities and other nonmonetary assets of the private sector will have to increase by about 23 percent (about 18 percent in real terms), even if the target for the state sector deficit is strictly adhered to. This may prove difficult to achieve without some increase in real interest rates.

The need to ensure an adequate level of interest rates to fund government debt is heightened by the development of the stock market in the recent past. The average market value of the shares quoted in the stock exchange doubled in the course of 1985, partly because of a rapidly growing demand by mutual funds. Total assets of the latter have increased more than five-fold since the end of 1984, and the share of stocks in these assets has also increased. The remarkable gains in the stock market have generated concern regarding their soundness and sustainability. The authorities noted, however, that the boom was largely a reflection of the improvement in the profit position of enterprises in recent years. The ratio between profits and the market capitalization of listed firms appears to have been broadly stable over the medium run, at least through 1985.

d. Incomes and labor market policies

As in other industrial countries, rigidities in Italy's labor market have contributed to the relatively poor performance of employment in recent years. According to a variety of indicators (for example, the rigidity of real labor costs, the dispersion of wage rates, the flexibility of work time schedules) Italy compares unfavorably with other major industrial countries. 1/ In particular, the elimination of the negative wage differential in the South is thought to have been a contributing factor to the persistence in the Mezzogiorno of high levels of unemployment, substantially above those prevailing in other parts of the country. 2/ The Italian authorities recognize the need to improve flexibility in the labor market. In September 1985, the Minister of Labor presented a medium-term employment program centered on two main themes, the employment problem in the South and the question of labor market flexibility. Past attempts to tackle rigidities in the labor market, however, have usually foundered during lengthy and difficult parliamentary discussions. For example, draft proposals concerning quicker and more flexible recruitment and mobility procedures and an overdue reform of the Wage Supplementation Fund (Cassa Integrazione Guadagni) have not been acted upon for over three years.

In 1984-85 two measures were taken in this area, namely a law covering part-time work and direct recruitments, and the reform of the wage indexation mechanism. Part-time employment has risen strongly following the adoption of the new regime, to around 6 percent of total employment. It is nonetheless still considerably lower than in other industrial countries. The share of direct hiring in new employment increased very markedly after the adoption of new rules allowing for the hiring of up to half of new employees on a direct basis instead of employers having to accept new workers in an automatic numerical order provided by labor exchange lists. The medium-term employment plan contains proposals aimed at furthering the development of part-time and fixed-term contracts, an extension of direct hiring, a raising of compulsory education to 18 years of age, a reform of apprenticeship programs (with lower entry wages) and of individual lay-off regulations, and a return of the Wage Supplementation Fund to its original function of supporting labor mobility in the face of industrial restructuring.

The second important change in terms of labor market flexibility concerns the modification of the wage indexation arrangement, that becomes effective in 1986. The new system, based on an agreement originally reached in the public sector and subsequently extended to cover all dependent employees in the private sector, for a period of four years, provides for (a) a shift from quarterly to semiannual adjustments; (b) a reduced degree of coverage, equal to 100 percent for

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1/ See Appendix I to the recent economic developments paper.

2/ This gap is analysed in further detail in Appendix II of the recent economic developments paper.

the portion of monthly salary up to Lit 580,000 (somewhat less than 40 percent of the average wage in manufacturing in 1985), and of 25 percent for the part in excess of that amount; and (c) consultations between the social partners in the case of changes in indirect taxation, in order to agree on modalities to limit the impact of such changes on the scala mobile index. The degree of coverage of the average industrial wage under the new system has been calculated to amount to around 50 percent, well below the level prevailing in the mid-1970s but only marginally below the 54 percent coverage estimated for 1985.

The new arrangement represents a progress in a number of areas. Firstly, the replacement of the fixed point system with percentage variations according to salary levels will reduce the wage leveling bias of the previous arrangement. Secondly, the reduced degree of indexation implies an increase in the share of nominal wages determined contractually, thus providing greater scope for a closer linkage of wage increases to productivity developments and to the financial conditions of individual enterprises and industries. However, the modification of the mechanism does not go far enough in ensuring the sterilization of changes in indirect taxes as it provides only for consultations among the social partners in the event of these changes. Moreover, the full protection accorded to the lowest wage levels means that the latter will continue to receive higher proportional increases, with continued adverse effects on the employment prospects for youth and unskilled labor.

e. External policies

A nonaccommodating exchange rate policy within the framework of the EMS has been an important element of the Italian authorities' medium-term strategy. The high levels of domestic inflation relative to the main trading partners have made a downward trend in the nominal exchange rate inevitable, but the authorities have generally followed rather than anticipated the inflation differentials and then have not fully accommodated them. The real exchange rate has consequently appreciated over the medium term vis-à-vis the main EMS currencies. Since the inception of the EMS and through the fourth quarter of 1985, the (exchange rate adjusted) CPI has grown by a cumulative 29 percent vis-à-vis Germany, and by 17 percent vis-à-vis France. If measured by relative unit labor costs the real exchange rate has also appreciated markedly. Compared to the EMS average it increased by around 19 percent between 1979 and the third quarter of 1985. An assessment of these developments needs, however, to be qualified by the consideration that the lira had been allowed to depreciate significantly prior to entering the EMS arrangement.

Adjustments of the lira's exchange rate have mostly taken place in the context of general realignments within the EMS. The realignment of July 22, 1985, however, was carried out at the request of the Italian authorities. It was prompted by the rapidly deteriorating external trade account, which reflected a growth of domestic demand significantly



faster than that of Italy's major trading partners, as well as a worsening of competitiveness through the first quarter of 1985. It was accompanied by the announcement of a package of measures aimed at containing the fiscal deficit which, however, were not fully implemented. The devaluation may have contributed to the improvement in the trade deficit in the second half of 1985. The overall gain in competitiveness was, however, rather limited. By the end of the year the real exchange rate measured by relative consumer prices was practically at its level at end-1984, and its average level for 1985 as a whole was broadly unchanged from that of the previous year.

In the last quarter of 1985 the lira came under strong pressure which the authorities countered by heavy intervention. The exchange rate was kept inside the upper half of the narrow EMS band (Chart 2) because of the authorities' concern about the impact of a depreciation on expectations and wage negotiations, and because it was felt that the pressures on exchange markets were largely caused by external factors outside Italy's control. The authorities' view is that the current exchange rate level is broadly adequate, and the decision to keep the ECU central rate of the lira virtually unchanged in the recent (April 6, 1986) EMS realignment underlines the importance attached to the maintenance of a degree of external discipline on domestic cost and price developments.

