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Minutes of Executive Board Meeting 86/107

10:00 a.m., July 2, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	Mawakani Samba
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
G. Grosche	
	Jiang H.
J. E. Ismael	
	J. R. N. Almeida, Temporary
T. P. Lankester	
H. Lundstrom	
	L. Leonard
	P. E. Archibong, Temporary
	C. A. Salinas, Temporary
Y. A. Nimatallah	
P. Pérez	
H. Ploix	
	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; B. Rose, Deputy Director; L. M. Beleza, H. B. Junz, A. Leipold, A. López-Claros, P. M. Nagy, D. C. L. Nellor, T. M. Ter-Minassian, H. Vittas. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; Fiscal Affairs Department: G. M. Bartoli, E. Namor, N. Rossi. Legal Department: J. K. Oh. Research Department: J. P. Horne, F. Larsen. Advisors to Executive Directors: L. P. Ebrill, S. Ganjarerndee, S. M. Hassan, J. Hospedales, K. Murakami, G. Nguyen, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, O. S.-M. Bethel, J. de la Herrân, F. Di Mauro, V. Govindarajan, G. K. Hodges, L. Hubloue, S. King, T. Morita, S. Rebecchini, J. Reddy, S. Simonsen, H. van der Burg, Yang W.

1. ITALY - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Italy (SM/86/121, 6/2/86). They also had before them a report on recent economic developments in Italy (SM/86/135, 6/17/86; Cor. 1, 7/1/86; and Sup. 1, 7/1/86).

Mr. Zecchini made the following statement:

At the outset I would like to convey the appreciation of my authorities for the staff's analysis, which is comprehensive and articulate, as it has been in the past. Although there is a general agreement on the broad lines of the analysis, it is not possible to gloss over the fact that my authorities do not share all the points of view expressed by the staff and especially the pessimism that lingers over most of the appraisal of the economic trends and results in the past few years.

External factors coupled with domestic imbalances prompted my authorities at the beginning of the 1980s to embark on a long-range adjustment effort. In spite of the fact that this effort took place in a difficult period characterized by a sharp appreciation of the dollar, a worsening of external terms of trade, and worldwide sluggishness in economic activity, Italy succeeded in reducing the inflation rate by 13 percentage points by 1985, in curtailing the external deficit on current account to about 1 percent of GDP (2.4 percent in 1980), and in tackling some of the major structural rigidities, like the indexation mechanism for wages and salaries. Progress has been uneven in some areas or slow in some years, but it has been continuing since the beginning of the adjustment, with no reversal in trends.

Lately, the same external factors that earlier prompted the adjustment action are easing some of the most pressing constraints on economic expansion. Although this is lessening the urgency for action, my authorities are aware that latent structural weaknesses and deep-rooted imbalances still persist and need to be addressed. Therefore, they remain committed to completing their task of restoring equilibrium in the areas where needed and improving economic and financial structures, thereby allowing the closing of the gap in economic performance with respect to the major European partners.

Economic performance in 1985 and outlook for 1986

In 1985, the Italian economy continued to recover following the path initiated in 1984, but the results did not fully live up to the initial expectations. In the face of an insignificant contribution from the foreign balance in real terms, the slowing down in the expansion of domestic demand was reflected in a deceleration of real GDP growth, which came into line with the average growth of the EEC economy. Such a growth rate allowed an increase in the overall level of employment by 0.5 percent without, however, being sufficient to offset the increase in the labor force and in the participation rate. The unemployment rate remained at a high level (10.6 percent), retaining also a very skewed distribution: unemployment rates were much higher in the southern regions, among young people and among women. With respect to the employment distribution among economic sectors, while the shedding of labor came close to an end in the industrial sector, the tertiary sector continued to be the only one to absorb labor.

The declining trend in the growth of nominal unit wages and salaries since 1980 continued in 1985 with a decrease of almost 3 percentage points, but its impact on slowing down unit labor costs (ULC) was somewhat compensated by the deceleration in productivity gains and the rise in nonwage costs. In the manufacturing sector, the same factors were even responsible for an acceleration in ULCs; their rise, however, did not exceed significantly the increase in prices of imported inputs. Moreover, unit costs in this sector lagged behind the dynamics of output prices, leaving room for the second year in a row for a widening of profit margins and improvements in companies' financing structures as a result of the increasing contribution of retained earnings. The improved profitability, together with the more favorable conditions in the domestic financial markets, particularly as a result of the buoyancy of the stock market, explain the continuing strength of private fixed capital investment. In particular, investment in machinery and equipment grew by more than 10 percent, attaining the peak values since the mid-1970s.

Inflation at the consumer level also declined, although not to the extent that was originally targeted. This deviation from the target can be attributed both to lagged effects of producer price rises in 1984 and the first half of 1985 and to increases in administered prices and public tariffs in excess of the programmed rate.

As to the external current account, the larger deficit in 1985 is attributable mainly to the worsening of the trade imbalance. This result would nevertheless appear less negative if considered in the light of two elements related to export trends. First, exports grew in volume at a pace much closer to the rate for imports than in 1984. Second, exports accelerated, leading to a widening of Italy's market share in a period of shrinking world export markets and of no major gain in overall external competitiveness. In fact, in spite of the exchange rate adjustments in February-March and in July 1985, the real effective exchange rate remained rather stable on a yearly average compared with 1984. Moreover, recent empirical analyses on the characteristics of Italy's specialization in international trade point out that increasing penetration into foreign markets occurred in a number of economic sectors that go beyond those in which Italy has traditionally enjoyed a comparative advantage.

The economic picture that I have described is bound to improve more rapidly in the current year as a result of two main factors, one external and the other internal.

On the one hand, the depreciation of the dollar and the lower world market prices for primary goods are bringing about an improvement in Italy's terms of trade. This is estimated to exceed 10 percent compared with the 1985 average level and will leave more scope for the expansion of domestic demand and output without leading to larger deficits in the external balance. Domestic demand is expected to grow at a rate close to 4 percent in real terms and GDP by about 3 percent, while the current account of the balance of payments would be in equilibrium, if not in surplus, should the major trading partners foster the growth of their domestic demand as advocated internationally. At the same time, employment is expected to increase by a number twice as large as in 1985 and inflation to fall rapidly.

The other factor for improvement is the consistency of the conduct of economic policies. My authorities are aware that the shift in the terms of trade is not permanent and that the new margins for maneuver that result from it have to be used to pursue the correction of deep-rooted internal disequilibria in a context of more stable growth of the economy than in the last five years. To this end, the initial benefits deriving from the lower prices for energy and primary product imports have already been apportioned to reducing the public deficit, enhancing competitiveness and maintaining incentives to save on these imports.

The first signs of the expected improvements in economic performance have become apparent in recent months. Industrial production in the first quarter recovered sharply, and the trade deficit in the first five months was more than halved with respect to the corresponding period in 1985. Furthermore, in March, like in February, the general wholesale price index declined, falling back to the level of 12 months earlier, and the rise in the cost of living index receded to 6.4 percent in May (8.6 percent in December 1985).

Current policy issues and prospects

(a) Fiscal policy

In line with the approach followed in the past few years, the program for fiscal action in 1985 invisaged a target for the state sector deficit that would lead to further progress in its reduction with respect to GDP. In fact, progress in this direction was very limited, as the borrowing requirement of the public sector, net of settlement of arrears, declined slightly as a ratio to GDP while for the state subsector it even increased by half a percentage point. The reason for such a disappointing outcome is to be found on the expenditure side of the budget rather than on the revenue side. Expenditure overruns were primarily recorded both in spending for pensions, owing to inflation adjustments for 1984 and to the raising of the longest dated, hence lowest, pension levels, and in the outlays for health care. Total fiscal revenue rose basically in parallel with GDP expansion, as the steeper increase in direct tax revenues was matched by the lower rise of indirect tax receipts.

It is well understood that in order to redress the unyielding fiscal imbalance it is necessary to correct the more or less automatic mechanisms that prop up spending year after year even in the face of a tax burden that, compared to GDP, has already achieved the European average levels and cannot be substantially raised further without inducing perverse economic consequences. This correction would require structural and institutional changes to such an extent as to make it doubtful, on the basis of past experience, whether they could currently win the necessary parliamentary support. Recent attempts by the Government to introduce far-reaching corrective measures have not succeeded, since the Parliament has either delayed approval, softened the measures, or rejected them. It appeared instead less difficult, first, to raise additional revenue and, second, to curb spending on a temporary basis.

For 1986, fiscal policy is not intended to depart from the medium-term strategy of holding real current expenditure constant, allowing capital expenditure to grow in parallel with nonimal GDP and stabilizing the tax burden at its current level in relation to GDP, although with a fairer distribution among taxpayers. The target for the state borrowing requirement, net of settlement of arrears, has been set at the same level as in 1985. This should ensure that it would fall as a ratio to GDP from 16.1 percent in 1985 to 14.6 percent. This target will be achieved mainly through the higher revenues stemming from the 1985 changes in the assessment of the tax base for personal income taxes and the VAT, from higher taxes on oil consumption, from condonation receipts for illegal constructions, from increases in contributions to the cost of health care, and from higher prices and tariffs for public goods and services. An additional contribution should however derive from measures that although they do not modify the expenditure growth mechanism do slow its dynamics. These measures include the reduction in the frequency of wage and pension adjustments for inflation, the elimination of some family allowances, and the ceiling imposed on the increase in public wages and salaries.

The 1986 initial budget represents a step forward in a strategy aimed at bringing the SSBR down to 10 percent (2.7 percent net of interest payments) of GDP in 1988, given current assumptions about real economic growth and interest rates. This strategy has been reaffirmed in framing the recent preparatory work for the Financial Law for the 1987 budget.

The crucial importance of strictly complying with the outlined medium-term strategy clearly emerges from an econometric simulation conducted by the central bank on the economic impact of this strategy. Assuming the current levels of oil prices and a 4 percent annual growth of world trade, the reduction of the public deficit net of interest payments to little more than 1 percent of GDP by 1988 would allow an average rate of real economic growth about 3 percent per annum, coupled with an almost 7 percent rise in fixed investment, a decline in the unemployment rate, a fall in inflation to 3.5 percent, and a surplus in the external current account. The improvement in business expectations and lower interest rates, both stemming from the reduced public deficit, are instrumental in attaining such positive results.

(b) Monetary policy

In 1985, there was less room for maneuver in monetary policy than in 1984, given its task of aiming at lower inflation in the face of an accelerating PSBR and difficulties due to the rise in public debt. These difficulties, far from being insurmountable, did not prevent the monetary authorities from attaining the appropriate degree of tightness required by their anti-inflationary medium-term strategy without significant deviations in the course of the year.

Expansion of domestic credit to the private sector amounted to 13 percent, just about the 12 percent target, and would be only 10.2 percent if adjusted for the abnormal rise of end-1985. The M2 aggregate grew by 11 percent, in line with the original projection, which was equal to the forecast nominal GDP growth; the increase would be 1 percent less if measured net of CDs. At the same time, the demand for other financial assets expanded by 30 percent. Interest rates, although declining in nominal terms, were allowed to rise in real terms during the year. These few indications are enough to reject the view that in 1985 there was accommodation or easing of monetary policy, and the same applies to recent years, as can be seen in Chart 5 of the staff report, where the continuous and sharp rise of the real interest rates on three-month Treasury bills since 1980 is evident.

Obviously, Italy's monetary policy stance cannot be properly assessed on a very short-term basis, as very temporary deviations from projected paths can occur and may be allowed consistent with the appropriate degree of flexibility required in monetary management. Effective action, however, has been taken to correct these deviations when they proved abnormal or protracted. Such was the case at the end of 1985, when unwarranted expectations of an imminent realignment of the lira and the other currencies in the EMS led to a sharp reduction of foreign liabilities by businesses and a surge of bank lending in lire at the yearly deseasonalized rate of 60 percent in December. The response of the authorities was to raise interest rates, to require foreign financing of export credit, and to reintroduce the ceiling on the growth of lire-denominated bank lending until June. These measures were intended to be temporary and have been reversed since last March in light of their successful impact and of the improvement in overall economic conditions.

For the current year, the monetary program aims at maintaining the cautious policy stance taken in 1985, with a view to reducing central bank financing of the Treasury and to allowing the external surplus to be the most important component of monetary base creation. To this end, the authorities will increasingly rely on a market-oriented approach for controlling monetary and financial aggregates. The target expansion of domestic credit to the private sector was set at 9 percent, which is 3 percentage points lower than the now expected nominal income growth. For M2, a 9 percent rate of increase is also projected, which would imply a net addition to financial asset portfolios of about 22 percent. This should be possible, contrary to the staff's view, without any significant increase in real interest rates, provided that the targets for the fiscal deficit are met.

