**FOR AGENDA**



SM/85/119

CONTAINS CONFIDENTIAL
INFORMATION

April 26, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Italy - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Italy, which is proposed to be brought to the agenda for discussion on Friday, May 24, 1985.

Mrs. Ter-Minassian (ext. 8844) or Mr. Spitaeller (ext. 8838) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

ITALY

# Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Article IV Consultation with Italy

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

April 25, 1985

## I. Introduction

A staff team consisting of Mr. L. A. Whittome, Mrs. T. Ter-Minassian, Messrs. E. Spitaeller, M. Beleza (all EUR), M. Mentini (EP-EUR) and, as secretary, Miss J. Murray (GEN), visited Rome from March 4-18, 1985 to conduct Article IV consultation discussions. The mission met with the Ministers of the Treasury, Budget, Labor, Industry and State Participations and with the Governor and Deputy Governor of the Bank of Italy, as well as with officials in these agencies. Mr. Zecchini, Executive Director for Italy, attended the meetings as an observer. The previous consultation discussions had taken place in October/November 1983 and the staff report was considered by the Executive Board on January 27, 1984. Italy has accepted the obligations under Article VIII. Fund holdings of Italian lire stood at SDR 1.8 billion (62.4 percent of quota) on February 28, 1985.

The five-party coalition Government under the premiership of the Socialist leader Mr. B. Craxi has been in power for over one and half years. Nationwide elections at the local level are to be held in May, to be followed by Presidential elections in mid-June. A popular referendum may be held in the first half of June on the restoration of the scala mobile points cut by government decree in 1984.

## II. Background

After three years during which external adjustment and a deceleration of inflation in Italy had been effected by restrictive monetary policy in the face of fiscal expansion, the fiscal-monetary policy mix was more balanced in 1984. Owing to a combination of corrective efforts, incidental effects, and deferments of expenditure, the borrowing requirement of the state sector declined in relation to GDP for the first time since 1980 (Table 1). This in turn allowed sufficient financing for the private sector to accommodate a recovery of demand and output without an acceleration in the growth of the monetary and credit aggregates. The improved mix of financial policies was complemented by incomes policy measures aimed at containing indexation-related wage increases and the rise in administered prices, including rents. Unfortunately, the fiscal performance weakened in the course of the year. The borrowing requirement of the state sector widened sharply in the last months of 1984. It also became progressively more apparent that a part of the improvement in the state sector finances was a reflection of reduced transfers by the Treasury to peripheral public entities which, in turn, drew down their bank deposits and stepped up recourse to bank credit.

On a general level, Italy's economic performance improved on most counts in 1984 (Table 2). Output recovered after three years of recession, inflation decelerated, and the overall balance of payments and international reserves developed relatively favorably. The Italian economy had entered 1984 under auspicious conditions, poised for recovery and with equilibrium in the external accounts. The adjustment in the external accounts had been effected through the use of restrictive credit and interest rate policies which brought on a decline in real domestic demand. The decline amounted to a cumulative 3.7 percent in 1981-83 and to 1.2 percent in 1983 alone, contrasting with an increase in that year of 1.6 percent in Italy's main trade partners. After three years of deficit the current account returned in 1983 to a surplus, equivalent to 0.2 percent of GDP (Table 3). The contribution of the foreign balance to output growth dampened the effect of the decline in domestic demand, and the cumulative decline in GDP over the three-year recession amounted to 0.7 percent.

In its early stages the recovery of 1984 was fueled mainly by a continued good export performance reflecting the recovery in external demand, as well as by an increase in inventories. By midyear private consumption, boosted by gains in after-tax real wages and especially nonwage incomes, was contributing to the recovery. It was later complemented by a strengthening of fixed investment especially in machinery and equipment, making the recovery more broadly based. Developments toward the end of the year, however, give rise to concern that support to growth has shifted too rapidly from the foreign balance to domestic demand. For the year as a whole domestic demand appears to have risen by around 3 percent, 0.6 percentage point faster than in Italy's partner countries. The differential was higher in the second half of the year, because of a loss of momentum in demand abroad and an acceleration in the rate of increase in Italy. In these circumstances, more favorable profit margins at home than abroad could not but divert sales from export to domestic markets and encourage imports. While the level of domestic orders rose continuously in the course of 1984, that of export orders rose in the first half only, declining in the second. On the whole, GDP grew by some 2 1/2 percent on average in 1984, with a small negative contribution from the foreign balance.

Industrial production rose in 1984 broadly in line with GDP, sustained by gains in productivity in the manufacturing sector. By contrast, total employment remained broadly stable with the continuing decline in industrial employment being offset by gains in the service sector. Stagnant employment and a growing labor force reflecting demographic trends and a rising participation rate resulted in a further worsening of unemployment. The unemployment rate stood at 10.4 percent on average in 1984, or 12 percent after adjustment for workers paid by the Wage Supplementation Fund. Youth unemployment in Italy accounts for a substantially higher proportion of the unadjusted unemployment rate than in other industrial countries. At the same time, registered unemployment among adult males is relatively lower in Italy, not least because their share in payments received from the Wage Supplementation Fund is large.