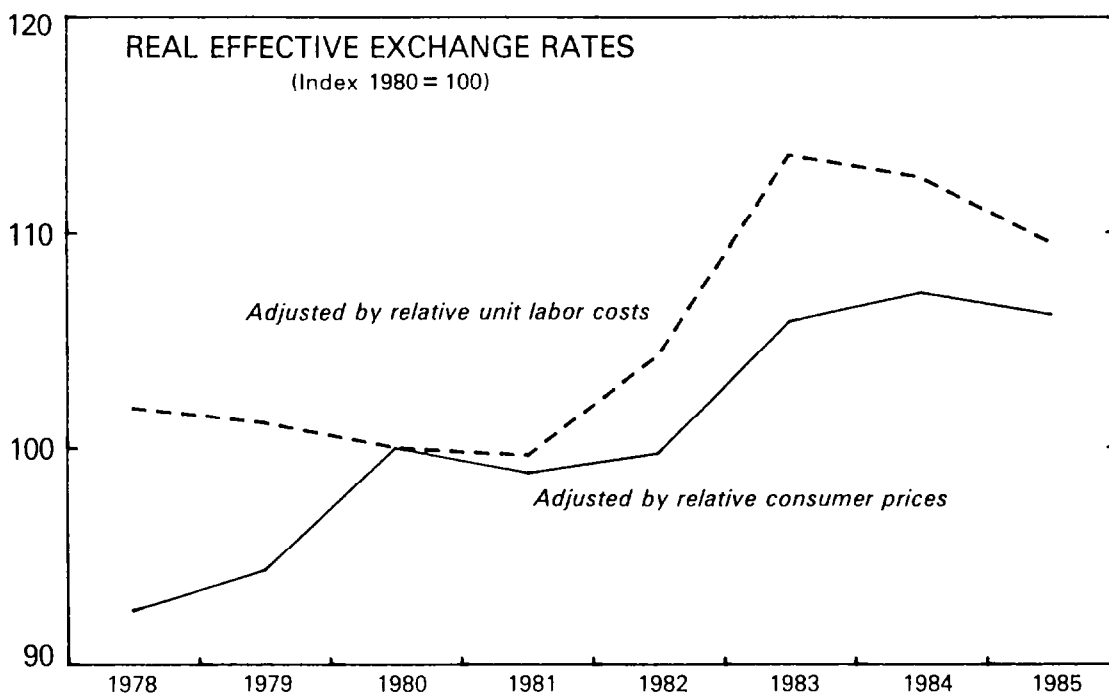
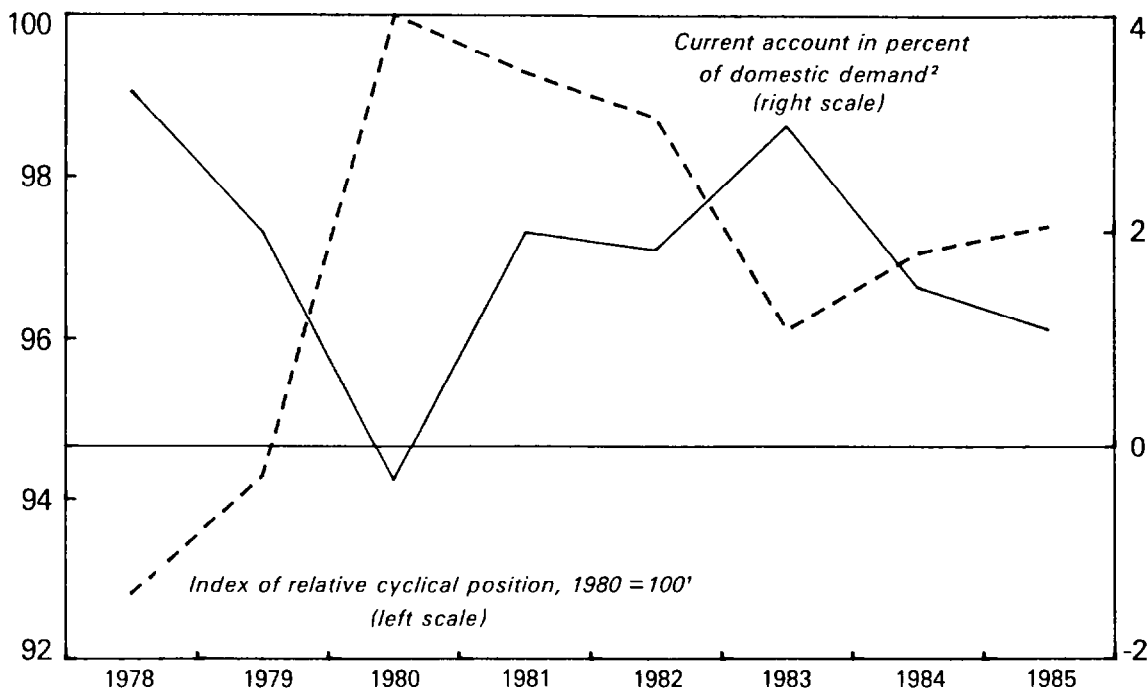
The medium-term impact of the real appreciation of the exchange rate of the lira over the last few years is not clear, as movements in the real trade balance have tended to reflect more closely and promptly changes in Italy's relative cyclical position than in relative cost and price developments (Chart 6). Available evidence on structural trends in the external trade points to a broad maintenance of Italy's share in world exports of manufactures but to a rising import penetration. It appears that the maintenance of export shares, in the face of a deteriorating competitive position, has been achieved mainly through a shift away from the transformation of raw materials and toward the production of higher value-added goods. This shift has been accompanied by increased imports of semimanufactures and of some types of finished goods from lower cost producers. Over the longer run the scope for a sustained growth of output in Italy broadly in line with that of its main trading partners, within the constraint of a balanced current account position, hinges on arresting the rising trend of import elasticity through, inter alia, an improvement in Italy's relative cost and price performance.

Italy's external debt is relatively modest (Table 3). As regards official foreign reserves, the favorable developments projected for the external accounts in 1986 are expected to lead to the recouping of most of the losses suffered in 1985. The debt service ratio is also relatively low, and in recent years Italian borrowers have been able to obtain favorable terms in international markets. The authorities' view

CHART 6

ITALY

# CURRENT ACCOUNT, RELATIVE CYCLICAL POSITION AND REAL EXCHANGE RATES, 1978-85



Source: IMF, Research department, and staff calculations.