Although levels of real interest rates early in 1986 appear high compared with the past and with those prevailing abroad, the authorities are proceeding with caution in inducing their reduction on the understanding that the latter has to follow rather than anticipate the decline in inflation trends. In fact, the deceleration of inflation has paved the way for several step reductions in nominal interest rates until recently, thereby allowing a slight decline in real rates. Meanwhile, in the first five months, the financial asset portfolios of the public have been expanding at such a rate as to contain the growth of M2 well within the projected path. In the same period, domestic credit to the nonstate sector, if properly measured net of seasonal and accidental components, has been increasing largely in line with the objective while the expansion of total domestic credit might give cause for some concern due to continuing escalation of public debt. In this respect, the authorities recognize that to create more room for interest rate reductions, it is necessary to proceed decisively toward the elimination of the public sector's primary deficit (i.e., the one net of interest payments).

(c) Labor market policies

In this area the Government has continued to make progress toward both the containment of the dynamics of labor costs and the easing of rigidities in labor practices. On the first front, its action has been crucial to secure such a reform of the pay indexation mechanism as to limit full indexation to the minimum salary level, leaving room for greater wage differentiation and consistency with productivity movements. On the second front, in 1985 the labor market experienced the first beneficial effects of the measures taken in the previous year to promote part-time jobs, solidarity contracts, and training contracts. The number of workers and enterprises involved in these arrangements increased sharply, thereby introducing a higher measure of flexibility in the market. To progress in this direction, a new measure was taken to support the creation of cooperative enterprises, especially among young unemployed persons. In spite of these measures, several factors of rigidity in the labor market still hamper higher employment and consequently are being addressed by the Government with new proposals. However, there does not seem to be enough evidence to contend that Italy remains at a disadvantage with respect to the other industrial countries because of these rigidities. This assessment may be warranted if limited to the flexibility of wage costs, but it is questionable if applied to working time and labor mobility. In the latter respect, recent studies show high mobility among economic sectors and between employees and self-employed persons.

(d) External policies

Exchange rate policy in 1985 remained directed toward the objective of not easily accommodating Italy's inflation differential with respect to major trading partners while prompting systemic gains in competitiveness through cost compression and production improvements. Accordingly, in spite of declining competitiveness of Italian products in the European markets early in the year, the lira's central exchange rate was not allowed to adjust, as this was unjustifiable given the prolonged weakness of the leading currency in the EMS and the expected decline of the U.S. dollar. The adjustment was implemented only in the summer, when inflationary expectations had been subdued. By the same token, further adjustments were strongly effectively resisted at year end in spite of heavy market pressure, since they were not warranted by the favorable fundamental trends in the economy and the external current account and could have jeopardized the anti-inflationary strategy. Analogously, a middle-of-the-line course was chosen for the lira between the appreciating deutsche mark and the depreciating French franc during the last EMS realignment in order to strike a proper balance between the two goals of reducing inflation and enhancing competitiveness.

As to the trade policy, progress was made in either easing or dismantling the few remaining restrictions on imports. Moreover, restrictions on direct and portfolio investment abroad were reduced with a vew to moving toward full liberalization in the near future in accordance of recent EC initiatives and the strengthening of the balance of payments position.

Mr. Nimatallah noted that on page 17 the staff had mentioned that the performance of the economy had reflected in part structural weaknesses, such as higher oil dependence. He doubted whether higher oil dependence was in fact a structural weakness. The staff's statement seemed to be biased and was misleading.

Mr. Zecchini said that he had interpreted the statement in question to mean that, given a certain production function--which could not be easily adjusted over a short time--more intensive use of oil when relative prices of energy inputs were changing could undermine Italy's international competitiveness over time if those changes were to prove to be volatile and reversible. The structural weakness was the economy's inability to change quickly the combination of energy inputs in the overall production function in response to durable changes in relative prices.

Mr. Nimatallah commented that Mr. Zecchini's interpretation would cause him no difficulty if the statement in question had referred to energy in general, rather than to oil in particular. As it stood, the text in question did not make economic sense.

Mr. Ismael said that the performance of the economy in 1985 had been less satisfactory than had been expected: the rate of growth had decelerated from 2.8 percent in 1984 to 2.3 percent in 1985; the fiscal imbalance had deteriorated to the equivalent of 16 percent of GDP; inflationary pressure had remained intense; the external current account deficit had increased; and the upward trend in the rate of unemployment had continued. He generally agreed with the staff that the authorities should concentrate on implementing an appropriate monetary policy, which should be in line with the developments in the fiscal deficit. In addition, a program should be adopted to reduce the rigidities in the labor market, and the authorities should formulate an appropriate medium-term policy mix.

Italy had experienced a sharp deterioration in its fiscal position since the 1970s, Mr. Ismael continued. Although income tax reform implemented in 1974-75 had improved the revenue-raising capability significantly, the acceleration in the rate of growth of expenditure had steadily added to the burden of financing the state sector. As a result, the public debt had increased to an unprecedented level, reaching almost 100 percent of GDP by the end of 1985. Such developments complicated the formulation of future budgets and had serious implications for the allocation of resources between the public and private sectors and for the stance of monetary policy. The authorities' determination to achieve medium-term adjustment by aiming for a gradual reduction in the overall deficit of the state sector by 1.4 percentage points in 1986 and by another 9.6 percentage points in 1987-91 was encouraging. Success would depend crucially on the implementation of measures to restructure the comparatively generous and costly health and pension schemes, improve the efficiency of loss-making public enterprises, and realign spending and revenue-raising responsibilities at the local government level. He fully agreed with the authorities that the future policy strategy should place more emphasis on expenditure control, as the tax burden was already substantial. The package of measures introduced in fiscal year 1986--which included an increase in social security contributions and public service charges as well as cuts in certain categories of social benefits--was certainly a first step in the right direction.

Over the previous four or five years, the persistent sizable fiscal deficits in Italy had clearly limited the flexibility available in the implementation of monetary policy, Mr. Ismael remarked. As a result of the unexpectedly large public sector borrowing requirement it was difficult, if not impossible, for the authorities to introduce a relatively accommodating monetary policy in order to foster economic growth without intensifying the pressure on prices and the external balance. The staff had correctly noted that the loose monetary stance in 1985 had been the main factor in the buoyant demand for imports, and that the higher than expected rate of monetary growth had offset other factors that had contributed to price stability. Furthermore, the ample liquidity in the economy had helped to finance capital flows, thereby prompting the authorities to introduce direct credit controls. He symphathized with the authorities, but their policy of financial accommodation was dangerous and should be reviewed. The financing of the fiscal deficit by the creation of base money in excess of 140 percent of the total expansion of the monetary base was inconsistent with the external objectives, especially exchange rate stability. A more appropriate course would be to increase interest rates somewhat. However, in the medium term there would be considerable room in which the authorities could maneuver, as the fiscal consolidation was expected to proceed smoothly and inflation differentials to narrow significantly.

The unfavorable trend in the rate of unemployment was a cause for concern, Mr. Ismael said. He welcomed the measures that had been introduced in 1984-85 concerning part-time work and direct recruitment as well as the reform of the wage indexation mechanism. However, much remained to be done. To encourage the longer-term development of the labor market there was an urgent need to establish a closer link between wage increases and productivity differentials, and measures to increase labor market flexibility should be formulated and implemented without delay.

The medium-term outlook was likely to be something between the two scenarios described by the staff, Mr. Ismael commented. In order to contain the ratio of government debt to GDP within manageable limits the authorities must steadily decelerate the growth of noninterest expenditure in relation to GDP. He agreed with the staff that the decline in oil prices should provide an opportunity for the authorities to accelerate structural reforms in the areas of pensions, health, and public services. Liberalization of the financial system and reliance on indirect monetary controls could not be achieved efficiently and smoothly unless the fiscal imbalance was reduced.

The staff had suggested that the inflation differential between Italy and its main trading partners called for a downward trend in the nominal exchange rate in order to maintain the level of the real exchange rate, Mr. Ismael remarked. Since 1981, the nominal exchange rate had not been sufficiently depreciated. As the staff had noted, the impact of a real exchange rate appreciation was unclear, but there was clearly a rising trend in import elasticity. A further comment on the behavior of import elasticity in relation to movements in the real exchange rate would be helpful.

Mr. Leonard said that the staff report clearly described the difficult conditions under which Italy had attempted to achieve adjustment over the previous several years. Some of the authorities' goals had been reached, while others had not. There was reason to feel optimistic as a result of developments with respect to inflation and the external current account balance in the wake of the decline in the world price of oil and the easing of interest rates in Europe. At the same time, however, the overall deficit of the state sector remained substantial.

For a number of years the fiscal deficit had been the major problem facing the economy and the major constraint on economic management in Italy, Mr. Leonard continued. Some progress had been made in reducing the deficit as a proportion of GDP in 1984, but the progress had been largely offset in 1985, when the deficit in relation to GDP had increased to 16 percent, overshooting the target by 1.2 percentage points. The relatively easy stance of fiscal policy had made the conduct of monetary policy difficult and had required the maintenance of high real interest rates and the reintroduction of certain credit controls. There was a danger that if substantial steps were not taken to begin the process of reducing the fiscal deficit, Italy might not be able to benefit in the short or medium term from the generally improving international environment.

The medium-term fiscal adjustment plan that the authorities favored called for a reduction in the ratio of the overall state sector deficit to GDP by about 9 percentage points in 1986-91, Mr. Leonard noted. That reduction would require, inter alia, no real growth of noninterest current expenditure. Such a program would go a long way toward removing the major imbalance in the economy, and the authorities should move resolutely in that direction. At the same time, he agreed with the staff that the medium-term fiscal plan might be based on overly optimistic growth assumptions, and in his opening statement Mr. Zecchini had expressed his reservations about the authorities' ability to effect the structural and institutional changes that were needed to redress what Mr. Zecchini had called the unyielding fiscal imbalances. If fiscal consolidation in the medium term was to be achieved, the process should begin with strong action forthwith;

at least, the present short-term fiscal targets--especially those for the current fiscal year--must be met. In addition, the authorities should intensify their effort to contain the growth of social benefits, the rapid growth of which in recent years had significantly contributed to the overshooting of the expenditure targets. The authorities should implement necessary reforms in the pension system, and he fully supported their intention to increase state revenues through higher taxes on oil products.

Given the loose fiscal policy, the largest part of the adjustment burden had fallen on monetary policy, Mr. Leonard remarked. That approach had resulted in high real and nominal interest rates that had exacerbated the fiscal problem by substantially increasing the proportion of public sector interest payments to GDP.

Given the adjustment burden carried by monetary policy, the exchange crisis in early 1986 and the need to introduce capital controls and ceilings on bank credit were unsurprising, Mr. Leonard said. However, he agreed with the staff that the direct credit control measures should be eliminated as soon as possible, and that a reduction of interest rates without monetizing the fiscal deficit would be advisable.

The authorities needed to give careful consideration to the proposed changes in public debt management, Mr. Leonard considered. The staff had mentioned that two such changes were under consideration, namely, additional coefficients for mandatory purchases of government securities by commercial banks, and the partial repeal of the so-called divorce between the Bank of Italy and the Treasury. Any such moves would have no more than a short-term positive impact and could soon result in an acceleration in the rate of inflation and in a deterioration in the external current account. The implementation of monetary policy would clearly be more effective if the sources of the present weaknesses in the economy were attacked and the demands made by the fiscal deficit on the resources of the economy were reduced.

Price performance in Italy had recently improved, Mr. Leonard remarked. The annual rate of increase in the consumer price index had fallen to about 6 percent. Unfortunately, the bulk of that improvement was due to lower energy and import prices; thus far, there had not been a marked deceleration in wages and labor costs. In consolidating the gains that they had made to date the authorities should persist in their efforts to moderate wage increases in the public sector and should reduce the rigidities in the labor market, especially those that militated against the employment of young persons. Even with the deceleration in the rate of price increase, a large inflation gap still existed between Italy and its major trading partners, thereby raising doubts about the underlying competitiveness of the economy. There was some danger that if the trend in energy prices were reversed and little progress was made in moderating wages, competitiveness could deteriorate quickly.