A marked deceleration in unit labor costs in manufacturing in 1984 facilitated the restoration of profit margins, implying a redistribution of income in favor of enterprises, which is consistent with the cyclical pattern of income distribution in the past. Inflation as measured by the cost of living decelerated through the year from 12.5 percent year-on-year in January to 8.7 percent in December. The average annual increase stood at 10.7 percent compared to a target of 10 percent (Table 2). The deceleration of inflation reflected in part the maintenance of a moderately restrictive stance of monetary policy in the last few years. However, the main factors behind the decline in the rate of inflation in 1984 were gains in industrial productivity typical of the early phase of cyclical upswing, the reduction by four index points of wage increases stemming from the scala mobile in the first half of the year, and the freezing of administered prices and rents.

The trade deficit on a customs basis widened from Lit 11.5 trillion in 1983 to Lit 19.2 trillion in 1984, equivalent to 3.2 percent of GDP. The rise in the deficit reflected both a loss in the terms of trade on the order of 1 1/2 percent and a faster volume growth in imports than in exports as a result mainly of the differential cyclical phasing of domestic demand in Italy and abroad. Competitiveness as measured by relative export values, which had improved marginally in 1983, stayed roughly unchanged in 1984. Relative unit labor costs which had deteriorated markedly in 1982 and 1983, improved on average in 1984, reflecting the moderation in wages and recovery of productivity, but remained significantly above the 1980-81 level (Chart 1). On a disaggregated basis, gains in competitiveness vis-à-vis the United States and on the U.S. market tended to be offset by losses vis-à-vis European competitors and on the European market. The fact that the U.S. market grew much faster than the European market was of considerable importance in this connection, especially since the share of Italian exports going to the European market is relatively larger. In addition to demand and price related factors affecting the Italian trade performance in 1984, a number of other factors were of importance, most notably those relating to transactions with state trading countries and to the energy balance. Italian exports to the U.S.S.R. in particular declined sharply as Italy was not in a position to provide the favorable financing terms required by the Soviet authorities. As for energy, Italy's dependence on imported oil and natural gas remains relatively high compared with other large industrial countries, making for a higher volume elasticity of total merchandise imports with respect to aggregate demand (see Appendix III of recent economic developments paper).

The deficit in the current account of the balance of payments in 1984 is provisionally estimated at Lit 5.5 trillion, equivalent to nearly 1 percent of GDP. The change from a surplus equivalent to 0.2 percent of GDP in 1983 was mainly a reflection of the widening trade deficit (Table 3). In itself a current account deficit on the order registered in 1984 is not worrisome. What does cause concern, however, is the fact that this deficit emerged against the background of a relatively moderate pace of recovery, ample spare capacity, historically high unemployment, and a relatively small loss in the terms of trade. In this respect the record in 1984 compares unfavorably with that of previous similar cyclical phases. The increased sensitivity of the trade balance to differential developments in domestic versus foreign demand is partly related to the fact that profit margins on domestic sales have been higher in recent years than those on sales abroad, especially on European markets. Also important are the continued high dependence on imported energy and the relatively larger absolute value of imports than of exports, which implies a greater impact on the trade balance of a 1 percentage point change in the volume or price of imports than of exports.

Net capital inflows matched the current account deficit, and the overall balance of payments registered a small surplus for 1984 as a whole. This conforms with the pattern observed in most years during 1979-84, when the capital account mainly reflected developments in the trade account. Short-term supplier credits have typically represented over 50 percent of capital inflows and over 60 percent of capital outflows, and the ratios of supplier credits to trade flows have remained broadly stable in the last few years. Capital flows in 1984 were also affected by widening real interest rate differentials in favor of Italy and by changes in regulations providing increased room for leads and lags toward the latter part of the year, both favoring inflows (see recent economic developments, Appendix on Exchange and Trade System). Official foreign exchange holdings including ECUs stood at US$19.1 billion at end-1984, equivalent to three months of merchandise imports, a relatively large margin by international standards. External medium- and long-term debt plus the net foreign position of commercial banks is estimated at US$57 billion (18 percent of GDP) at the end of 1984. The external debt service ratio is estimated at 11 percent of exports of goods and services in 1984.