<sup>1</sup> Difference in the growth rate of real total domestic demand in Italy and 16 partner countries, 1980 trade-weighted.

<sup>2</sup> Excluding the oil balance.



is that Italy ought to take advantage of the improved external environment and aim at current account equilibrium in the next few years, and at a surplus in the medium term, in order to reduce the external debt.

Trade policy has been generally shaped within the framework of the EC. As regards unilateral restrictions, the authorities indicated a preparedness to raise quotas on sensitive imports provided a corresponding effort was made by the countries affected. Most quotas were adjusted in value terms in 1985 to reflect price movements. The Italian authorities are committed to a gradual dismantling of the remaining exchange controls as developments in the external position allow. In 1985 a series of liberalization measures were taken in this respect. <sup>1/</sup> The freeze on the commercial banks' net foreign position was lifted, and the restrictions on their daily foreign exchange position were made less strict. The rules on foreign financing of import or export credits were liberalized, and in particular, the requirement of external financing of exports was abolished in October. The restrictions on direct and portfolio investments abroad were also eased, and limits on the use of credit cards by Italian tourists abroad were raised substantially. In mid-January 1986, and as part of the policy package aimed at containing the heavy official reserve losses sustained over the previous months, the Italian authorities reintroduced some of the previously abolished capital controls. The subsequent improvement in the reserve position and the favorable outlook for the external accounts allowed the lifting of these measures in mid-April, as well as the adoption of some further liberalization of exchange controls.

### 3. Prospects

A marked improvement in some aspects of the Italian economy is expected for 1986, largely on account of the recent favorable developments in the external environment. The fall in international energy prices and the depreciation of the U.S. dollar are likely to lead to a significant decline in import prices and a large improvement in the terms of trade, which are the major factors behind the projected deceleration in inflation and improvement in the external current account.

The staff projections in Tables 2 and 3 are based on the following assumptions: (a) an average exchange rate of Lit 1,560 per U.S. dollar, consistent with an approximately constant real exchange rate over the period April-December 1986; (b) an average international price of oil of US\$15 per barrel, a 43.8 percent fall relative to 1985; (c) some slippage in the implementation of the announced stance of financial policies, namely a state sector deficit of Lit 113 trillion involving an excess of less than 1/2 of 1 percent of GDP over the official target and rates of growth for the main monetary and credit aggregates about 1 percentage point above present targets; and (d) a deceleration of the

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<sup>1/</sup> See the Appendix on the exchange and trade system in the recent economic developments paper.

growth of labor costs per employee in industry of over 2 percentage points to 9 percent which implies only modest wage awards and wage drift on average for the year.

The real income effect from an estimated 10 percent terms of trade gain is projected to contribute to an acceleration of domestic demand of the order of 1 percentage point, to 3.5 percent, in 1986. Private consumption is projected to grow by 3.2 percent, and a significant improvement in the profit position of enterprises is expected to contribute to a recovery of investment after the fall in the second half of 1985. The expansion of domestic demand and the substantial fall of the relative price of tradeable goods is projected to result in a strongly negative contribution of the foreign balance (-1.1 percent) leading to a rate of growth of GDP similar to 1985 (2.3 percent). The rate of inflation in consumer prices is projected to decline to around 5 percent by year-end (about 6 percent on average) and the current account of the balance of payments to show a surplus equivalent to 0.4 percent of GDP. The shift in the current account position is essentially due to the projected savings on the energy import bill: under the above assumptions for oil prices and the exchange rate, and assuming constant 1985 volumes, the lesser expenditure on the imports of hydrocarbons (crude oil, refined products, natural gas) is estimated to amount to somewhat over 2 percent of GDP. This positive effect will, however, be partly offset by the decline in OPEC demand (which accounted for close to 10 percent of Italy's export markets in 1985) and by the increased competition from countries whose currencies are linked to the U.S. dollar.

The expected improvement in Italy's economic performance in the current year may not be sustained in 1987 and beyond, even if the gain in the terms of trade is not reversed. In the absence of a significant reduction of the fiscal deficit, inflation may well reaccelerate, and the current account could deteriorate significantly. The magnitude of the public sector borrowing requirement may be such that the accumulation of financial assets it implies will not be consistent with the maintenance of the rate of inflation at around 4-5 percent. The required slowdown in nominal incomes would be difficult to achieve, unless financial policies were tightened significantly.