Mr. Nimatallah noted that on page 19 the staff had suggested that 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 fiscal deficit. The staff had recently made a similar recommendation to the Danish authorities. However, it was short-sighted to take advantage of a decline in the price of oil to increase taxation in the private sector in order to bolster public sector revenue. The effort to reduce a public sector deficit should be concentrated on containing public expenditure. A careful effort to improve revenue collection methods was clearly preferable to a rushed effort to increase private sector taxation following a decline in oil prices. Higher taxes on oil to benefit the public sector might be warranted in some cases--for example, certain African countries that had a weak public sector and a government sector that had a critical need for increased revenue. That approach was not appropriate for a sophisticated economy like Italy's.

Mr. Grosche said that the staff was to be commended on the frankness of its appraisal of the performance of the economy in 1985. He shared much of the staff's disappointment in that performance. It was particularly worrying that the major imbalance in the economy, the fiscal deficit, had deteriorated further, reaching the equivalent of 16 percent of GDP. He fully agreed with the staff that reversing the alarming trend in public finances was the key to a fundamental and lasting improvement in the economy. The growing fiscal deficits added to the already large public debt and thereby to the burden of interest payments. The deficit also complicated the conduct of monetary policy, as was reflected in the rapid expansion of the monetary base in 1985; the public sector had pre-empted a large and growing share of domestic savings. Improving economic policy and performance must be based on a significant reduction in the fiscal deficit.

He was pleased that the authorities recognized the need for fiscal consolidation, Mr. Grosche continued. A number of measures were envisaged under the budget for 1986, and a medium-term fiscal adjustment program had been established. However, those efforts were merely the first step in the right direction. Much more needed to be done, especially over the medium run. For example, under the medium-term adjustment program the authorities intended to keep state sector noninterest current expenditure constant in real terms and to keep the tax burden unchanged. However, given the size of the fiscal deficit, noninterest current expenditure should be cut in real terms, and revenue-raising measures should not be ruled out. In addition, there was room in which to make additional cuts in social expenditure, especially in the pension system and in transfers to enterprises. The measures in that area that the authorities had already introduced were welcome, but he agreed with the staff that the proposals thus far to reform the pension system appeared to fall short of what was needed. In the field of revenue-raising, additional efforts were needed to strengthen the effort to reduce tax evasion. In addition, various public service prices should be further adjusted in response to increased costs. He fully agreed with the staff that revenues from increased taxes on oil products should be used to reduce the budget deficit and not to finance new expenditure.

Efforts were clearly needed to improve and increase the transparency of data, Mr. Grosche remarked. The lack of data on local government activities precluded the publication of statistics on the consolidated general government. Improvements in the collection and presentation of data would enhance the public perception of the fiscal position of local institutions, thereby contributing to the effort at fiscal consolidation.

Significant progress in containing the fiscal deficit was a prerequisite for enabling monetary policy to achieve the authorities' goals, Mr. Grosche said. The staff had clearly spelled out the limitations on the conduct of monetary policy as a result of the high and rising public sector borrowing requirement. The fact that the rate of monetary expansion was determined to a large and growing extent by the public sector borrowing requirement and that a sizable part of the budget deficit had to be financed indirectly by the Central Bank was worrying. He agreed with the staff that efforts to facilitate the financing of the budget deficit by forcing commercial banks to maintain certain portfolio coefficients and by abolishing the so-called divorce between the Central Bank and the Treasury were not helpful. Such efforts should not be continued, as they would tend to foster the crowding out of the private sector through an increase in interest rates or would lead to a marked acceleration of monetary expansion and an intensification of inflationary pressures. In addition, somewhat more ambitious monetary targets for 1986 were warranted. As the staff had stressed, the underlying rate of inflation remained high, and domestic liquidity was ample.

The labor market continued to be a cause for serious concern, Mr. Grosche remarked. Only limited progress had been made in recent years in improving the functioning of that market. Previous attempts to reduce rigidities had frequently faltered and had produced only small positive results. However, the modification of the wage indexation arrangement in 1985 was an important step forward. Nevertheless, it still fell short of what was desirable. The measures envisaged under the medium-term employment plan were welcome, but experience showed that it was difficult to implement fully such measures.

The authorities were to be commended for their policy of maintaining a strong exchange rate for the lira, Mr. Grosche said. The decision under the latest realignment within the EMS to keep the rate of the lira broadly unchanged had contributed to a dampening of domestic price pressure, although it had also led to a deterioration in Italy's external competitiveness. Domestic price and cost performance in Italy continued to compare unfavorably with that of Italy's main trading partners, and the present exchange rate level probably would be sustainable only if the cost and price differentials could be substantially cut. The rate of growth of real imports in the first quarter of 1986 had substantially exceeded the rate of growth of exports, indicating that a loss of competitiveness had already occurred. Nevertheless, the movement in the terms of trade suggested that a significant improvement in the external current account balance could be expected for all of 1986. That improvement should be seen as an opportunity to liberalize trade restrictions and to make further progress in eliminating the remaining restrictions on capital transactions. The recent steps in that direction and the authorities' intention to move toward full liberalization in the near future were welcome.

He agreed with the staff that the authorities should make good use of the opportunity offered by the favorable environment of lower oil prices and increased demand in Italy's major trading partners, Mr. Grosche commented. The improved environment had brightened the prospects for Italy's economy in 1986. It was crucial for the authorities to use the present opportunity to make sizable and lasting progress toward solving the structural problems facing the economy. The window of opportunity would not remain open for long. The staff had stressed that the expected improvement in Italy's economic performance in 1986 might not be sustained in 1987 and beyond.

Mr. Templeman noted that in placing Italy's recent economic adjustment efforts in perspective the staff had noted that the adjustment in Italy since the second oil shock had not progressed as far as adjustment in most other industrial countries. Real economic growth in Italy had been lower than the industrial country average, the rates of unemployment and inflation higher, and the external current account had been in deficit most of the time. Italy's substantial dependence on imported energy had admittedly made economic adjustment difficult. However, many of the problems facing Italy's economy were clearly homemade, including the chronic large fiscal deficits and the continued labor market rigidities. Some advance had recently been made in the labor area, but it was hard to see much progress in strengthening the fiscal accounts.

Economic performance in Italy in 1985 had been disappointing, especially the overrun of the fiscal deficit, Mr. Templeman remarked. However, the world economic environment in 1986 gave the authorities a renewed opportunity to make better progress on adjustment, including structural reform. It would be particularly important to initiate a stronger medium-term effort to scale down the size of the fiscal deficit and to pursue labor market reforms with determination. That conclusion was supported by the Bank of Italy's econometric simulations as a part of the medium-term fiscal strategy to which Mr. Zecchini had referred in his opening statement.

Very large fiscal deficits had prevailed over an extended period in Italy, Mr. Templeman observed. The ratios of fiscal deficits to GDP had exceeded 10 percent at least in the previous five years, and a similarly large ratio was expected for 1986. Persistent deficits tended to feed upon themselves through rising interest payments. However, even excluding the growing burden of interest payments, the general government deficit had risen from 1.8 percent of GDP in 1980 to 4.7 percent in 1985. In addition, the public debt had risen in relation to GDP in the same period from 66 percent to 100 percent, and the general government deficit had absorbed 57 percent of gross private savings in 1985, compared with 31 percent in 1980. Expenditures of the entire public sector in 1985 had accounted for about 63 percent of GDP, while some 50 percent of the growth of general government expenditure in 1981-85 had been accounted for by social transfers and interest payments.

The fiscal outlook for 1986 and beyond was very worrisome, Mr. Templeman continued. Even with the measures included in the 1986 budget, the deficit was likely to approach 15 percent of GDP. The steps that the authorities had taken to raise public utility charges and health and public service fees, to restrain pension and family allowance benefits, and to limit public sector wage increases to 6 percent were in the right direction. Improved business profitability might make it possible for businesses to absorb increased employer pension contributions at the present stage. However, such increases underscored the dilemma of periodic shifts in the financial burden of generous social benefits back and forth between the government and the business sector, without adequately dealing with the level and allocation of social benefits themselves. Appendix III in SM/86/135 and the recent Executive Board Seminar on social expenditures in the G-7 countries shed light on the serious implications of the growing social benefits burden. He wondered whether the authorities agreed with the outlook described in Appendix III and what they planned to do about it.

The fiscal outlook for 1987-91 described in the staff report was revealing, Mr. Templeman went on. Even with rather optimistic assumptions about growth, inflation, interest rates, and import elasticities, and even holding unchanged the ratio to GDP of noninterest current expenditure and capital expenditure, the ratio of the deficit of the state sector to GDP would be reduced to only about 5.3 percent in 1991 while the public debt ratio would remain in excess of 100 percent. The results according to the Bank of Italy's simulation for 1988 were somewhat more favorable. In any event, however, a much stronger fiscal adjustment effort was needed than had been evident to date. In 1987-91, particular attention would have to be paid to pension reform, cost containment for health services, and continued restraint of the wage bill. Modifications of local government finances might be needed in light of the disassociation of spending responsibilities from taxing responsibilities at that level of government.

The fiscal overruns in 1985 underscored the difficulty in monetary management owing to the constant pressure to finance the large budget deficits, Mr. Templeman commented. Financing of the state sector deficit through the expansion of the monetary base in 1985 had amounted to 23 percent of the base, compared with only 14 percent in 1984. At the same time, several credit targets had been exceeded at least to some extent. The authorities had had considerable success in placing large amounts of government securities with the public in recent years, because of the high savings rate in Italy and the maintenance of real positive interest rates in the country. However, it appeared that with its growing stock of debt the Government could crowd out other borrowers. For example, between 1977 and 1984, the share of household financial holdings in the form of government bonds had risen from 6 1/2 percent of the total to

26 1/2 percent. At the same time, the high cost of servicing the public debt at remunerative real interest rates was again encouraging proposals to increase portfolio investment requirements and to restore partially the residual deficit financing role of the Bank of Italy. Both alternatives should be resisted.

The external current account deficit had increased in 1985, but the decline in world oil prices and other factors should result in a small surplus in 1986, Mr. Templeman noted. In addition, the size of Italy's external current account deficits in recent years had not been large, owing partly to the high private savings rate in Italy. Nevertheless, some attention needed to be given to the effect of the exchange rate on Italy's competitive position in the light of recent movements in relative unit labor costs and wholesale prices. The achievement of a degree of exchange rate stability imposed a discipline on business and labor to limit domestic costs, but a combination of a realistic exchange rate, trade liberalization, and liberalization of capital controls would also help to foster competition and economic efficiency and to restore a better balance in world payments positions.

He continued to be troubled by the tendency in staff reports on EC members simply to refer to a country's trade policy as being determined in the context of the EC, Mr. Templeman said. The apparent assumption was that the Executive Board could not look much beyond that statement to assess a member's trade policy as embodied in EC decisions. Italy and other individual EC members were responsible for their trade policies, and the Executive Board should review those policies in the same way in which it reviewed the same policies of other members.

One of the main disappointments in Italy's performance in 1985 was the near cessation of progress in closing the inflation gap with Italy's major trading partners, Mr. Templeman remarked. To some extent, lower import prices in 1986, owing to the decline in world oil prices and to the appreciation of the lira against the dollar, might provide temporary help. However, cost containment, including wage restraint in the public sector, would remain crucial over the longer run. Appendix I in SM/86/135 suggested that the rigidity in real wages was attributable at least partly to the pervasive and generous wage indexation throughout the 1970s and the early 1980s. In addition, there had been a sharp decline in wage differentiation resulting from the flat rate cost of living adjustments--regardless of wage levels--that had been embodied in the indexation system that had been in effect until the beginning of 1986. The segmentation of labor markets had led to much higher unemployment rates for youth, women, and long-term unemployed persons in Italy than in other countries. Moreover, part-time work, which had become an important element of labor market flexibility in other industrial countries, especially for young persons and women, was much less common in Italy than in other G-7 countries and had been declining until recently. Staff comment would be welcome on the question raised by Mr. Zecchini as to whether rigidities in working time and labor mobility were really more serious in Italy than in other industrial countries.

Some labor market reforms had already been introduced, Mr. Templeman continued. In particular, the reform of the wage indexation system beginning in 1986--in order to reduce the frequency of wage adjustments from four times to two times a year--and the introduction of differential adjustments according to salary levels, should help to contain wage pressure and, more important, should allow differential wages to be paid that could take into account differences in productivity and ability to pay. Measures that had been taken in 1984 and 1985 concerning part-time work, temporary contract work, and the direct recruitment of employees, rather than recruiting solely through labor placement offices, were positive steps. In addition, the ten-year employment plan proposals of September 1985 would be moves in the right direction. However, the past record of delays and difficulties in reaching a social consensus to introduce such reforms was not encouraging. The lack of estimates of the fiscal implications of such reforms made it difficult to judge any possible trade-off between the implementation of labor market reforms and the achievement of fiscal goals.