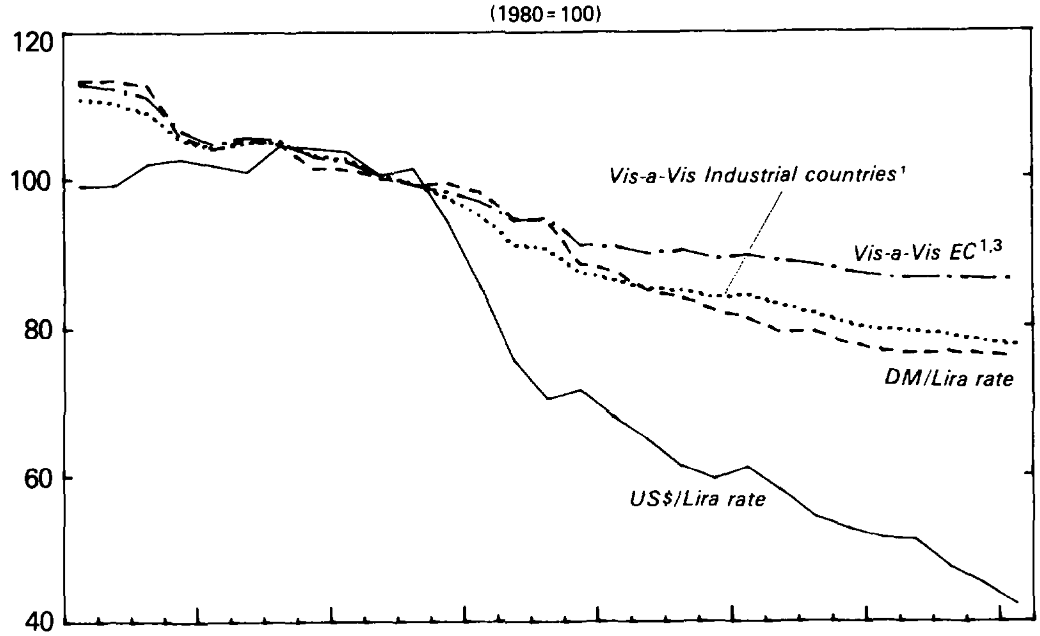
The exchange rate of the lira depreciated by 16.7 percent vis-à-vis the U.S. dollar in the course of 1984. The corresponding effective depreciation (MERM rate) amounted to 4.9 percent reflecting the relative strength of the lira vis-à-vis major currencies other than the U.S. dollar, particularly those within the EMS. This strength is to be seen in connection with the large and, in the latter part of the year, rising positive real interest rate differential in favor of Italy, reaching 4 percent vis-à-vis Germany in December (Monthly Charts on Exchange Market Developments, EBD/85/95). The result was a relatively large accumulation of deutsche marks and an increasing rate of real appreciation of

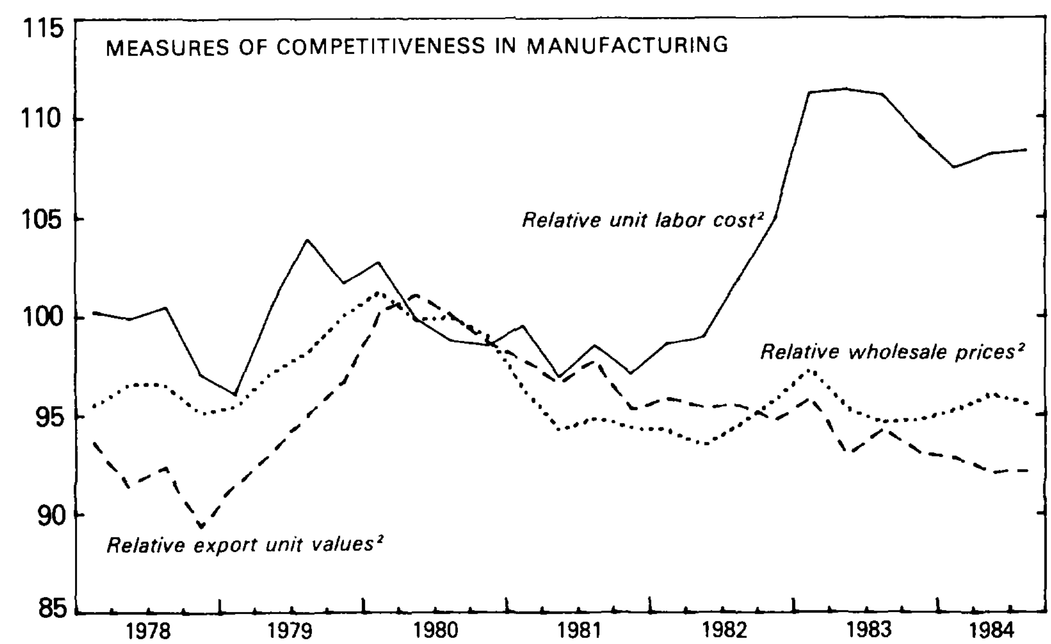
CHART 1

ITALY

# SELECTED EXCHANGE RATE INDICES

(1980=100)




Sources: International Financial Statistics, IMF, Reserach departments.

[1]Nominal effective exchange rates, based on 1980 average trade weights.