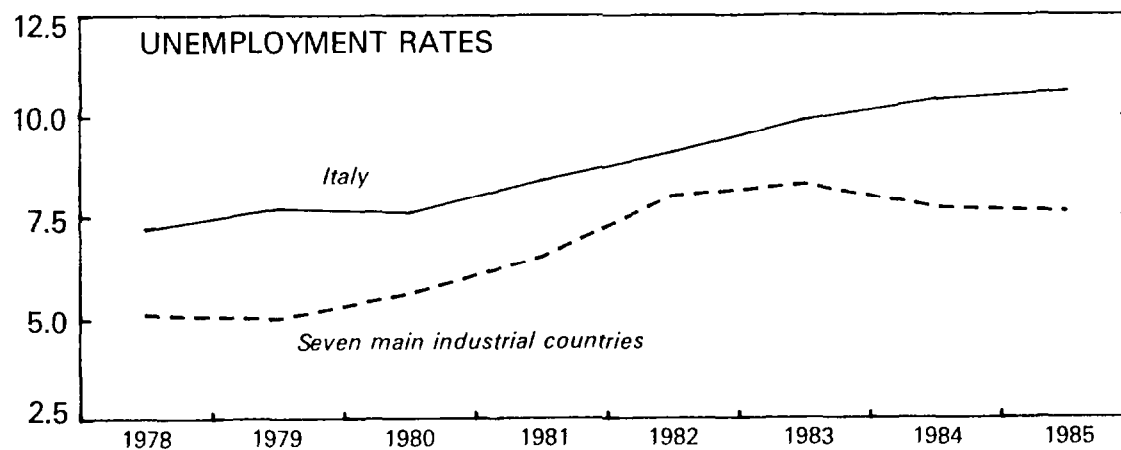
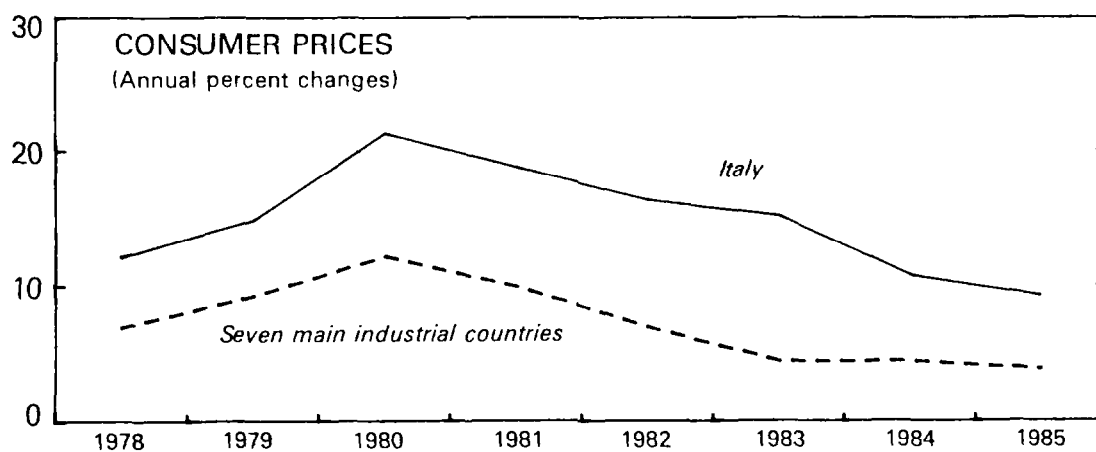
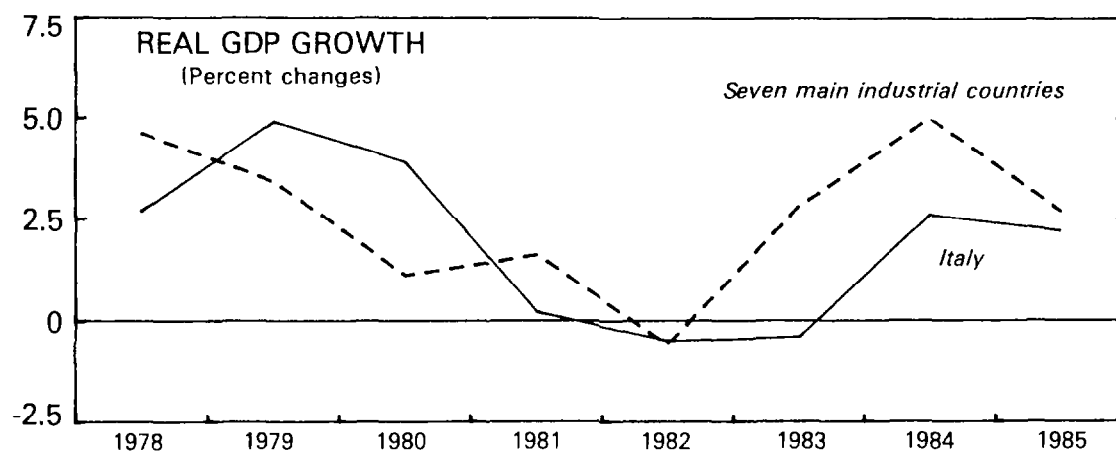
### III. Staff Appraisal

The adjustment of the Italian economy to the second oil shock of 1979-80 has lagged behind that of other major industrial countries (Chart 7). During the five-year period 1981-85 the rate of growth of real GDP has averaged less than 1 percent a year (as opposed to over 2 percent in the other main industrial countries) and the rate of unemployment has averaged nearly 10 percent of the labor force, 2 percentage points above the average of other industrial countries, with youth unemployment reaching 35 percent, as compared to 16 percent in these other countries. The rate of inflation has exceeded the

CHART 7

ITALY

GROWTH, INFLATION AND UNEMPLOYMENT, 1978-85





average of industrial countries by a sizable, albeit declining, margin. The current account of the balance of payments has remained in deficit through most of the period.

This performance of the Italian economy has reflected in part structural weaknesses, such as higher oil dependence, but must be primarily attributed to the high and rising preemption of resources by the public sector. The need to reconcile fiscal deficits equivalent to over 15 percent of GDP with a stance of monetary policy aimed at providing a measure of convergence in Italy's inflation performance with those of its EMS partners has required rising real interest rates, which, in turn, have boosted the growth of the public debt. The discipline of relatively firm monetary and exchange rate policies has fostered a restructuring of Italian industry, and there have been sizable investments in the modernization of equipment and a strong growth of productivity which, in conjunction with wage moderation, have improved the profit position of enterprises. The reduction of the degree of wage indexation has also made a contribution to this improvement. Italy thus faces the challenges of the oil "countershock" with a strengthened industrial structure but with growing financial imbalances primarily linked to the public sector deficit.

The adverse effects of these financial imbalances were again demonstrated by the disappointing performance of the economy in 1985, when inflation ceased to fall, growth remained sluggish, the deficit in the current account of the balance of payments widened, and pressures developed on the exchange rate and reserves. The public finances deteriorated further, with the deficit of the state sector rising to the equivalent of 16 percent of GDP, compared with an initial target of 14 1/2 percent, and the financing of this deficit through monetary base creation nearly trebled from the 1984 level. The development of the monetary aggregates during 1985 illustrates the constraints that a loose fiscal policy and a large stock of public debt impose on monetary policy, especially on the scope for a reduction in real interest rates.

The favorable external environment created by the fall in oil prices and in the U.S. dollar and by the recovery of demand in Europe provides the opportunity for a substantial improvement in the performance of the Italian economy in 1986, with a decline in the rate of inflation and a shift of the current account of the balance of payments into surplus. To ensure that this improvement continues over the next few years, it is crucial that adequate efforts be made to reduce the imbalances which remain in the economy. The extent of the improvement in 1986 and, in particular, the prospects for 1987 will depend largely on the success achieved in avoiding some risks that lie ahead. One risk is obviously that of too rapid a growth of wages through contractual increases, especially at the plant level, and through drift. This danger is especially acute in the present circumstances, with the renewal of numerous labor contracts scheduled to take place in the second half of this year, against the background of improved profit and liquidity conditions of enterprises and of rising demand. If real wages



were to rise significantly, there would follow a short-lived burst in consumption, a rapid growth in imports and ultimately renewed pressures on prices. It is important that the Government, as the largest employer in Italy, set an example through a strict adherence to the guidelines for public sector wages set in the 1986 budget.