Accelerating the pace of economic adjustment and reform in Italy was important not only for Italy, but also for the rest of the world, Mr. Templeman said. He hoped that the authorities would take full advantage of the improved world economic environment to step up the pace of adjustment in Italy in 1986.

Mrs. Ploix remarked that the authorities had made some progress with respect to inflation, industrial output, investment, and profitability. However, the overall performance in 1985 compared with that of 1984 was in many respects a step backward. During the discussion on the staff report for the 1985 Article IV consultation with Italy her chair had mentioned that the economy had reacted very quickly to the appropriate policies, and there was every reason to fear that the economy might react just as quickly to inappropriate policies. In fact, over the previous year, imperfect policies had had disappointing results. The various slippages, especially in the fiscal area, were fully described in the staff reports. The resurgence of the external constraint with the increase in the external current account deficit was evidence of the persistence of the deep-rooted imbalances in the Italian economy.

The staff had noted that the adjustment of the Italian economy had lagged behind the adjustment of other major industrial countries, Mrs. Ploix noted. Indeed, delays in implementing corrective policies in Italy had led to a deterioration in the overall economic situation in Italy, as the problems facing the economy had continued to build up. Therefore, the assurances that Mr. Zecchini had given in his opening statement with respect to the authorities' determination to introduce appropriate policies were encouraging. The staff had made sensible and appropriate recommendations.

She agreed with previous speakers that public finances were at the core of the problems facing the economy, Mrs. Ploix said. The staff had correctly underscored the threat for the medium term posed by the large budget deficit. Sizable budget deficits were evident in other countries, but the deficits in Italy had been relatively large, and as Mr. Zecchini had noted, there was no certainty that the effort to reduce the deficit in Italy had the necessary Parliamentary support. The fiscal deficit in 1985 was the equivalent of 16 percent of GDP--17.7 percent including arrears. The share of public expenditure in GDP was nearly 60 percent in 1985, and the public debt represented 100 percent of GDP while interest payments accounted for 9.3 percent of GDP. It was clear that strong actions were required on both the revenue and expenditure sides.

On the revenue side, the recent decision to raise taxes on oil consumption was welcome, Mrs. Ploix continued. However, that measure would be fruitful only if it yielded supplementary revenues and was not a substitute for other measures of fiscal discipline. Indeed, the tax burden in Italy had already reached the average European level, and she agreed with the staff that further increases of taxes in Italy might well be counterproductive. Still, the fiscal deficit in Italy was excessively large; it exceeded the European average.

On the expenditure side, the authorities' decision to halt the rising trend in real current spending and to permit capital expenditure to grow only in parallel with nominal GDP was welcome, Mrs. Ploix went on. While those objectives were commendable, they were not ambitious, given the present large fiscal imbalance, and more dramatic measures would be preferable. Meeting the authorities' fiscal goals was of crucial importance. Reducing the financing need of the public sector was essential to limiting the constraints on the conduct of monetary policy and to controlling inflation. In that connection, the first paragraph on monetary policy at the bottom of page 9 and the top of page 10 of SM/86/121 fully summarized the situation.

Incomes policy was particularly important, given the external constraint and the increasing rate of unemployment, Mrs. Ploix said. The dynamism of some of the sectors of the economy and the high level of investment of the recent past were commendable. However, the deterioration in the trade balance in 1985 and in the first quarter of 1986 suggested that Italy's competitiveness was not strong. She wondered whether the medium-term outlook for the external accounts was as sound as expected. The figures in SM/86/135, Supplement 1 are all the more worrying in that respect. In the first quarter of 1986 the rate of growth of real imports of goods and services had risen by 17 percent while imports had grown by 6 percent. The preservation of Italy's market shares was particularly difficult, since the rate of inflation in Italy, although having decelerated somewhat, was still higher than the rate in Italy's main trading partners. As production in Italy had a sizable import content, she agreed with the staff that the authorities should halt the rising trend in import elasticity through, inter alia, an improvement in Italy's relative cost and price performance. However, despite the increasing rate of unemployment, unit labor costs had continued to increase at an alarming rate in 1985. Cost reductions in Italy owing to productivity gains and the decline in commodity prices should permit a deceleration in the rate of inflation in Italy. The authorities' decision to modify the wage indexation arrangement and the first results of that modification were welcome; they should help to eliminate one of the major rigidities in Italy's labor market.

There were other areas of weakness in the Italian economy, Mrs. Ploix remarked. For example, she agreed with the staff that a nonaccommodating monetary policy and a stable exchange rate were indispensable safeguards against unfavorable developments in the coming period.

She agreed with Mr. Zecchini that the expected improvement in the world economic environment owing to the depreciation of the dollar and lower commodity prices should bring welcome relief to the Italian economy, Mrs. Ploix commented. That relief was also an opportunity--that should be fully exploited--to reduce the major and deep-seated imbalances in the economy, thereby paving the way for a durable recovery. The latest developments in the Italian economy with respect to inflation, industrial production, and trade appeared to be positive and were clearly a reflection of the more favorable international environment. Those developments should support the needed convergence of Italy's economic performance with the performance of its main trading partners. That objective was at the core of the Italian authorities' policy, and she fully supported it.

Mr. Schneider said that the impact of the large financial imbalances on the Italian economy had made it particularly difficult for the authorities to implement consistent economic policies and to achieve a sustainable medium-term growth path. The staff report contained overwhelming evidence that only the implementation of comprehensive and mutually supportive adjustment policies could create conditions in which economic growth could be restored without rekindling inflation and intensifying exchange market pressures, which were ever-present dangers. In 1985, the authorities' attempts to reduce the costs of servicing the public debt and to support private sector activity through an accommodating monetary policy had soon had to be reversed due to the deterioration in the inflation differential vis-à-vis other EEC countries and to the increase in the external current account deficit.

The fiscal position was at the core of the problems facing Italy's economy, Mr. Schneider stated. That position had sharply deteriorated over the previous five years in terms of both the size of annual budget deficits and the public debt as a percentage of GDP. General government debt was expected to exceed the level of GDP in 1986, and the staff had forecast that that ratio would further increase in coming years, as Italy had reached the worrying stage at which only a drastic tightening of budgetary policy could arrest the growth of the public debt. Apparently the Government had not yet gained sufficient political support for a comprehensive set of budgetary measures aimed at a speedier reduction of the burden of the public sector on the economy. Medium-term policy goals continued to be formulated in terms of a gradual reduction of the government deficit; GDP growth was still the key objective that shaped the desirable stance of domestic financial policies. He doubted whether such priorities and the accompanying gradualistic approach to solving the budgetary problem would make it possible to achieve sustained adjustment. A stronger commitment to the correction of the fiscal imbalances was desirable. That policy reorientation should preferably be based on a systematic inventory of all expenditure mechanisms that had led to the buildup of the deficits; there should be a comprehensive fiscal adjustment plan that would dismantle the widespread system of public transfers to households and enterprises. It was encouraging to learn from the staff report that such an approach was emerging in respect of the pension sector, the position of which was worrying.

Unless the fiscal adjustment was embodied in a broad-based program that was strictly adhered to, monetary policy would continue to be squeezed between the pressure stemming from the external debt and the desirability of reducing the cost of servicing the public debt, Mr. Schneider commented. He fully agreed with the staff that, given the continued fragile external equilibrium and the burden on monetary policy of financial adjustment, the room in which to maintain an accommodating interest rate policy was very limited and was a factor almost exclusively of external developments. Attempts to accommodate monetary policy beyond those developments by forcing interest rate movements or by creating specific provisions for preferential financing of the public sector did not offer a lasting solution; they were likely to result in either a crowding out of private sector activity or excessive expansion of domestic liquidity. In that event, strong exchange market pressure would soon re-emerge, and the reintroduction of far-reaching credit and exchange controls to combat such pressure could hardly be avoided. Therefore, the only valid way in which the authorities could solve the conflict between external and domestic considerations would be to support monetary policy through a strong and credible fiscal program that would create scope for a lasting reduction in interest rates by increasing market confidence and improving prospects for lower inflation and reduced public borrowing requirements.

The policy stance would support a number of positive developments that might have an important impact on the medium-term outlook for the economy, Mr. Schneider went on. First, it was encouraging to learn from the staff that, owing to the shift from the transformation of raw materials toward the production of higher value-added goods, Italian industry had succeeded in increasing its export market shares. The fact that that conversion had been achieved despite the internal imbalance in the economy showed that Italy still could count on a dynamic industrial base that offered prospects for sustained and viable growth in the medium term provided that appropriate financial policies were implemented.

Additional welcome steps, particularly the modification of the wage indexation mechanism, had been taken to attack rigidities in the Italian labor market, Mr. Schneider said. In addition to its immediate advantages with respect to increased wage flexibility, the modified wage indexation arrangement along with other related measures underscored the growing general awareness that ultimately the persistent problem of high unemployment could be solved only through structural and market-oriented labor policies that were based on flexible recruitment and wage procedures rather than through accommodating financial policies. To safeguard the success and sustainability of that policy reorientation the authorities must create the conditions for a stable and noninflationary financial environment. The fact that a proposal to restore the scala mobile to its full extent had been rejected by a popular referendum should indicate to the authorities that public opinion seemed to be leaning toward stronger adjustment of the country's lasting imbalances and should encourage the authorities to formulate and implement a comprehensive economic program.

Mr. Fujino said that economic developments in Italy in 1985 compared unfavorably with those in 1984, when improvements in most areas of the economy had been achieved. Real GDP had continued to grow in 1985, and business investment had remained strong, as spending on plant and machinery had grown by 11 percent. However, in many other important areas, such as inflation, unemployment, the external current account deficit, and the exchange rate, the performance of the economy in 1985 had been disappointing.

The disappointing results in 1985 had been due primarily to the public sector deficit and the relatively accommodating monetary policy in the first part of 1985, Mr. Fujino went on. With a view to building on the progress that had been achieved in 1984 the initial budget for 1985 had included a target for a reduction in the state sector deficit of about 1 percentage point of GDP. That target was consistent with the authorities' medium-term financial objectives. However, in fact, the deficit had increased by half a percentage point, reaching 16 percent of GDP. It was particularly worrying that the growth of noninterest current spending had significantly exceeded the target because of the large volume of social expenditure. If the medium-term financial adjustment program were to be successful, noninterest current account expenditure must not be allowed to rise in real terms. However, the prospects were not promising. In particular, pensions were expected to grow significantly if the present pension plans were not changed. The authorities apparently had begun to move toward the containment of the growth of social expenditure. The authorities had already decided in 1986 on less frequent cost of living adjustments of pensions. The various expenditure containment measures together with revenue-raising measures in the 1986 budget should reduce the state sector deficit by the equivalent of 1.5 percent of GDP. Given developments in 1985, it was important to avoid any slippage in the implementation of the budget.

Much remained to be done over the medium term, especially in the area of pensions, to ensure that expenditure would be contained in line with the medium-term adjustment plan, Mr. Fujino continued. Experience in Japan suggested that it was difficult and time-consuming to gain the necessary consensus for basic and comprehensive reform of a social security system. Mr. Zecchini had correctly stressed the political difficulty in undertaking such reform, but unless fundamental steps were taken the imbalance might reach unbearable proportions. The ratio of public debt to GDP in 1985 was roughly 100 percent, the second highest ratio among the industrial countries. The large and increasing volume of outstanding debt fed on itself through interest payments. Consideration should be given to possible improvements in public debt management. Recourse to such measures as the introduction of additional coefficients and mandatory purchases of government securities by commercial banks would not provide a lasting solution to the financial imbalance in the economy.

The authorities intended to maintain a cautious monetary policy in 1986, when M2 was expected to increase by 9 percent, Mr. Fujino said. There seemed to be some difference of opinion between the staff and the authorities about the possibility of reaching that target without any significant increase in real interest rates. While there might be room for a gradual reduction in interest rates, caution should be exercised in that area in view of the authorities' objective of maintaining overall policy restraint.

Flexible management of the exchange rate together with a nonaccommodating monetary policy were needed to maintain domestic cost and price discipline, Mr. Fujino remarked. That exchange rate policy could be sustained over the longer run only if Italy's inflation performance matched that of its main trading partners. He agreed with the staff that the present favorable external environment provided a good opportunity for the authorities to liberalize import restrictions.