[2]Adjusted for exchange rate changes, vis-avis 14 industrial countries.

[3]Excludes Luxembourg, Ireland and Greece.

the lira vis-à-vis the deutsche mark (in terms of relative consumer prices) from 3 percent in the first quarter of 1984 to nearly 5 percent in the fourth quarter. Partly with a view to moderating the upward pressure on the lira, the authorities introduced during 1984 a number of measures to liberalize controls on capital outflows (see recent economic developments, Appendix on Exchange and Trade System).

## III. Report on the Discussions

### 1. Overview

The measure of improvement in policy coordination in 1984 appeared to vindicate in large part the adjustment efforts of the monetary authorities over the period 1981-83. After putting an end to their role as residual lender to the Government in 1981, the authorities moved in 1983 from direct monetary control through ceilings on credit expansion to the private sector to indirect control through reserve requirements and--more importantly--interest rates, while keeping a tight rein on the monetary base. In these circumstances the economic consequences of lack of control over the public finances, namely the crowding out of the private sector through high real rates of interest, became more apparent. This should have helped foster a growing political consensus in favor of fiscal restraint. Unfortunately, the momentum toward fiscal correction diminished in the course of 1984 and little progress appears to have been made toward a lasting improvement in the public sector finances.

The tightening of monetary policy in 1981-83 and the consequent strength of interest rates and the exchange rate put pressure on entrepreneurs to seek greater gains in productivity through modernization of production and shedding of labor. At the same time, incomes policy and the rising level of unemployment helped moderate wage costs and reduce strike activity. As a result, the rise in unit labor costs in manufacturing was more than halved in 1984, profitability of enterprises improved significantly, especially in the industrial sector, inflation decelerated and real disposable income recovered, reflecting boosts in nonwage incomes and a reduction in fiscal drag.

Favorable developments in the Italian economy in 1984 contrast with deteriorating trends through the year in the public sector accounts and in the balance of payments and at the end of the year an apparent cessation of the earlier deceleration in inflation. Accordingly, the starting point for 1985 is not favorable and, unless appropriate corrective measures in the areas of fiscal policies and income determination are promptly implemented, 1985 is likely to witness a reversal in part of the progress made in 1984. Such an outcome would compromise not only the prospects for an achievement of the Government's economic objectives for 1985 but also its medium-term plan of convergence with its main EMS partners.

The Government's medium-term scenario for the period to 1988 aims at an average annual increase in real GDP of 3 percent, a deceleration of inflation from 10.7 percent in 1984 to 7 percent in 1985 and to 5 percent as of 1986 and a decline in the real interest rate to a level more in line with GDP growth. Crucial to such a development is a fiscal adjustment plan which targets constancy in real terms of public current expenditure net of interest payments and an increase of public capital expenditure in line with the growth of GDP. The result would be a decline in the ratio of total government expenditure to GDP. The ratio of revenues to GDP is targeted to remain unchanged, but the composition of revenues is to be altered substantially as a result of efforts to secure a more equitable distribution of the tax burden. Accordingly, the ratios of both the state sector and the general government deficits to GDP would decline and the government debt, which currently stands at around 90 percent of GDP, would stabilize at around 100 percent of GDP by 1988. 1/

Within this medium-term plan the Government's objectives for 1985 are a rate of inflation of 7 percent, real growth of 2.5 percent and a current account deficit in the balance of payments equivalent to less than 1/2 percent of GDP. In the fiscal area, the Government's aim is to secure a reduction in the state sector deficit to below 15 percent of GDP. Achievement of this target would facilitate the maintenance of a positive real growth of credit to the private sector while a further deceleration in the growth of the monetary and credit aggregates occurred. Finally, in the area of incomes, the Government has set a target of 7 percent for wage increases, in line with the inflation target and intended to improve Italy's cost competitiveness.

The discussions between the Italian authorities and the staff focussed on the chances for realizing the Government's economic objectives in the light of current trends in the Italian economy and of possible slippages in policy implementation. The discussions highlighted the need for a properly coordinated stance of policy, within which individual strands of policy would be mutually reinforcing, and hence the need to break with a past when monetary policy in particular had to effect the necessary adjustment while fiscal policy was set on an expansionary course.