The main safeguards against an excessive growth of labor costs should be a nonaccommodating stance of monetary policy and a firm management of the exchange rate. The recent decision by the Italian authorities to keep the central rate of the lira in terms of the ECU broadly unchanged during the recent EMS realignment underscores their commitment to such policies. This strategy is, of course, only sustainable over the longer term if an adequate degree of convergence in Italy's inflation performance with those of its main trading partners is secured. The staff supports the authorities' intention to achieve a deceleration in the rates of growth of the monetary and credit aggregates in 1986. Indeed, a more pronounced deceleration might well be appropriate, given the ample liquidity currently existing in the economy and the growth in the last few years of channels of financing outside the banking system. A nonaccommodating monetary policy would be consistent with a desirable early return to indirect methods of monetary control, provided that interest rates are managed flexibly to reflect market conditions. The staff shares the view that prolonged resort to quantitative credit controls leads to distortions in the financial markets and to a growing disintermediation of the banking system, and hopes that the credit ceilings introduced as an exceptional measure in January 1986 will be abolished by mid-year, as scheduled.

The prospective deceleration of inflation and the decline in interest rates abroad offer an opportunity to lower domestic interest rates gradually. In the view of the staff, it is important that this opportunity be exploited with caution, bearing in mind the overriding objective of maintaining a level of real interest rates that is consistent with the targets for nonmonetary financing of the public sector deficit and credit restraint. The staff does not share the view that the burden of the public debt and real interest rates in general can be lastingly reduced by stepping up administrative controls such as portfolio coefficients on the banking system or by abolishing the so-called "divorce" between the Bank of Italy and the Treasury. There are serious risks that such policies would lead either to an excessive expansion of the money supply, thereby jeopardizing the inflation target and the external position, or to increased crowding out of the private sector through higher real lending rates.

A realistic interest rate policy is also essential for a successful integration of Italy in the international capital markets through a further liberalization of capital controls, which the staff fully supports. This integration could foster increased competition in the Italian banking system, thereby promoting efficiency and reducing the costs of financial intermediation and the fragmentation of credit markets. The staff welcomes the recent removal of the emergency foreign

exchange controls introduced in January and hopes that the authorities' medium-term strategy of dismantling the remaining restrictions on capital movements will be continued in 1986. The staff also considers that the current favorable external environment provides a good opportunity for the authorities to liberalize the unilateral discriminatory import restrictions. The new round of trade negotiations will offer an important opportunity for global trade liberalization. The staff would urge the Italian authorities to work with Italy's EC partners to achieve a more liberal common external trade policy.

The scope for a sustained decline in interest rates in 1986 and beyond, within the framework of a disinflationary monetary policy, hinges crucially on the progress that can be made in reducing the borrowing requirements of the public sector. The budget for 1986 targets a significant reduction of the state sector deficit in relation to GDP, to be achieved mainly through revenue increases, partly of a once-over nature. A beginning is expected to be made in reducing noninterest expenditures in relation to GDP, in line with the targets set out in the medium-term fiscal adjustment plan. Slippages in the implementation of the budget must be avoided by keeping wage increases in the public sector and the growth of public employment firmly in line with budget allocations, and by carefully monitoring the implementation of the budget of peripheral public entities such as municipalities and local health units. The room for increased taxation of oil products created by the decline in oil prices and in the exchange rate of the U.S. dollar should be used to reduce the deficit. The authorities' policy not to fully pass on to consumers the decline in oil prices seems also justified by the fact that Italy's record in reducing the elasticity of energy use to GDP compares unfavorably with that of most European countries.

It is clear that whatever progress can be made in 1986 to reduce the public sector deficit will only represent a first step. Projections show that, even on rather optimistic assumptions about the growth of GDP, inflation and real interest rates, it will be necessary to reduce substantially the ratio of noninterest public expenditure to GDP over the next five years, if the relatively modest aim of arresting the growth of the public debt in relation to GDP by early in the next decade is to be achieved. The boost to both household and enterprise incomes provided by the decline in oil prices creates an opportunity to make a decisive beginning in the structural reform of pensions, health services and, more generally, the provision of public services, which will inevitably entail costs for certain groups of the population. Among the corrective measures that could be considered are the setting of stricter eligibility criteria for benefits and greater reliance on private mechanisms for the provision of, for example, health care and old-age insurance. The improved profitability of private enterprises and enterprises with state participation would also offer the opportunity for a critical review of various fiscal and financial incentive schemes. It is also necessary to go further in adjusting the prices of

various public services to costs, while intensifying efforts to contain these costs through firm wage policies and cutbacks in marginal services.

Some progress has been made in recent years in improving the functioning of the labor market. However, the dispersion of unemployment rates by age, sex and geographic location remains pronounced, and greater than in other industrial countries, suggesting that further progress in making the labor market more flexible is urgently needed. A greater use of temporary and part-time contracts, more flexible hiring procedures, and a reform of the Cassa Integrazione Guadagni would effectively encourage mobility. A closer link between contractual wage increases and productivity differentials and also the possibility of lower entry wages for first-time job seekers would help contain unemployment, especially among young people and in the South.

Italy's economic performance since the beginning of the 1980s has been mixed. Substantial progress has been made in reducing inflation, restructuring industry, and liberalizing the financial system. But major weaknesses and rigidities remain, especially in the public finances and the labor market, which, if uncorrected, would eventually threaten the gains achieved so far. The staff welcomes the fact that these weaknesses are increasingly recognized and proposals to deal with them are being put forward. It would be very unfortunate if the externally generated improvements in prospect for this year were to be used to postpone the necessary corrective effort. It is to be hoped, rather, that the authorities will use this opportunity to help create the conditions for a lasting improvement in the performance of the economy over the next several years.

It is recommended that the next Article IV consultation with Italy be held on the standard 12-month cycle.