Substantial progress had been made in restructuring Italian industry, Mr. Fujino commented. Italian enterprises had improved their profitability through modernization and productivity gains. However, the progress in removing the rigidities in the labor markets had been slow.

As a result of the decline in oil prices and the depreciation of the U.S. dollar, the economic performance of Italy was expected to improve in 1986, Mr. Fujino remarked. Indeed, the rate of inflation in Italy had already begun to slow, and the trade balance had improved.

Mr. Pérez said that he broadly agreed with the staff appraisal. The appendices to the staff report on recent economic developments in Italy were particularly useful.

The staff reports clearly showed that the performance of the economy in 1985 had been less satisfactory than had been expected, Mr. Pérez continued. After making progress in almost every macroeconomic area in 1984, Italy had suffered a series of setbacks in 1985, when GDP growth had accelerated, the downward trend in the rate of inflation had slowed, and the public sector deficit had increased. In addition, the balance of payments had deteriorated sharply, thereby placing considerable pressure on the exchange rate and reserves. However, Italy had made some progress in 1985 in tackling one of the major structural problems, namely, the rigidities in the labor market, and the authorities should persevere in their efforts in that area. The steps that they had taken to promote part-time employment and, above all, the reform of the wage indexation mechanism were major steps in the right direction. In addition, the financial position of individual enterprises had improved, thereby establishing the foundation for continuing the upward trend in private investment that had been evident in recent years.

As Mr. Zecchini had stressed in his opening statement, economic conditions in Italy had improved in recent months owing to the favorable international economic environment, Mr. Pérez said. Nevertheless, although the prospects for 1986 were encouraging, the economy continued to face large and growing structural problems that cast doubt on the sustainability of favorable current trends over the medium term.

The main cause of Italy's disappointing performance in 1986 was the excessive growth of public spending and the increase in the public sector deficit, Mr. Pérez continued. The authorities were clearly aware of the need to correct the path of public finances, but political and social factors had prevented the adoption of adequate corrective measures and institutional reforms. The most recent political crisis in Italy clearly showed that Italy lacked the political consensus that would enable the authorities to address decisively the major structural problems.

In his opening statement Mr. Zecchini had said that he was optimistic about the trend in the fiscal deficit for 1986, 1987, and beyond, Mr. Pérez remarked. In his view, however, the permanency of the improvement was doubtful. In Italy, as in many other countries suffering from large and growing public sector deficits and substantial public debt, the authorities should devote considerable attention to not only the actual deficit but also the so-called inflation-adjusted deficit.

The staff report provided some information on how the inflation-adjusted public sector deficit had evolved in recent years, Mr. Pérez went on. The operational public sector deficit had moved from a surplus of 2.8 percent of GDP in 1980 to a deficit of 7.9 percent in 1985. The recent improvement in inflation in Italy should make an important contribution to the effort to curb the overall deficit. Nevertheless, the authorities' actions to increase government receipts and reduce noninterest expenditures on a permanent basis were not sufficient to place Italy on a satisfactory medium-term adjustment path. Indeed, it was his impression that the operational budget would increase again in 1986, thereby clouding the prospects for Italy's economy.

The increased private savings had made it possible to meet the growing public sector borrowing requirements without exerting excessive pressure on the monetary aggregates, Mr. Pérez commented. Although the high level of savings had prevented a major disruption of private sector economic activity, it was clear that the persistently negative public sector savings had absorbed a growing amount of household savings that might otherwise have financed productive investment; as a result, the achievement of growth and employment targets had been placed in jeopardy. Furthermore, it was important to consider the extent to which Italy could maintain a growing operational public sector deficit without provoking either increasing external disequilibria or a crowding out of private investment.

Given the expansionary fiscal policy, monetary policy had had to assume most of the burden of holding the line against inflationary pressures, Mr. Pérez remarked. In view of the size and trends of the budgetary financing problems, the monetary authorities were to be commended for the way in which they had sought to manage monetary policy. Nevertheless, despite the achievements that had been made in the recent past in moving toward more market-oriented means of monetary control, there had been a setback in that area in 1985, when the authorities, in the absence of a sustained effort to adjust the public finances, had increased the amount of financing provided to the government. Although that trend was to be temporary, it was a clear example of the difficulty that the authorities had in maintaining a nonaccommodating monetary policy in the face of a growing public sector deficit.

The authorities were to be commended for their decision to keep the lira unchanged in terms of the ECU during the recent alignment in the EMS, Mr. Pérez said. That decision clearly showed the Government's commitment not to accommodate Italy's inflation differential with respect to its main trading partners through exchange rate adjustment and to seek instead to maintain wage discipline and to achieve productivity increases.

Mr. Yang commented that in the early 1980s the authorities had made considerable progress in reducing inflation, restructuring industry, and improving the balance of payments position. In 1985, the economy had remained on a recovery path, but the progress had fallen short of the initial objectives, as GDP growth had slowed, the rate of inflation had ceased to decelerate, the external position had deteriorated, and the fiscal deficit had continued to grow, causing the growth of the large public debt to accelerate. Meanwhile, some positive signs in the economy were also noteworthy. Gross fixed capital formation had risen by 4 percent in 1985. The bulk of the new investment was for modernization and technological innovation and in conjunction with the good productivity performance had brightened the prospects for future growth. The financial position of the major enterprises in which the state participated had continued to improve, with beneficial effects on the state budget. The moderation in the wage indexation mechanism, if strictly maintained, would help to reduce unit labor costs and lessen the pressure on prices as well as on the government budget. The current favorable external conditions, including the fall in oil prices, the depreciation of the U.S. dollar, and the reduction in interest rates, suggested that the Italian economic situation could improve substantially in coming years.

It had become increasingly clear that the growing fiscal deficit and public debt were the main weaknesses in the Italian economy, Mr. Yang remarked. The imbalance between government revenue and expenditure had intensified the pressure on prices and the balance of payments and had kept interest rates high. By adding to the public debt the fiscal position would continue to be difficult in coming years. It had become increasingly clear that a fundamental adjustment of the budget system--

and not merely short-term policy measures--was urgently needed. Pensions were the main component of social expenditure, and a gradual reform of the pension system would help to consolidate the fiscal position and should be given the highest priority. Proposals to eliminate cumulative pensions, increase the retirement age, and establish strict eligibility requirements had already been made. He hoped that an effort would be made to make the proposals acceptable to the majority of Italians.

He agreed with the staff that a nonaccommodating stance of monetary policy was essential to improve the economy, Mr. Yang said. The difficult monetary management task was to keep monetary policy from being nonaccommodating when monetary base creation had to accommodate the huge fiscal deficit. Apparently monetary policy had been given an excessively large role in the adjustment effort. He wondered why the authorities wished to repeal the so-called divorce between the Bank of Italy and the Treasury. That divorce seemed to be a prerequisite for an effective monetary policy.

The size of the underground economy in Italy was large in comparison with that of other industrial countries; it was equivalent to roughly 10 percent of GDP, Mr. Yang noted. He wondered whether an effort could be made to bring the underground sector into the taxable sector through tax reform measures.

Mr. Lankester said that the staff had noted that the adjustment of the Italian economy since the 1979-80 oil shock had lagged behind the adjustment of the other major industrial countries. Some progress had been made: the rate of inflation had been cut by two thirds since 1981; wage pressures had been moderated substantially; sizable investment had helped to modernize and restructure Italian industry; productivity growth had been strong; and the latest economic indicators suggested that in the short term the economy would be buoyant. Although the improved prospects were due considerably to exceptionally favorable external factors, the authorities could take some credit for the positive developments, especially through their efforts to maintain in recent years a cautious monetary policy and the limited progress that they had made in reforming the labor market. However, compared with other countries' performance and the Italian authorities' own aspirations, Italy's recent record had been disappointing. He agreed with the staff that the principal reason for the disappointing outturn was the continued large public sector deficit. The resilience of the Italian economy was evident in the fact that the public sector deficits had not resulted in an even more disappointing performance. The staff had argued convincingly that economic performance would have been significantly better if the deficit problem had been attacked more successfully. The staff was also persuasive in arguing that there were risks in the future if the deficit were not reduced.

He had never read another staff report for an Article IV consultation that was so dominated by a single theme, Mr. Lankester continued. The staff's emphasis on the public sector deficit was justified. Inflation-adjusted deficits were a useful analytical device, although he doubted whether they were useful as operational targets. An examination of the inflation-adjusted fiscal deficit shed light on the prospects for an economy. The Italian authorities had successfully moved to reduce the rate of inflation and would wish to consolidate and make further progress in that area. But the sharp fall in nominal GDP growth from more than 18 percent in 1981 to about 11 percent in 1985 had not been accompanied by a commensurate fall in the fiscal deficit. Indeed, the overall state sector deficit had increased from just under 13 percent of GDP in 1981 to 16 percent in 1985. Hence, the inflation-adjusted deficit had risen sharply, from 1.7 percent of GDP in 1981 to 7.9 percent in 1985. In addition, there had been a dramatic increase in the ratio of debt to GDP. That increase in the real demand of the public sector had been financed largely by domestic borrowing. The sustainability of that situation had depended upon the private sector continuing to maintain a high savings ratio and being prepared to hold a large part of additional savings in the form of government paper. However, there was evidence that real interest rates were being pushed up by the reluctance of the public sector to take on more debt. Failure to curb the deficit as traditionally measured and as adjusted for inflation could easily produce a situation in which the private sector's willingness to continue increasing its holdings of government debt would be pushed beyond acceptable limits.

The authorities should give first priority to dealing with what Mr. Zecchini had called the unyielding financial imbalance, Mr. Lankester considered. The deterioration in the financial position in recent years had resulted to a significant extent from the strong growth of expenditure rather than from a weakness of revenues. The share of current expenditure in GDP had risen by more than 10 percentage points since 1980. As the authorities recognized, a major re-examination of their public expenditure priorities was required if the upward trend in the deficit was to be stopped, let alone reversed. Given the inevitable upward pressure on social security spending, even the objective of holding noninterest current expenditure constant in real terms would be difficult in the absence of a willingness to introduce painful measures.

A separate but related question was how fast the adjustment measures should be introduced, Mr. Lankester said. In his view, a more front-loaded adjustment effort than the authorities had envisaged was called for. It would help to bolster private sector confidence in the likely success of the authorities' adjustment efforts. The effort to cut the deficit should emphasize expenditure restraint rather than tax increases. Nevertheless, and possibly as a part of the front-loaded adjustment exercise, a case could perhaps be made for some selective tax increases, and he supported the staff's suggestion that the possibility of recouping all or some of the benefits of lower oil prices might be worth considering.

While the large fiscal deficit remained, there would undoubtedly be considerable strain on the effort to maintain monetary control, Mr. Lankester continued. That strain had been reflected in the upward pressure on real interest rates. In the face of those and other pressures the authorities had felt obliged to reimpose ceilings on bank credit earlier in 1986. Such controls involved a cost in the form of the misallocation of financial resources. He hoped that the authorities would be able to avoid recourse to controls in the future, and that the present ones would be rolled back.

The statistical base seemed to be deficient in several important areas, Mr. Lankester said. For example, data on general government finances were not fully available beyond 1975. He hoped that the authorities, with the assistance of the staff where appropriate, would be able to eliminate the statistical problems.

The Italian economy had long proved able to perform better than pessimistic observers had expected, Mr. Lankester commented. Nevertheless, the threat of potential pressure on the external current account and on inflation that had been posed by the fiscal deficit remained serious. The authorities should use the breathing space that had been given by the relatively favorable external environment in 1986 to ensure that the adjustment process was firmly under way.

Mr. Lundstrom remarked that there had been some welcome recent improvements in the Italian economy, especially in the areas of prices, industrial restructuring, and financial liberalization. In many respects, however, the performance of the Italian economy had not compared favorably with that of other major industrial countries. Italy's real per capita growth had nearly stagnated, the rate of unemployment had become alarmingly high, especially among young workers and in the south, and the rate of inflation considerably exceeded the average of the industrial countries. The comparisons in the staff report between Italy and other major industrial countries were helpful, and similar comparisons should be made more frequently in future consultation reports.