## 2. Economic policies

### a. Fiscal policy

The public finances represent a long standing area of weakness in the Italian economy. The government deficit has widened both over time

---

1/ Sensitivity analysis conducted on the Government's fiscal projections show that fulfillment of the objectives of the plan is crucially dependdent on the realization of underlying assumptions particularly as regards inflation and the relation of the real interest rate to the real rate of growth of GDP.

and in an international context. 1/ The overall deficit of the state sector increased from the equivalent of 2-3 percent of GDP on average in the 1960s to around 6 percent in the first half of the 1970s and to 11 percent of GDP in the second half. It rose further to 15 percent during 1981-84 (Table 1). These increases compare with declines in the period 1975-80 to 1981-84 in the deficits of the Central Government in the United Kingdom and Germany from 5.3 percent to 3.8 percent and from 2.4 percent to 2.3 percent, respectively, and with an increase of the deficit in France from 1.7 percent to 3.1 percent. The increase of the deficit in Italy mainly reflected the escalation of interest payments on the public debt relative to GDP. The noninterest component of the state sector deficit rose modestly, from 6 percent of GDP in 1975-80 to 6.8 percent on average in 1981-84. The other major European countries, however, did relatively better in containing their noninterest deficit. 2/ The fact that a relatively larger component of the deficit is accounted for by interest payments means that in Italy discretionary fiscal correction had to be relatively larger to secure an equivalent effect on the overall deficit.

A comparative analysis of noninterest expenditures in European countries shows that these expenditures, despite a rapid growth in recent years, remain somewhat lower in relation to GDP in Italy than in other major EC countries. 3/ Final consumption expenditures were roughly in line with the EC average in 1983 and significantly below the levels prevailing in the United Kingdom and Germany. The ratio of real growth in social expenditures to real growth in GDP was slightly lower in Italy than

---

1/ There are three commonly used definitions of the government sector in Italy. The "state sector" encompasses the state budget, other entities in the Central Government such as the autonomous agencies (railroads, state monopolies, highways, postal and telecommunication systems), the Fund for the South, the Postal Savings and Loans Funds and the Treasury accounts of the local authorities and the National Pension Fund (INPS). The "General Government" concept extends to the Central Government, the social security institutions and the local authorities. The "public sector" includes the General Government and the autonomous agencies.

2/ The noninterest deficit rose from 0.8 percent to 1.2 percent of GDP in France, it declined from 1.6 percent to 0.5 percent in Germany and it shifted from the equivalent of 1.5 percent of GDP to a surplus of 1.1 percent in the United Kingdom.

3/ In 1982 the ratio of current expenditures to GDP stood at 49.5 percent in Italy, 44.6 percent in the United Kingdom, 44.8 percent in Germany, and 47.5 percent in France (OECD, Economic Outlook, December 1984). In the same year the ratio of interest payments to GDP stood at 8.5 percent in Italy, 4.3 percent in the United Kingdom, 1.4 percent in Germany, and 1.6 percent in France.

among OECD member countries on average during the 1960s and the 1970s. 1/ The ratio of current revenues to GDP in Italy, while rising, has remained significantly below the EC average throughout the last 20 years. The maintenance of relatively low revenue ratios in the face of levels of expenditures more closely aligned with those prevailing elsewhere in Europe has meant a series of deficits to which the interest burden on the accumulating public debt has imparted a growing dynamism, especially in the recent years of increased nonmonetary financing and real interest rates in excess of real output growth.

The scope for lasting fiscal adjustment continues to be hampered by structural weaknesses. Authority for expenditure decisions remains decentralized and largely divorced from the responsibility to secure financial coverage of expenditures. This has made effective budgetary planning and the control of deficits very difficult, for the Ministry of the Treasury cannot gauge with any degree of certainty the prospective size of its financial transfers to the local authorities, including local health units. A similar problem exists in predicting the financing needs of the National Pension Fund (INPS), which includes the Wage Supplementation Fund. In both instances, financing requirements have generally exceeded official estimates, with excesses typically coming to light toward the end of the fiscal year when it is too late to adopt corrective measures.

The problems of expenditure control are exacerbated by constraints on increasing revenues. This applies in particular to direct taxation at the source which in Italy is subject to higher progressivity than in most other countries. It also applies, but for different reasons, to direct taxes on the self-employed and to indirect taxes. In both instances, tax evasion on a large scale has kept revenues low. The share of those taxes in total tax revenues has remained low by international standards, suggesting that evasion is more widespread in Italy than abroad. The Government has recently begun a determined effort to counter evasion and to put its tax system on a sounder and more equitable basis. With the so-called Visentini package, named after the Minister of Finance, the Government has curtailed deductions and the widespread practice of income splitting in which the self-employed distributed their incomes among family members for tax purposes. More importantly, it has introduced presumptive income taxation on the basis of a variety of indicators to be applied by the revenue collecting authorities in the assessment of income and tax liability. Whenever such determination is contested, the burden of proof falls on the contesting party, while previously it lay with the authorities.

---

1/ The ratio of real growth in social expenditure to real GDP growth in Italy stood at 1.7 during 1960-75 and at 1.6 during 1975-81 compared with a corresponding value of 1.8 during both periods in the OECD member countries on average (the values during 1975-81 for the United Kingdom, Germany and France stood at 1.8, 0.8 and 2.2, respectively). See OECD, Social Policy Studies, Social Expenditure 1960-90, 1984, Tables 1 and 4, pp. 22 and 28.