Table 1. Italy: Selected Financial Indicators, 1981-86

	1981	1982	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
					Target	Outturn
(As percent of GDP)						
Fiscal indicators						
State sector						
Revenues	30.0	35.1	35.7	36.3	36.9 <u>3/</u>	36.1 37.1
Expenditures	42.8	50.2	52.1	51.8	51.7 <u>3/</u>	52.1 51.7
Overall balance <u>4/</u>	-12.8	-15.1	-16.4	-15.5	-14.8 <u>3/</u>	-16.0 -14.6
Share of deficit financed through: <u>5/</u>						
Medium- and long-term bonds	11.0	32.7	76.2	59.0		70.4
Treasury bills	53.2	39.4	11.8	16.1		-1.5
Monetary base creation	25.7	17.3	1.4	14.4		22.7
Other	10.2	10.5	10.6	10.6		8.4
General Government						
Tax revenue	37.2	39.9	43.0	42.2		41.9
Total revenue	39.8	42.5	45.6	44.9		44.8
Current expenditures	46.4	49.5	51.5	51.9		51.9
Of which:						
Interest payments	7.2	8.5	9.0	9.6		9.3
Total expenditures	51.7	55.1	57.3	57.9		58.8
Current balance	-6.8	-7.2	-6.2	-7.4		-7.4
Financial balance <u>6/</u>	-11.8	-12.6	-11.7	-13.0		-14.0
(End of period; percentage change except as otherwise indicated)						
Monetary variables						
Monetary base <u>7/</u>	11.7	12.6	13.3	12.5		14.9
M2	10.0	18.0	12.3	12.1	10.0	10.7 9.0
Total domestic credit	18.1	20.9	20.7	19.7 <u>8/</u>	16.0	18.0 13.9
Lending to nonstate sector	13.5	13.4	13.2	15.6 <u>8/</u>	12.0	12.8 7.0
Share of credit to the state sector in total domestic credit expansion (in percent)	61.7	68.6	70.7	65.4 <u>8/</u>		69.9 80.0
Total financial assets <u>9/</u>	19.0	20.3	20.2	20.3		17.8 15.0
Share of the Treasury in monetary base creation (in percent)	164.8	122.6	35.8	72.4		142.4
(In percent; period averages unless otherwise indicated)						
Interest rates						
Discount rate (end of period)	19.0	18.0	17.0	16.5		15.0 13.0 <u>10/</u>
Three-month treasury bills	19.6	19.4	17.8	15.3		13.9 13.0 <u>10/</u>
Prime rate	21.4	21.6	19.4	17.7		16.4 15.4 <u>10/</u>
Average deposit rate	12.6	13.4	12.5	11.8		10.9 10.0 <u>10/</u>

Source: Data provided by the Italian authorities.

1/ Provisional estimates.

2/ Official forecasts.

3/ Estimates of February 1985. The original September target aimed at an overall deficit equivalent to 14.2 percent of GDP.

4/ Including net lending but excluding debt liquidations.

5/ In percent of the total state sector deficit.

6/ Excluding net lending.

7/ Adjusted for the automatic increase in reserve requirements.

8/ Adjusted for distortions related to the removal of credit ceilings.

9/ Domestic component of financial assets net of shares held by the private sector.

10/ April (partly estimated).

Table 2. Italy: Main Economic Variables, 1981-86

(Percent changes)

	1981	1982	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
Real demand and output (1970 prices)						
Private consumption	0.5	0.5	-0.3	1.9	1.9	3.2
Public consumption	3.3	2.6	2.4	2.4	2.5	2.0
Fixed investment	0.6	-5.2	-3.8	6.2	4.1	4.0
Stockbuilding <u>3/</u>	-3.1	--	-0.6	0.6	--	0.3
Total domestic demand	-2.2	-0.3	-1.1	3.3	2.4	3.5
Exports of goods and services	5.2	0.4	3.4	6.5	8.2	3.5
Imports of goods and services	-5.3	1.5	-0.4	9.2	9.4	8.5
Foreign balance <u>3/</u>	2.3	-0.2	0.9	-0.3	--	-1.1
GDP	0.2	-0.5	-0.2	2.8	2.3	2.3
Industrial production	-1.6	-3.1	-3.2	3.4	1.2	1.6
Wages, costs and prices						
Labor costs per employee						
in manufacturing	20.2	17.8	15.1	11.4	11.4	9.0
Productivity in manufacturing	0.6	-0.3	0.5	7.0	3.7	2.8
Unit labor costs in manufacturing	19.5	18.4	14.5	4.2	7.5	6.0
Consumer prices	17.8	16.5	14.7	10.8	9.2	6.0
GDP deflator	18.3	17.8	15.0	10.8	8.8	8.6
Unemployment rate (levels)	8.4	9.1	9.9	10.4	10.6	10.8
Disposable income of households	20.9	17.1	14.2	14.4	11.1	10.2

Sources: Ministry of the Budget and Ministry of the Treasury, Relazione Generale sulla Situazione Economica del Paese; data provided by Italian authorities; and staff projections.

1/ Partly estimated.

2/ Staff projections.

3/ Changes in stockbuilding and the foreign balance are expressed as percentage of GDP in the previous year.

Table 3. Italy: External Developments, 1981-86

	1981	1982	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
Trade developments (percent changes)						
Imports, c.i.f., customs basis						
Unit value	36.6	8.6	4.8	11.3	8.1 <u>3/</u>	-10.0
Volume	-11.3	3.2	0.2	9.1	7.1 <u>3/</u>	8.5
Exports, f.o.b., customs basis						
Unit value	23.2	15.0	7.4	9.6	9.0 <u>3/</u>	--
Volume	4.7	0.3	3.7	6.6	6.3 <u>3/</u>	3.5
Balance of payments summary (in billions of lire)						
Trade balance, f.o.b.-f.o.b.	-12,032	-10,739	-4,682	-10,775	-13,444	-4,175
Services	1,945	2,159	4,088	3,403	3,320	5,250
Private transfers	1,639	1,987	2,131	2,556	2,691	2,750
Official transfers	-777	-819	-354	-268	-599	-600
Current balance	-9,225	-7,412	1,183	-5,084	-8,032	3,255
(As percent of GDP)	-2.3	-1.6	0.2	-0.8	-1.2	0.4
Nonmonetary capital	11,386	5,185	1,900	474	6,212	
Errors and omissions	-628	-294	710	4,667	-6,532	
Overall balance	1,533	-2,521	3,793	57	-8,352	
Gross official reserves (excluding gold) <u>4/</u>	20,134	14,114	20,172	21,128	15,712	
Net foreign position of commercial banks <u>4/</u>	-13,391	-10,631	-12,870	-15,139	-14,576	
External debt outstanding <u>4/5/</u> (As percent of GDP)	46,600 13.9	49,700 14.5	53,400 16.4	55,700 17.5	63,100 15.3	
Memorandum items:						
Average exchange rates						
Italian lire per U.S. dollar	1,136.8	1,352.5	1,518.8	1,757.0	1,909.4	1,598.2 <u>6/</u>
Percent change in lira/US\$ rate <u>7/</u>	32.7	19.0	12.3	15.7	8.7	-8.7 <u>8/</u>
Effective exchange rate (MERM weights, 1980 = 100)	86.7	80.2	76.1	71.1	67.0	67.6 <u>6/</u>

Sources: Bank of Italy, Annual Report; IMF, International Financial Statistics; data provided by the Italian authorities; and staff estimates and projections.