The staff had concluded that the mixed performance of the Italian economy was attributable primarily to the considerable and growing trend of the public sector to pre-empt resources, but structural weaknesses had also played a role, Mr. Lundstrom noted. In 1985, the overall deficit of the state sector had amounted to 16 percent of GDP, compared with the target of 14 1/2 percent, which had not seemed particularly ambitious, in view of the deficit of 15 1/2 percent of GDP in 1984. Indeed, 1985 was the fourth consecutive year in which the deficit had exceeded 15 percent of GDP. Such deficits obviously were not sustainable. The financing of the deficits had required high and generally rising real interest rates that had contributed to the rapid growth of public debt, which had fueled itself through rising interest payments. The public debt had reached approximately 100 percent of GDP in 1985, the highest ratio among industrial countries, with one exception. However, the high savings rate of the private sector had allowed the fiscal deficits to be financed without generating unsustainable external current account imbalances. As a result, Italy had escaped accumulating a large external debt, although the public sector deficit had pre-empted domestic savings.

The measures to curb the fiscal deficit in 1986 were welcome, although they were hardly impressive, Mr. Lundstrom said. The authorities hoped that those measures, along with stronger than projected revenue performance, would lead to an improvement of 1 1/2 percent in the fiscal deficit, a modest target. They recognized the need for more fundamental adjustments in the mechanisms of expenditure determination, as well as in the guidelines for the preparation of the 1987 budget, which was to be a first step toward the reform of the budgetary process. The authorities should be encouraged to accelerate the pace of fiscal adjustment and to strengthen their efforts in that area in order to reduce the deficit to a more manageable and sustainable level.

The measures that the authorities had introduced to reduce rigidities in the labor market--especially the law covering part-time work and direct recruitment--already seemed to have produced some encouraging results, Mr. Lundstrom commented. The medium-term employment program was welcome. He hoped that it would be more successful than previous attempts to tackle rigidities in the labor market.

The modification of the wage indexation mechanism was an important change in the labor market, Mr. Lundstrom considered. The new system, which was based on an agreement covering a period of four years, provided for semiannual adjustments, a reduced degree of coverage, and consultations among the social partners in order to limit the impact of changes in indirect taxation on the scala mobile index. All those steps were in the right direction, despite their obvious shortcomings, which the staff had described. The authorities should make further progress in those directions. Two of the members in his constituency had abolished elaborate wage indexation systems, and thus had managed to rid themselves of the detrimental effects stemming from those systems. Those effects were apparent in Italy and in other countries where wage determination was subject to highly automatic mechanisms. Abolishing the wage indexation system would be a significant safeguard against excessive growth of labor costs and would complement a nonaccommodating stance of monetary policy and firm management of the exchange rate.

He agreed with the staff that a nonaccommodating monetary policy would be consistent with a return to indirect methods of monetary control, Mr. Lundstrom commented. Prolonged resort to quantitative credit controls would create distortions in the financial markets and hamper economic growth. Hence, the abolition of the credit ceilings that had been introduced as an exceptional measure in January 1986 was welcome. Furthermore, Italy needed a realistic interest rate policy in order to integrate successfully the country with the international capital markets through a further liberalization of capital controls.

The fall in oil prices and in the U.S. dollar had improved the prospects for the Italian economy in 1986, Mr. Lundstrom remarked. He hoped that the Italian authorities would consider those developments as an opportunity rather than as a form of relief. It would be unfortunate if those favorable developments were used to postpone the corrective effort that was clearly required. After 1,060 days of political stability, Italy was in a political transition period, and he hoped that the incoming Government would use the present room for maneuver to create conditions for a lasting improvement in the economy.

Mr. Kabbaj said that Italy's economic and financial performance in 1985 was clearly less favorable than in 1984, when expanding international demand and greater convergence between fiscal and monetary policies had contributed to real GDP growth in Italy that was higher than in most other economies and to a sharp deceleration in the rate of inflation in Italy. The 1984 performance had also benefited from the adjustment over the previous three years, when strict credit controls had encouraged the manufacturing sector to make important gains in productivity through the modernization of production and a significant reduction in labor costs.

During the previous Article IV consultation with Italy, Executive Directors had expressed concern that the adjustment momentum had slowed in late 1984 and that the authorities' 1985 targets with respect to inflation, real output, the fiscal deficit, and the external current account would not be attainable unless corrective measures were urgently implemented, especially in the state sector's finances, Mr. Kabbaj continued. Despite the improved performance in 1984, Italy's financial imbalances and structural weaknesses were still significant and continued to call for sustained adjustment in order to achieve greater convergence with the EMS countries and Italy's other trading partners in Europe. At the time of the previous consultation, there had also been concern that the progress that had been made in reducing the scope of Italy's wage indexing system could be reversed by a national referendum.

While the authorities had won a major victory on the wage indexation issue, the outcome for 1985 largely confirmed the concern that had been expressed during the previous consultation by the staff and the Executive Board, Mr. Kabbaj went on. Although the rate of inflation had been further reduced, the rate of improvement had markedly slowed and there had been little progress in containing the large inflation differential between Italy and its EMS partners. The external current account deficit had increased to 1.2 percent of GDP while real GDP growth had decelerated and, despite an increase of 0.5 percent in overall employment, the rate of unemployment--which had already been excessive--had further increased to 10.6 percent.

Even more important, there had been a further deterioration in fiscal performance in 1985, Mr. Kabbaj said. Despite the slower growth of interest expenditure, the state sector deficit had increased to the equivalent of 16 percent of GDP, compared with 15.5 percent in 1984 and the 1985 budget target of 14.8 percent. In 1985, as in previous years, fiscal performance had caused monetary policy to bear an excessive burden of adjustment, had compounded exchange rate management, and had contributed to a large loss in foreign reserves.

Despite the relatively less satisfactory 1985 performance and continued financial weaknesses, Italy had achieved a significant measure of structural adjustment over the previous five years and was in a stronger external position, Mr. Kabbaj commented. Moreover, the prospects for 1986 and 1987 had substantially improved as a result of the more favorable external environment, including lower oil prices. Those developments should considerably contribute to a resumption of adjustment efforts in Italy and to increasing real GDP growth to rates that were more compatible with Italy's social and demographic conditions. The authorities were aware that the achievement of those objectives depended crucially on their ability to contain the growth of the state sector borrowing requirement and to maintain adequate monetary, income, and exchange rate policies.

The targets in the authorities' medium-term fiscal adjustment program were appropriate, especially the reduction in the ratio of noninterest expenditure to GDP, the maintenance of the tax burden at the average European level, and the considerable curtailing of the state sector deficit in relation to GDP, Mr. Kabbaj said. The fiscal measures that had been implemented in 1986 and the announced broad guidelines for the preparation of the Financial Law for 1987 appeared to be largely in line with the medium-term targets, although their attainment could still be jeopardized by structural weaknesses in the procedures for determining expenditure.

The rise in real interest rates in 1985 had indicated that the Bank of Italy's nonaccommodating monetary stance had been maintained, Mr. Kabbaj remarked. As the staff had noted, however, there was obviously still an incompatibility between the large borrowing need of the state sector and monetary policy objectives as they affected the balance of payments and the exchange rate. That incompatibility had reduced the monetary authorities' room for maneuver, causing an interruption in the progressive transition toward increased reliance on market-oriented mechanisms and leading to a reintroduction of credit control ceilings. However, that interruption was in response to temporary pressures on the exchange rate with the decline in the U.S. dollar, and the ceilings were scheduled to be abolished by mid-1986.

Commenting on income and labor policies, Mr. Kabbaj said that while Italy's economy, as well as the economies of the other EEC countries urgently needed to be more flexible, the Italian authorities had continued to introduce significant measures to remove labor rigidities despite the social and political difficulties in so doing. The recent measures included a further modification of the wage indexation arrangement and a law aimed at promoting part-time employment and direct hiring in new employment.

The authorities had shown caution in their exchange rate management by resisting pressure to accommodate the economy's large inflation differential vis-à-vis Italy's main trading partners, Mr. Kabbaj commented. That stance had enabled Italy to maintain over the medium term a relatively stable real exchange rate and had forced the industrial sector to improve external competitiveness through effective productivity gains. However, large quantitative import restrictions were still maintained in Italy, as well as in other EEC countries; they were aimed particularly against products from developing countries. The recent considerable gains in industrial productivity in Italy and the overall improvement in its external competitiveness should encourage Italy to begin to remove those restrictions in the coming period.

Mr. Rye considered that the key issues that had been raised in the staff reports were the central importance of fiscal restraint for achieving continued progress toward Italy's medium-term economic objectives, and the existence of a window of opportunity to make faster progress in fiscal and other structural reforms. He sympathized with Mr. Zecchini, who had noted in his opening statement that the authorities had made progress in recent years, particularly in beginning to tackle some of the deep-seated structural problems, such as those in the labor market. It was important to recognize the difficulty in making such changes in the political environment of Italy. He agreed with Mr. Zecchini that while progress had been uneven in some areas or slow in some years, it had been continuing. Hence, the main difference of view seemed to be about the pace of change, and not the direction of change.

There was some difference of view between the staff and the authorities and Mr. Zecchini about the short-term outlook, and the latest available data suggested that the relative optimism of the authorities and Mr. Zecchini seemed to be justified, Mr. Rye continued. But in any event, the short-term outlook was a secondary consideration. If that outlook was brighter than the staff report had suggested, it could be argued even more strongly that there was an opportunity at present to go further in the direction of fiscal and other structural reforms than the authorities apparently intended. In other words, it would be more feasible for the authorities to place at risk some short-term gains in growth and employment in order to improve their chances to reach their medium-term objectives.

He agreed with the staff that the disappointing overall performance of the economy in recent years must be attributed primarily to the high and rising level of pre-emption of resources by the public sector, Mr. Rye commented. The state sector deficit in 1985 was extremely high--16 percent of GDP--and an early and substantial reduction of the deficit should be the primary objective of Italian economic policy. The failure to achieve the fiscal deficit target in 1985 was disappointing and illustrated one of the problems of the gradualist adjustment approach: if targets were missed, there might be retrogression rather than progress, while a more decisive approach to adjustment, even if it did not fully succeed, was likely at least to achieve some gain.

He agreed with the staff that the authorities should make every effort to avoid slippages in the implementation of the 1986 budget 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 budget of peripheral public entities, Mr. Rye continued. He would have preferred a faster reduction in the deficit than was envisaged by the authorities, especially as the medium-term fiscal adjustment plan was based on optimistic growth projections. On the basis of the latest estimates, the relative fiscal deficit would be no smaller in 1986 than the 1985 target. In order to achieve a significant and lasting reduction in the deficit, fundamental reforms of some components of the budget seemed to be necessary. He agreed with the staff's recommendations for a reduction in noninterest public expenditure, including reform and stricter means of testing social security benefits together with a reduction, where possible, in incentive schemes.

Such objectives could not be achieved in the short term, Mr. Rye went on. The authorities would have to be prepared to pursue the approach that he had in mind for a number of years in order to eliminate the large fiscal imbalances that plagued the economy.

He agreed with the staff's conclusion on page 9, Mr. Rye said, that the targets of a steady deceleration in inflation, the maintenance of external balance, and the broad stability of the lira within the EMS required a degree of control over the growth of monetary aggregates that might be inconsistent with the large public sector borrowing requirement. The Government's objective of significantly reducing real interest rates also might be inconsistent with the large public sector borrowing requirement. He also agreed with the staff that in the absence of a sustained effort of adjustment of the public finances, it would be virtually impossible to implement a steady, medium-term monetary policy in Italy. Those monetary considerations underscored the need for fiscal restraint.

The current favorable external environment gave the authorities an opportunity to make faster progress than hitherto in the structural adjustment of the Italian economy, Mr. Rye commented. The word "opportunity" had been used a striking number of times--with good reason--in the staff appraisal. On page 17 the staff had concluded that the favorable external environment provided the opportunity for a substantial improvement in the performance of the Italian economy in 1986, and the latest information suggested that such an improvement was occurring. The real question was whether the policies that would enable a better performance to be sustained would be maintained with sufficient vigor. A case could be made for sacrificing, if necessary, some short-term gains in growth and employment in order to improve the medium-term growth prospects.

On page 19 of the staff report it was suggested that the boost to both household and enterprise incomes provided by the decline in oil prices created an opportunity to make a decisive beginning in the structural reform of pensions, health services, and, more generally, the provision of public services, Mr. Rye continued. It would be appropriate in Italy's situation to garner some of the oil price fall for public revenues through an increase in taxes. The latest information suggested that the savings for the 1986 budget from lower interest rates were perhaps being offset by higher outlays on noninterest items. A further comment on that trend would be helpful.

He broadly supported the staff's comments on the other major policy issues that were mentioned in the report, Mr. Rye said. In particular, he endorsed the staff's comments on the need for continued wage restraint and agreed that the authorities should liberalize the unilateral import restrictions and work with their EC partners to achieve a more liberal common external trade policy.