While the changes incorporated in the Visentini package are clearly necessary, their effects on tax revenues and more importantly on the overall economy remain uncertain. If successful, the effort to curb evasion will be instrumental in bringing into the open a part of the so-called "underground" economy, especially in the services sector and in small industries, where it is thought to loom large. 1/ It is difficult to predict the reactions of economic agents affected by the higher tax burden, in particular the precise mechanisms and extent of success of their likely effort to shift this burden onto others, e.g. by raising prices for their products and services.

For 1984 the Government had set a target for the state sector deficit of no change in absolute value from its 1983 level. Accordingly, the initially projected deficit of Lit 107 trillion was to be scaled down to around Lit 91 trillion through a package of revenue-raising measures, a recall of bank deposits of local authorities into the Treasury and savings on interest payments. Contrary to the record of earlier years when the target of no change in the deficit had been substantially overshot, the outturn for 1984 was not far off target and the state sector deficit declined in relation to GDP for the first time in five years (Table 1). Revenue outturn was broadly in line with projections and, had it not been for the unexpectedly large increase in transfers to the National Pension Fund (INPS), the state sector deficit would have remained unchanged in absolute value. INPS recorded, however, a deficit of Lit 26.7 trillion, nearly Lit 4.5 trillion above the initial forecast, largely on account of a shortfall in contributions from the amounts forecast, reflecting the decline in industrial employment, moderation of nominal wages and, reportedly, increased evasion. In addition, because of the slack in the labor market, payments by the Wage Supplementation Fund, which is part of INPS, rose by 23 percent over the already high levels of 1983.

The containment of the state sector deficit was attributable in part to a marked deceleration in capital spending in reflection of delays in disbursements of appropriated funds and of reductions in transfers of equity capital to the major enterprises having state participation and the National Electricity Board (ENEL), where financial conditions improved significantly in 1984. More important was a sharp deceleration in transfers to the regional and local authorities, including the local health units. This decline was due not to a narrowing of the deficits of the entities involved, which appear rather to have widened further in 1984,

---

1/ Estimates of the size of the "underground" economy in Italy have ranged between 5 percent to over 20 percent of GDP. A recent study by the National Institute of Statistics has analyzed the implications of different sizes of the "underground" economy on key economic ratios, including the revenue, public expenditures and public sector deficit ratios to GDP. It has concluded that, within the more likely range of estimates of the "underground" economy--5 percent to 10 percent of GDP--the changes in these ratios would be significant but not such as to alter substantially the picture of the public finances in Italy (see recent economic developments paper).

but to a drawdown of the bank deposits of these entities, as well as their stepped up borrowing from banks, partly in anticipation of the removal by end-1984 of the provision that the state would take over the service of debt contracted to finance investment and partly as a result of an operation consolidating debt incurred by the local health units toward their suppliers. In the main, therefore, the improvement in the state sector finances in 1984 was a reflection of financial operations. This is borne out by the fact that the deficit of the General Government on a national accounts basis, which includes the local entities, and excludes financial operations, widened from a level equivalent to 12.4 percent of GDP in 1983 to 13.5 percent in 1984 (Table 1).

For 1985, the initial budget was formulated in the context of the Government's medium-term plan, namely keeping constant both real noninterest expenditure and the ratio of tax revenues to GDP. The state sector deficit was initially projected at Lit 96 trillion (under 14 1/2 percent of GDP). The Italian authorities have recently modified the initial budget projections to take account of increases in expenditures voted by Parliament in recent months and of higher projected transfers to the National Pension Fund (INPS). At the same time, the authorities have taken into account "savings" in interest payments associated with a shift from semiannual to annual payments of interest on medium-term bonds and with a larger than expected resort to monetary base financing in December 1984 and the early months of 1985.

On the basis of these modifications the deficit of the state sector is now officially projected to rise to over Lit 117 trillion, about 17 1/2 percent of GDP in the absence of corrective measures. The authorities' objective is to contain the deficit to Lit 100 trillion through revenue-raising measures, including the above-mentioned Visentini package, an amnesty on illegal construction in exchange for payments of fines and taxes involved, and a recall into the Treasury of bank deposits of local authorities. The most recent estimates suggest that these measures may yield no more than Lit 6-7 trillion in 1985. Some additional revenue may be forthcoming from the automatic growth of taxes which appears to have been underestimated in the official projections. There are, on the other hand, serious risks of overruns in budgeted expenditures. In particular, the assumption of increases in personnel expenditure in line with the 7 percent inflation target appears unrealistic as public sector wage increases seem already to have exceeded that target, judging by accrued increases from 1984, contractual increases for 1985 already in place, and increases during 1985 related to indexation. Further, the budgeted increase less than 4 percent in purchases of goods and services is almost certain to be exceeded even if the inflation target were to be met. Also, budget overruns would lead to higher increases in interest payments, which in the budget are premised on a deficit of Lit 100 trillion. In view of the impending elections, the adoption of corrective measures seems unlikely before midyear, which makes it the more likely that the deficit will exceed the Lit 100 trillion target in 1985 by a significant margin.