1/ Provisional estimates.

2/ Staff projections.

3/ January-November over same period of 1984.

4/ End of period, in millions of U.S. dollars.

5/ Includes medium- and long-term debt and the net external liabilities of commercial banks.

6/ Average of first quarter of 1986.

7/ Positive sign indicates a depreciation.

8/ Average of first quarter of 1986, compared to fourth quarter of 1985.

Fund Relations with Italy

(As of April 30, 1986)

I. Membership status

- (a) Italy became a member of the Fund on March 27, 1947.
- (b) Italy is an Article VIII member.

A. Financial Relations

II. General department (General Resources Account)

- (a) Quota: SDR 2,909 million.
- (b) Total Fund holdings of Italian lire: SDR 1,896 million  
(65.2 percent of quota).
- (c) Reserve tranche position: SDR 1,013 million.
- (d) Current operational budget: the Italian lira is not  
included in the current budget
- (e) Lending to the Fund: under the GAB Italy has undertaken to  
lend the equivalent of SDR 1,105 million; nothing has  
been called to date.

III. Stand-by or extended arrangement and special facilities

None.

IV. SDR department

- (a) Net cumulative allocation: SDR 702.4 million.
- (b) Holdings: SDR 336.2 million or 47.9 percent of net  
cumulative allocation.
- (c) Current designation plan: Italy is not included in  
the current plan.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange rate arrangements

Since March 13, 1979 Italy has participated in the exchange rate mechanism of the European Monetary System with a 6 percent margin. The bilateral central rate of the lira was changed by 7.8 percent against other participating currencies on July 22, 1985 (resulting from a 6 percent devaluation of the lira and a 2 percent revaluation of other currencies). On average, in 1985 the lira depreciated by 8 percent against the U.S. dollar and by 5.7 percent in nominal effective terms. During the first quarter of 1986, the lira appreciated against the U.S. dollar by 9.5 percent relative to the average of the fourth quarter of 1985, and it appreciated by 1.7 percent in nominal effective terms. The EMS realignment of April 6, 1986 resulted in a 1.6 percent devaluation of the lira vis-à-vis its central ECU rate.

VIII. The last Article IV consultation was concluded on March 18, 1985 and the staff report (SM/85/119, 4/26/85) was considered by the Executive Board on May 24, 1985.

The mission will propose that the next Article IV consultation be held on a 12-month cycle.



Basic Data

Area (thousand square kilometers)	301.3
Population (mid-1985)	57.2 million
Labor force (1985 average)	23.2 million
GDP per capita (1985, thousands of lire)	Lit 11,971

<u>Use and supply of resources (1985)</u>	<u>In billions of lire</u>	<u>In Percent</u>
Private consumption	434,100	63.4
Public consumption	136,870	20.0
Gross fixed investment	124,850	18.2
Change in stocks	<u>4,897</u>	<u>0.7</u>
Gross domestic expenditure	700,717	102.3
Exports of goods and services	174,212	25.4
Imports of goods and services	<u>-190,086</u>	<u>-27.8</u>
Gross domestic product	684,843	100.0

<u>Selected economic indicators (annual percentage change)</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
GDP (at constant prices)	0.2	-0.5	-0.2	2.8	2.3
Private consumption (at constant prices)	0.5	0.5	-0.3	1.9	1.9
Gross fixed investment (at constant prices)	0.6	-5.2	-3.8	6.2	4.1
Industrial production	-1.6	-3.1	-3.2	3.4	1.2
Exports of goods (in lire)	29.0	15.3	11.4	16.7	16.0
Imports of goods (in lire)	21.2	12.1	5.0	21.5	16.6
Unit labor costs in manufacturing	19.5	18.4	14.5	4.2	7.5
Consumer prices	17.8	16.5	14.7	10.8	9.2
GDP deflator	18.3	17.8	15.0	10.8	8.8
Money and quasi-money (M2; end-year)	10.0	18.0	12.3	12.1	10.7
State sector overall deficit (as percent of GDP)	12.8	15.1	16.4	15.5	16.0

<u>Balance of payments (in millions of SDRs)</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Exports of goods, f.o.b.	63,419	65,611	67,370	70,964	76,509
Imports of goods, f.o.b.	-72,395	-72,803	-70,253	-76,947	-83,443
Net services and transfers	2,094	2,228	3,612	3,160	2,792
Current account	-6,882	-4,964	729	-2,823	-4,143
Net capital movements <u>1/</u>	8,026	3,276	1,608	2,855	-165
Overall balance	1,144	-1,688	2,336	32	-4,308
Gross official reserves (excluding gold, end-year)	17,298	12,794	19,268	21,278	14,305

1/ Includes errors and omissions.

Italy - Statistical Issues

1. Outstanding Statistical Issues

a. Financial accounts

Balance sheet data for the most recent reporting periods are incomplete, resulting in data gaps in the IFS page for Italy. The Bank of Italy has informed the Bureau of Statistics that a major revision of the data processing system is in process, which will help to overcome these problems.

b. Government finance

Monthly data are reported regularly for IFS. They cover the transactions of the Treasury, the Postal Saving and Loan Fund, and the autonomous enterprises.

Data in the 1985 GFS Yearbook extend through 1984, and cover the budgetary central government sector, 12 social security institutions and funds and several miscellaneous extrabudgetary entities. Data on expenditure by economic type were not available beyond 1980, while data on local governments were available only for 1975. The lack of data on local government precludes the publication of statistics on consolidated general government. Data on financing and debt are also incomplete. Information on tax revenue provided to the Fund is not consistent with comparable data reported to the OECD.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Italy in the May 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Italy which during the past year have been provided on a timely basis.