Mr. Sengupta remarked that Mr. Zecchini was probably correct in calling the staff's appraisal pessimistic. Mr. Zecchini's approach also was not overly optimistic; it suggested a studied caution.

The economic performance in 1985, following the appreciable improvement in the economy in 1984, did not give much cause for enthusiasm, Mr. Sengupta continued. In 1985, the rate of growth in real GDP had decelerated, the fiscal deficit and the expansion of the monetary base had exceeded the target, the trade deficit had risen, there had been a considerable decline in foreign exchange reserves, the rate of inflation had fallen only slightly, and while the level of employment had increased, the rate of employment had also risen as a result of the growth of the labor force.

However, there had been some promising developments in 1985, Mr. Sengupta went on. Although the slowing of GDP growth had been a reflection mainly of the deceleration in the expansion of domestic demand, the growth of gross fixed investment had been fairly rapid--4 percent. There had been a significant increase in the production of final investment goods of 5 percent in 1985, compared with about 2 percent in 1984. There was room for improvement in capacity utilization, which, despite the recent pickup, was still below the peak of about 78 percent of the early 1980s. The profitability in the manufacturing sector apparently had been substantial, as was suggested by the buoyancy of the stock market. In addition, export market shares had grown by about 4 percent in 1985, compared with 1.4 percent in 1984, and exports had grown by more than 6 percent in real terms.

The external outlook for Italy was promising, Mr. Sengupta commented. The recent fall in oil prices and in the U.S. dollar provided an opportunity to improve the performance of the economy in 1986. He agreed with Mr. Rye that it was fully justifiable for the authorities to impose a tax on oil in order to raise revenues in the wake of the fall in oil prices.

The authorities recognized that their policies must be consistent and should promote the medium-term adjustment effort, Mr. Sengupta said. They aimed to improve the financial position by reducing the fiscal deficit and the rate of monetary expansion in 1986.

After improving briefly in 1984, the fiscal deficit had risen in 1985, owing mainly to expenditure overruns, Mr. Sengupta noted. Mr. Zecchini seemed to have implied that major corrections in the fiscal imbalance would require structural and institutional changes that would not receive the necessary parliamentary support. Mr. Zecchini had said that it would be far less difficult to raise additional revenues and perhaps to curb spending, mainly on a temporary basis. He wondered whether those conclusions were an admission that large reductions in the fiscal deficit could not be achieved in coming years. A major effort at fiscal balance would over time require some structural and institutional changes. Sooner or later the question would arise whether the public debt should be as large as nearly 100 percent of GDP. Interest payments by the public sector accounted for almost 10 percent of GDP in 1984, compared with 6 percent in 1980. Interest payments would grow over time if the public sector borrowing requirement were not contained. In that connection, he was pleased that the 1986 fiscal deficit was expected to be nearly 1.5 percentage points smaller than the deficit of 16 percent of GDP in 1985. The latest information showed that the fiscal outcome in the first quarter of 1986 was nearly on target. The staff had not explained whether that achievement was a result of deliberate fiscal action or favorable exogenous factors.

The staff seemed to suggest that monetary policy had been accommodating in 1985, since domestic credit expansion to the private sector had been 1 percentage point higher than had been targeted, Mr. Sengupta said. But that development by itself did not mean that monetary policy had been accommodating, as the staff seemed to have implied. In that connection, Mr. Zecchini's arguments were convincing. The monetary authorities had had less room for maneuver in 1985 than in 1984 because of the accelerating growth of the public sector borrowing requirement.

The 1986 monetary program was aimed at a deceleration in the growth of domestic credit to the private sector and of M2, Mr. Sengupta noted. Given the public sector borrowing requirement, those objectives could be achieved by keeping real interest rates sufficiently high and without resorting to quantitative credit controls. The authorities felt that interest rate reductions were possible in view of the decline in the domestic rate of inflation and in interest rates abroad. The authorities believed that a reduction in interest rates would be consistent with the target growth rate for the money supply and with the anticipated growth of the stock of financial assets. He agreed with Mr. Zecchini that that consistency was possible, provided that the targets for the fiscal deficit were met.

In early 1986, real interest rates had been high and the stock market had been generally buoyant, Mr. Sengupta observed. Those developments might be an indication that the monetary policy stance was appropriate. However, caution was needed in effecting reductions in interest rates because of the need to ensure that the anticipated decline in the inflation rate would take place. Mr. Zecchini had correctly argued that to make additional room in which to reduce interest rates, it would be necessary to reduce the state borrowing requirement and the public sector deficit.

The authorities' efforts to contain labor costs through modifications in the wage indexation mechanism and to increase labor mobility were welcome, Mr. Sengupta said. However, the beneficial effect of those measures would only be felt after some time.

The trade performance in 1985 was less encouraging, Mr. Sengupta went on, as the trade deficit had increased, owing mainly to a rise in imports. The trade performance had caused a considerable increase in the external current account deficit. While there had been a substantial net inflow of capital owing to the sizable foreign long-term loans contracted mainly by the public sector, it had been more than offset by the large negative errors and omissions item, which reflected heavy capital outflows in the latter part of 1985 in response to expectations of a depreciation of the lira and relatively easy domestic financial policies. The outflows had had to be covered by substantial losses of official reserves.

However, the prospects for 1986 were favorable, Mr. Sengupta remarked. The fall in oil prices and the expected deceleration in the rate of inflation should help the authorities to maintain Italy's export market shares. The management of the exchange rate policy seemed to be adequate.

Commenting on trade policy, Mr. Sengupta said that he was pleased that very few quantitative restrictions on imports and import payments remained for subzone A/3. That subzone included "third countries"--which apparently covered a large part of the developing world. Italy's imports from non-oil developing countries had increased in 1985. The authorities should increase developing countries' access to the Italian market. The increase in Italy's official development assistance in 1984 and 1985 was welcome.

He hoped that the authorities would succeed in their efforts to achieve medium-term adjustment through measures that promoted growth as well as price stability, Mr. Sengupta commented. He agreed with Mr. Zecchini that, with the improvement in the terms of trade, the Italian economy could perform well in 1986, when it expected that GDP would grow by 3 percent, domestic demand would rise by 4 percent, the rate of inflation would fall, substantial growth in employment would occur, and an external current account balance or perhaps a surplus would be achieved, provided, as Mr. Zecchini had stressed, that the major trading partners fostered the growth of their domestic demand as had been advocated internationally.

Mr. Wijnholds said that the Italian economy remained something of an enigma: while various problems could be identified, and the staff's warnings in a number of areas were fully appropriate, the economic outlook for 1986 was relatively positive. Part of the explanation for that outcome was that the external environment was much more favorable in 1986. Nevertheless, it was somewhat surprising that fixed investment was increasing rapidly despite high real interest rates and the absorption by the public sector of a large share of private savings. The Italian economy seemed to have a different dynamism from other European economies and somehow seemed to produce acceptable results despite having significant disequilibria.

The staff had underscored the important risks in the present economic situation in Italy, Mr. Wijnholds noted. The present favorable conditions needed to be utilized to attack some of the fundamental weaknesses in the economy, particularly government finances, if a return to lasting and satisfactory growth and moderate inflation were to be achieved. The staff had stressed that economic performance in Italy had lagged behind that of other large industrial countries since 1979/80, as economic growth in Italy had averaged less than 1 percent a year while the rate of inflation had remained considerably higher in Italy than in most other industrial countries. Italy had admittedly been struck relatively hard by the second oil shock. At the same time, Italy stood to gain a good deal from the recent decline in the price of oil. That oil countershock provided a significant opportunity to place the Italian economy on a sounder footing. It would be unfortunate if that opportunity were lost because of an inadequate policy response. In that connection, a greater than expected buoyancy in domestic demand seemed to lend even more urgency to the effort to avoid a flaring up of inflation with possible renewed pressure on the exchange rate.

A central issue for the Italian economy over the previous several years was the public sector finances, which remained the fundamental weak spot in the economy, Mr. Wijnholds remarked. Moreover, that problem was becoming more serious, as the staff report and previous speakers had stressed. An improvement without delay in noninterest expenditure was crucial if the authorities were to retain a grip on total expenditure. Increases in revenue through higher taxes on energy products would be a positive way in which to contribute to the much-needed reduction of the public sector deficit, which, at 16 percent of GDP, was by far the largest among the industrial countries.

Monetary policy had the difficult task of containing inflation at a time of a sizable fiscal imbalance, Mr. Wijnholds commented. The nonaccommodating stance of monetary policy and the authorities' intention to achieve lower growth rates for money and credit in 1986 were commendable. He agreed with the staff that, given the liquidity in the economy, a somewhat stronger deceleration of the monetary aggregates would be desirable. Any forced attempt at lowering interest rates should be avoided. He was pleased to note from Mr. Zecchini's opening statement that the authorities recognized that interest rate reductions would have to be preceded by further progress toward eliminating the public sector deficit net of interest payments. In addition, the so-called divorce between the Central Bank and the Treasury should not be changed. As to the liquidity in the economy, he wondered whether it had contributed to the strong performance of the Italian stock market which, after doubling in 1985, had increased by a further 75 percent during the first five months of 1986. He also wondered whether such large stock market gains had not had significant wealth effects.

Important improvements in wage formation had been made, but some unsatisfactory elements remained, Mr. Wijnholds said. The recent restructuring of the scala mobile was clearly a favorable development, but further progress would be desirable. For example, the inclusion of indirect taxes in the scala mobile needed to be reviewed. Another area of concern was minimum wages. It was unfortunate from an economic viewpoint that the wage rate was fully insulated from the effects of inflation. Since the rate of unemployment of young persons in Italy--35 percent--was much higher than the average rate for the industrial countries as a group, the authorities should seriously consider the impact that a more flexible minimum wage policy might have in that area. Experience in his country suggested that a reduction in the minimum wage for young persons contributed to a significant reduction in their level of unemployment.

The authorities' use of the exchange rate in a nonaccommodating fashion within the EMS was commendable, Mr. Wijnholds commented. That policy had contributed to greater convergence among the EMS partners by lowering inflation rates, narrowing somewhat the inflation differential, and fostering industrial restructuring. Unfortunately, the devaluation of the lira in 1985 had not been accompanied by sufficient concrete budgetary measures. However, the Italian position during the most recent European realignment and the recent limited liberalization of capital movements in Italy were positive elements. The authorities should introduce further liberalization measures in the near future.

Mr. Almeida considered that, on balance, the Italian economy had performed well in 1985, as significant improvements had been made in the areas of inflation, structural rigidities, and the fiscal deficit. In addition, the rate of economic growth had declined but was still in line with the EEC average, and the small increase in unit labor costs had caused a widening of profit margins with favorable effects on fiscal investment, particularly in machinery and equipment. Monetary policy had been kept tight, and real interest rates had continued to rise in 1985, while the authorities had correctly continued to move away from direct monetary control in favor of market-oriented instruments.

The monetary targets for 1986 seemed to be appropriate, Mr. Almeida said; they were less than the expected nominal growth in income and, as Mr. Zecchini had noted, they would not add to the pressure on real interest rates as long as the fiscal targets were met. The fiscal policy for 1986 was realistic: there was to be a decline in the state borrowing requirement by 1.5 percent of GDP resulting mostly from higher revenues, as the Parliament had decided not to curb spending.

As the latest data showed, there had been a substantial reduction in labor market rigidities over the previous two years, Mr. Almeida remarked.

Several new pieces of legislation had increased the flexibility in part-time employment, reduced the scope of wage indexation, and increased the flexibility of working hours. He doubted whether the available data justified a conclusion that Italy remained at a disadvantage in labor mobility compared with other countries. A staff comment on that matter would be helpful.

Mr. Mawakani recalled that during the previous discussion on Italy his chair had noted that although the state sector had generally performed better in 1984, the latest information had indicated that the fiscal deficit could worsen in 1985 and would continue to pose a major constraint on the effectiveness of several other policy areas. In fact, Italy's economic performance in 1985 had been consistent with that observation. The positive developments that had occurred in 1984, including the progress that had been made in adjusting the Italian economy in line with the economies of other industrial countries, had come to a virtual halt in 1985.

Real GDP growth had decelerated in 1985, reflecting the deceleration in the expansion of domestic demand in 1984, Mr. Mawakani continued. Some progress had been made on the inflation front, owing partly to the effect of the fall in oil prices. In the external sector, the current account deficit had increased, and the pressure on the lira and foreign reserves had intensified.