b. Monetary policy

The last few y^ars have witnessed a gradual but significant change in the conduct and instruments of monetary policy. Throughout the 1970s and in the early 1980s the authorities regarded total domestic credit (including bonds) as the main intermediate target of monetary policy. This target was set in the light of the objectives for growth, inflation and the balance of payments. Given the projected borrowing requirements of the state sector--mostly financed domestically--domestic credit expansion to the nonstate sector (private sector and local authorities) tended to be determined residually in the initial monetary program. Despite the fact that the authorites did not fully compensate excesses in the state sector borrowing requirement over the initial projections through a corresponding reduction in credit to the nonstate sector, the latter declined in real terms by 3 percent a year on average in 1981-83 while total domestic credit increased on average by 2 1/2 percent per year over the same period. Thus, the share of credit to the nonstate sector was reduced to less than 30 percent of total domestic credit expansion by 1983 (Table 1 and Chart 2). At the same time the ratio of financial assets held by the nonbank public to GDP rose to the record level of 120 percent by end-1983 and a very substantial part of these assets represented claims on the public sector.

Quantitative ceilings on bank credit to the nonstate sector represented the main instrument of monetary control until 1983, with reserve requirements and portfolio coefficients playing a supporting role. Over the last few years, however, the Italian authorities became increasingly concerned with the distortions engendered by the prolonged use of quantitative credit restrictions, particularly the growing disintermediation of the banking system and the proliferation of accounting practices designed to mask the true growth of bank credit. They, therefore, gradually shifted the emphasis in the conduct of monetary policy to control of the monetary aggregates and in particular of the monetary base. The essential conditions for such a shift were created by removing the legal requirement that the Bank of Italy act as the residual buyer of treasury bills and by increasing intervention in the secondary market for government paper. The credit ceilings were formally ended in mid-1983 but the Bank of Italy exercised moral suasion in this area until the end of that year.

The transition in 1984 from a system of quantitative control of bank credit to one of control of base money and of credit to the private sector primarily through interest rates was on balance successful, especially in view of the fact that it occurred in a phase of cyclical recovery of domestic demand. The rates of growth of total domestic credit and of the monetary aggregates decelerated slightly, while the growth of bank lending to the nonstate sector--even after correction for the re-emergence of previously unreported credits--increased significantly in real terms to accommodate the recovery in demand and output (Table 1). The relative moderation in the growth of the monetary aggregates was facilitated in the first half of the year by the containment of the borrowing requirements of the state sector. More crucial was the preparedness of the monetary authorities to operate interest rate policy flexibly, allowing the rates to rise in real terms in the course of 1984 (Chart 3). The prospect of a marked widening in the public sector deficit in the last months of the year in the face of continued rapid growth in credit to the nonstate sector--which in the first eight months exceeded 16 percent--prompted the authorities to raise the discount rate by 1 percentage point in September 1984. The increase spread quickly across the structure of interest rates, dampening significantly the growth of credit to the nonstate sector and moderating the impact of the rapid increase in the borrowing requirement of the state sector in the last months of the year on the monetary base.

The announced stance of monetary policy for 1985 is geared to securing a further deceleration in the rate of inflation and to moderating the growth of domestic demand to a rate more closely in line with that of Italy's main trade partners. Specifically, the authorities are targeting rates of growth of the monetary base and of bank credit to the nonstate sector of the order of 10 and 12 percent, respectively. On the assumption that the state sector deficit is contained to the target level of Lit 100 trillion, both total domestic credit and financial assets in the hands of the nonbank public are projected to rise at rates slightly in excess of 16 percent, significantly higher than the projected growth of nominal GDP. The authorities recognize that in order to keep the growth of the monetary and credit aggregates close to the targets it will be necessary to continue to manage interest rates flexibly, possibly allowing them to rise further in real terms, especially if significant excesses were to be recorded in the public sector borrowing requirement.

The discount rate was lowered by 1 percentage point in January 1985 in response to the continued deceleration of inflation in the last months of 1984 and with a view to fostering a reduction in the differential between lending rates and treasury bill rates. The latter purpose was not achieved as commercial banks were reluctant to reduce lending rates by more than 1 point on account of uncertainty about the scope for a corresponding reduction in deposit rates. The acceleration in the growth of the monetary base in recent months has raised the authorities' concern over the room for maneuver in interest rate policy, and has led to a 1 percentage point increase in treasury bill rates in April.