Status of IFS Data

		<u>Latest Data in</u> <u>May 1986 IFS</u>
Real Sector	- National Accounts	First qtr. 1985
	- Prices: WPI	December 1985
	CPI	December 1985
	- Production	December 1985
	- Employment	Fourth qtr. 1985
	- Earnings: (Wages)	December 1985
Government Finance	- Deficit/Surplus	December 1985
	- Financing	December 1985
	- Debt	December 1985
Monetary Accounts	- Monetary Authorities	October 1985
	- Deposit Money Banks	November 1985
	- Specialized Credit Institutions	October 1985
	- Insurance Companies	March 1980
Interest Rates	- Discount Rates	January 1986
External Sector	- Merchandise Trade:	
	Values:	December 1985
	Prices: (unit values)	October 1985
	- Balance of Payments	Second qtr. 1985
	- International Reserves	March 1986
	- Exchange Rates	March 1986

Medium-Term Adjustment Scenarios 1/

The worsening imbalance of public finances in Italy was accompanied by an improvement in the current account in the 1980 to 1983 period, with the brunt of the external adjustment being borne by the private sector through a marked rise in its net savings, as private sector gross investments fell sharply. 2/ Although private sector savings continued to rise in relation to GDP in 1984-85, the concomitant pickup in investment meant that the private sector could no longer accommodate the further, rapid widening of the general government deficit, and the current account of the balance of payments accordingly moved back into deficits of the order of 1 percent of GDP in both years. The authorities' latest medium-term plan to 1991 postulates the need to substantially raise the ratio of private investment to GDP (which in 1985 remained some 5 percentage points of GDP below its pre-oil shock levels), with a consequent decline in the net savings of the private sector, and to maintain the current account of the balance of payments in equilibrium so as not to add further to an external debt amounting to some 12 percent of GDP at end-1985. 3/

Scenarios A and B in this Appendix (Table 4) accordingly assume a gradual return of private sector savings and investment ratios to the levels prevailing just prior to both the first and second oil shocks, and a maintenance of the current account of the balance of payments in equilibrium as from 1987, which would approximately halve the external debt-to-GDP ratio by the end of the decade. Scenario A shows that the fiscal rules set out in the authorities' medium-term adjustment plan (i.e., maintenance of both revenues and capital expenditures constant in relation to GDP and of current noninterest expenditures constant in real terms) would lead to a general government deficit consistent with the targeted investment and current account performances only if real GDP

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1/ The medium-term fiscal adjustment scenarios in this appendix are essentially an update of the exercise contained in the recent economic developments paper for the 1985 Article IV consultation with Italy (SM/85/127, 5/10/85, Appendix II). The simulations are based on a simplified accounting framework, which utilizes primarily the national flow of funds accounts and the interactions between the public sector deficit, interest payments and the public debt. Their role is prevalently illustrative, and they do not purport to reflect the complex interplay between the macroeconomic environment and the assumed fiscal stance.

2/ For relevant data, see recent economic developments paper, Chapter IV.

3/ Total public and private sector medium- and long-term debt, excluding the net external position of the commercial banks. The authorities' intention is to concentrate the investment and growth effort on the next five years, during which demographic pressures on employment trends will be the most marked, and to seek current account surpluses thereafter in order to reduce the external debt outstanding.

growth were maintained at the relatively high rate assumed in the plan (an average annual growth of 3.5 percent). Even under this optimistic scenario, the public debt to GDP ratio would continue to increase, peaking at 116 percent of GDP in 1989. An average real GDP growth rate of 3.5 percent per annum would, however, be considerably higher than that projected for European industrial countries, 1/ and would be consistent with current account equilibrium only under the assumption of a considerable reduction in the elasticity of imports to demand. In the absence of such a reduction, current account equilibrium will require a tighter financial stance and slower growth. More specifically, in the fiscal field, slower GDP growth of 2.5 percent per annum would imply a more severe cutback in noninterest current expenditure, in the order of over 1 percent in real terms per annum, in order to secure a general government deficit compatible with the targeted investment and current account performances (Scenario B).

While keeping in mind the limitations inherent in such exercises, the above scenarios serve to illustrate the fact that the medium-term plan's fiscal rules would lead to an adequate adjustment path only under a relatively optimistic growth scenario, and that if this were not forthcoming the rules would need to be substantially tightened--in terms of a real contraction in noninterest current expenditure--for the investment and current account targets to be achieved, and for the external debt to be reduced in relation to GDP.

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1/ An average 2.7 percent over the 1988-91 period in the baseline scenario assumed in IMF, World Economic Outlook, April 1986.

Table 4. Italy: Medium-Term Fiscal Adjustment Scenarios, 1986-91

(In percent of GDP; unless otherwise indicated)

	1986 <u>1/</u>	1987	1988	1989	1990	1991
<b>Scenario A <u>2/</u></b>						
Assumptions:						
1. Current account balance	0.4	--	--	--	--	--
2. Private investment	14.5	15.7	16.7	17.7	18.0	19.0
3. Private savings	28.1	27.4	26.4	25.0	24.0	23.6
4. General government balance <u>3/</u>	-13.3	-11.7	-9.7	-7.3	-6.0	-4.6
5. Real GDP growth, in percent	2.3	3.5	3.5	3.5	3.5	3.5
Results:						
6. Interest payments	9.7	9.3	8.7	7.8	7.8	7.7
7. General government debt	104.2	110.5	114.4	115.6	115.4	113.8
<b>Scenario B</b>						
Assumptions:						
1-4 as in A above;						
5. Real GDP growth, in percent	2.3	2.5	2.5	2.5	2.5	2.5
Results:						
6. Noninterest current expenditure, real growth	--	-1.4	-1.3	-0.9	-1.1	-1.3
7. Interest payments	9.7	9.4	8.8	8.0	8.1	8.0
8. General government debt	104.2	111.5	116.3	118.4	119.0	118.3
<b>Memorandum items:</b>						
Average interest on public debt	11.0	9.0	8.0	7.0	7.0	7.0
GDP deflator	4.0	4.0	4.0	4.0	4.0	4.0

Source: Staff calculations.

1/ Staff forecasts.

2/ Scenario A also assumes adherence to the authorities' medium-term fiscal adjustment rules (constant ratios of revenues and capital expenditures to GDP, and zero real growth of noninterest current expenditures). Scenario B assumes constant ratios of revenues and capital expenditures to GDP, and derives the path for noninterest current expenditure residually.

3/ Excluding net financial operations; in the projections of the general government debt such operations are included, for an amount equivalent to 2 percent of GDP per year.