Despite the slow progress that was being made in adjusting the Italian economy in line with the economies of other industrial countries, some achievements in significant areas had been made, Mr. Mawakani said. The return of Italian enterprises to a satisfactory level of profitability and self-financing, which was a reflection of the buoyant expansion in fixed investment, was encouraging. The improvement in the climate of labor relations and the sharp deceleration in unit labor costs in manufacturing together with the restraint on wage claims were welcome. In addition, there had been improvements in the financial system in line with changes in the international financial environment.

The progress that had been made thus far should be consolidated in order to move the economy from its present sluggish state toward its full potential, Mr. Mawakani considered. He broadly agreed with the thrust of the staff appraisal. The authorities should be encouraged to take advantage of the favorable developments in the international economy--the fall in oil prices and the depreciation of the U.S. dollar--to introduce corrective measures. He was pleased to note from Mr. Zecchini's opening statement that the authorities attached crucial importance to adhering strictly to the medium-term strategy in order to achieve a 6 percentage point reduction in the state sector borrowing requirement in 1988 compared with 1985. Such an achievement would be translated into a real GDP growth rate of about 3 percent per year, a further deceleration in the rate of inflation, a decline in the unemployment rate, and a surplus on the external current account.

The performance in the fiscal sector in 1985 once again showed that public finances were a long-standing weakness in the Italian economy, Mr. Mawakani commented. The deficit of the state sector had increased and, as a result, monetary expansion had accelerated rapidly to meet the financing requirements of the public sector; credit to the Treasury had caused a substantial expansion of the monetary base. Therefore, the authorities needed to maintain a proper balance between a cautious monetary stance and fiscal discipline in order to meet their fiscal targets. Expenditure control measures should therefore be strengthened and rigorously applied. Finally, the gradual increase by Italy in its official development assistance to 0.33 percent of GNP in 1984 and Italy's other special assistance to developing countries despite the difficult budgetary situation in Italy were welcome.

Mr. Nimatallah said that the overall performance of the economy in 1985 was less satisfactory than in 1984, mainly because of the deterioration in the fiscal position. That outcome was particularly serious in view of the decline in the rate of inflation over the previous several years. Deficits as large as those in Italy tended to limit the effectiveness of other policy instruments. In particular, the traditional mix of nonaccommodating exchange rate and monetary policies had come under pressure, and the trend toward a market-oriented approach to the conduct of monetary policy had suffered a setback.

The authorities were aware of the problems, and they were to be commended for their commitment to reverse the fiscal deterioration, Mr. Nimatallah commented. Efforts to reduce the deficit should concentrate on cuts in expenditure, since general government tax revenue already amounted to 42 percent of GDP. However, some revenue measures should be introduced to improve the efficiency of tax administration, and the tax base should be broadened with a view to enhancing incentives.

It was important that the steps to reduce the fiscal deficit should be aimed at resolving some of the underlying, longer-term structural issues, Mr. Nimatallah considered. In addition, the authorities should take advantage of the window of opportunity that had been opened by the recent improvement in the external environment. He was pleased that the authorities did not intend to impose oil import taxes, thereby safeguarding the competitiveness of their energy-extensive industries and encouraging growth.

The latest information showed that there had been a tangible improvement in economic performance thus far in 1986, Mr. Nimatallah remarked. In particular, the fiscal deficit was expected to decline to 14 percent of GDP. However, such a large deficit was still a cause for concern, as it absorbed almost 60 percent of gross private savings. Since the private sector presumably was normally more productive and efficient than the public sector, and since a large part of the fiscal deficit financed current expenditure items such as social services, the large crowding out in Italy was unsustainable and could harm investment and capital formation. The authorities would have to plan ahead to enhance capital formation and to modernize the economy. In that connection, their intention as a first step to keep expenditure, excluding interest payments, constant in real terms was welcome. However, attaining even that objective would require continued firm resolve. There was a natural tendency for some components of expenditure to be elastic with respect to GDP growth. That tendency was most obvious in the case of social expenditure. Italy's problems in that respect were compounded by the fact that Italy, alone among the G-7 countries, already had to use debt financing to cover its social expenditure program.

While improving the fiscal situation was clearly a key to restoring economic balance in Italy, there were of course other policy areas that required more attention than hitherto, Mr. Nimatallah said. In particular, labor market policies had an important role to play. The staff had shown that, by a number of measures, labor market performance had recently tended to become relatively less flexible. Institutional constraints and the widespread use of indexation techniques were held to be the contributing factors to the unsatisfactory labor market performance. In that context, the recent significant policy measures that had been taken to reform both conditions of employment and the wage indexation schemes were welcome. The authorities' intention to take a systematic approach to enhancing labor market flexibility within the context of a ten-year plan was encouraging. While the recent shift toward basing wage contracts on inflationary expectations was a step in the right direction, wage increases should ultimately be linked to productivity gains rather than to the inflation rate.

In his opening statement Mr. Zecchini had argued that, with respect to labor market rigidities, Italy might not be at a disadvantage in comparison with other industrial countries, Mr. Nimatallah noted. While that might well be true, the main point was that labor market rigidities continued to be widespread in almost all industrial countries. It was in that context that the authorities should consider whether the time was ripe to initiate a national debate on finding ways in which to alleviate unemployment problems, including the desirability of reducing the number of work hours per week--by, say, five hours--with a corresponding reduction in compensation. Such an approach would help alleviate unemployment, mitigate social problems, and reduce fiscal expenditure.

The authorities were to be commended for their commitment to reduce significantly the growth of credit and liquidity, Mr. Nimatallah said. Their intention to eliminate the recently introduced quantitative credit restrictions was welcome. While in general he favored coordination between central banks and treasuries, he would be reluctant to endorse a partial repeal of the so-called divorce between the Bank of Italy and the Treasury if the purpose was to achieve an accommodating monetary policy.

The authorities' continued adherence to a cautious exchange rate policy within the context of the EMS was commendable, Mr. Nimatallah stated. A useful discipline was derived from that policy. The authorities' commitment to keep the Italian lira within its EMS limits had sent an important signal.

The authorities were to be commended for the steps that they had taken to strengthen the economy, Mr. Nimatallah said. Reducing the fiscal deficit would increase the resources available to the private sector and would accelerate the rate of capital formation in that sector. Those steps would in turn bring the economy onto a path of sustained growth. He hoped that the authorities would intensify their adjustment efforts and fiscal consolidation within a medium-term context. That approach would not only improve the domestic balance in Italy, but would also keep Italy's policy and performance in line with those of its partner countries.

Mr. Salinas stated that he broadly agreed with the staff appraisal and shared the concern that had been expressed in the staff reports about the management of public finances, the persistence of structural rigidities in significant areas of the economy, and the outcomes with respect to inflation and the external accounts, which had fallen short of expectations. It was clear that the public sector imbalances remained the main cause of the weaker performance of Italy in recent years and that they had imposed a heavy constraint on overall economic policy formulation. Those developments had become increasingly serious in the 1970s and had resulted in a growing public debt that had largely fueled itself, a crowding out of the private sector, inefficient resource allocation, and constant pressure on the domestic price level and the external accounts.

Unless the authorities took strong steps to reduce the huge fiscal deficit, there was a growing risk of a further increase in the already large public debt burden to an unsustainable level that undermined the prospects for economic growth in coming years, Mr. Salinas continued. Those strong actions should take place on both the expenditure and revenue sides. Further restraint on expenditure seemed possible, given the rate at which expenditure had grown over the previous several years. An improvement in the quality of expenditure was needed to ensure more efficient resource use in priority areas. He agreed with previous speakers who had suggested that the authorities could benefit from the current low oil prices by means of taxation, although he recognized that that step should be considered only as a temporary source of financing. It was important to stress the role that a moderation of labor costs could play in reducing current expenditure as well as in helping to restore competitiveness and bolster import substitution industries.

To avoid excessive growth of labor costs the authorities should maintain a restrictive monetary policy together with firm exchange rate management and a more decisive effort to eliminate labor market rigidities, Mr. Salinas considered. The decision to keep the central rate of the lira in terms of the ECU unchanged during the recent EMS realignment and the progress that the authorities had made in somewhat reducing the rigidities in the labor market and in promoting productivity were welcome. Those actions were steps in the right direction, but by themselves they were insufficient to deal with the structural weaknesses of the economy and with the growing deterioration of the external current account.

Italy's general support for an open multilateral trading system contrasted with its lack of action to reduce trade barriers, Mr. Salinas remarked. The failure to reduce those barriers had negatively affected Italy's adjustment effort and domestic resource allocation and had damaged the efforts by many developing countries to stabilize their economies. He agreed with the staff that Italy should work with its EC partners to achieve a more liberal common external trade policy, particularly in view of the clearly more favorable external environment that many EC countries were enjoying.

He agreed with the staff that the medium-term prospects for Italy would not be encouraging unless the authorities implemented the required corrective fiscal measures, Mr. Salinas said. In the absence of such action, the rate of inflation could further accelerate and the external current account might well continue to deteriorate, thereby further endangering economic growth.

Mr. Qureshi recalled that the latest Interim Committee communiqué had mentioned that, to the extent possible, the benefits of oil price declines should be passed on to end-users in the interest of encouraging noninflationary growth in the world economy. Of course, the applicability of that global recommendation should be assessed in the context of the particular circumstances of individual countries. Accordingly, the case for increasing oil taxes in Italy should be viewed in the specific context of the economic circumstances of Italy. The basic fiscal problem in Italy apparently was not a lack of adequate growth in revenue; rather, the problem was a lack of adequate restraint of expenditure growth. On page 8 of the staff report it was mentioned that revenues had grown faster in Italy than in other industrial countries. As a ratio of GDP, current revenues of the general government in Italy had risen from 38 percent in 1980 to 44.8 percent in 1985, compared with an increase of just 1 percentage point over the same period in Germany and 3 percentage points in France. Despite the relatively rapid growth of revenues in Italy, the fiscal problem in Italy had become increasingly serious, while the fiscal situation in the other industrial countries had eased. Hence, it was clear that the basic fiscal problem in Italy was on the expenditure side, rather than on the revenue side. Of course, that conclusion did not mean that the revenue side in Italy should be neglected, but it was important to see the fiscal problem in Italy in its proper perspective.

It was also important to remember that oil was already one of the most heavily taxed items in Italy, Mr. Qureshi commented. Gasoline taxes in Italy were already higher than gasoline taxes in other European countries, and the final price of gasoline in Italy was already more than three times the refinery price.

In considering the appropriateness of an increase in oil taxation in Italy it was relevant also to bear in mind the efficiency criteria for taxation of oil in comparison to other energy items, Mr. Qureshi said.

For example, while the benefits of the decline in oil prices were being taxed away and thus were not being passed on to some types of users in Italy, there had been a cut in the end-user prices of electricity.

Mr. Nimatallah commented that, in addition to the points that Mr. Qureshi had made, it was useful to bear in mind the need to encourage economic growth in assessing the appropriateness of increased oil taxes in Italy. There was some evidence that certain parts of the industrial world were in danger of a recession. It was therefore important to pass on the benefits of the lower oil price to private sector investors and consumers in order to encourage economic growth. Depriving the private sector of that opportunity at the present stage would certainly be regretted later. The advantages for the U.S. economy of the lower oil prices already seemed to be fading even though the United States had not increased its oil taxes; the growth incentive of the lower oil prices would certainly have been diminished if oil taxes had been increased following the price reduction. Authorities in industrial countries should think carefully before discarding an opportunity to encourage growth.

Mr. Wijnholds said that recent projections by the EEC staff included a higher economic growth rate in 1987 than the staff had projected. Apparently there was no particular danger of a recession in Italy in the coming period.

Mr. Nimatallah said that he agreed with Mr. Wijnholds that there was no great danger of a recession in Italy at the present stage. However, he had meant to stress the need to take steps that would ensure that economic growth in Italy could be sustained. To that end, the low energy prices, particularly for oil, could be a helpful incentive.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/106 (6/30/86) and EBM/86/107 (7/2/86).

2. YEMEN ARAB REPUBLIC - TECHNICAL ASSISTANCE

In response to a request from the Governor of the Central Bank of Yemen for technical assistance in the monetary, financial, and central banking fields, the Executive Board approves the proposal set forth in EBD/86/174 (6/24/86).

Adopted June 30, 1986

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/163 and 85/164 are approved. (EBD/86/172, 6/24/86)

Adopted July 1, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/86/154 (6/27/86) and EBAP/86/155 (6/30/86) and by an Assistant to Executive Director as set forth in EBAP/86/156 (6/30/86) is approved.

APPROVED: March 20, 1987

JOSEPH W. LANG, JR.
Acting Secretary