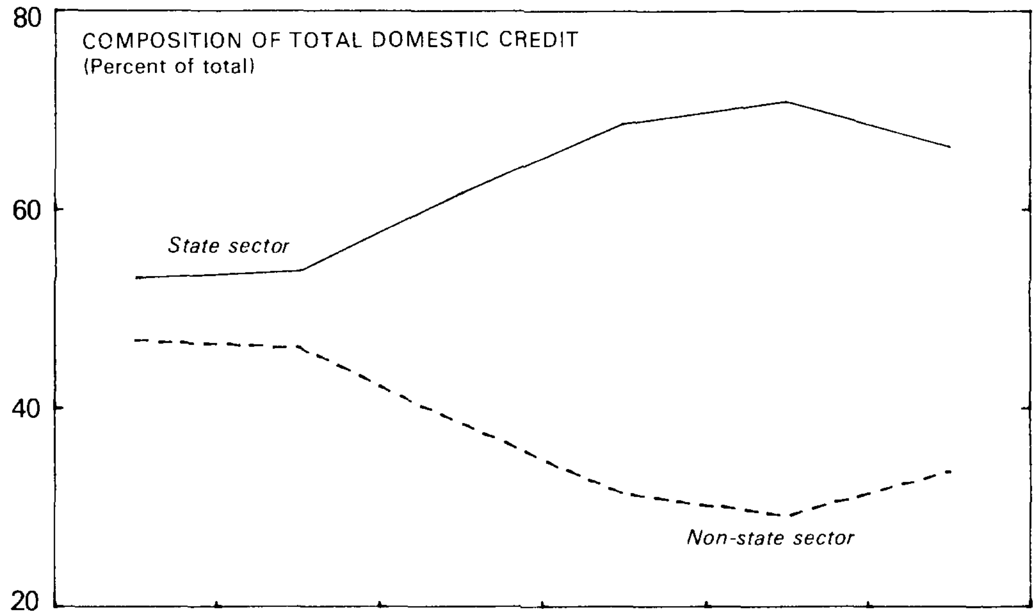
c. Incomes and labor market policies

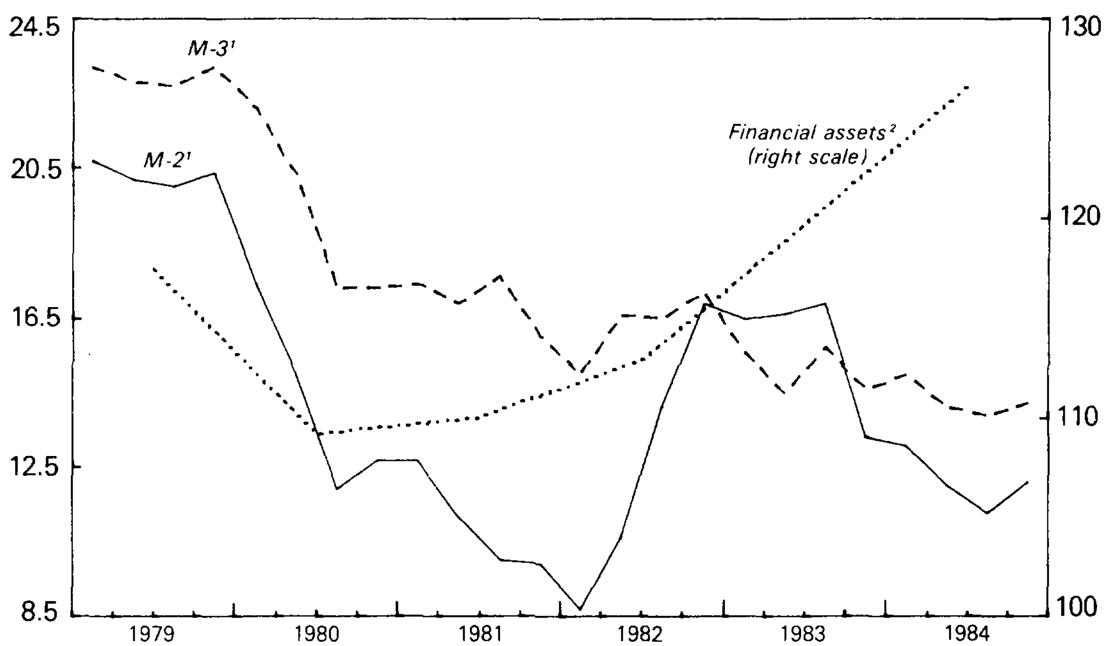
In the past two years the Italian Government has moved with considerable determination in the area of incomes policies. In January 1983 a government-sponsored compromise won the support of unions and employers, breaking the deadlock in wage negotiations. Agreement was reached to reduce indexation through the scala mobile by 15 percent in exchange for a general guarantee that real wages would be maintained and working hours reduced and in exchange also for reductions in the fiscal drag, increases in family allowances and the revocation of proposed cuts in health and pension expenditures. The agreement of employers was secured through a partial takeover by the state budget of social security contributions.

CHART 2

ITALY

# SELECTED MONETARY INDICATORS



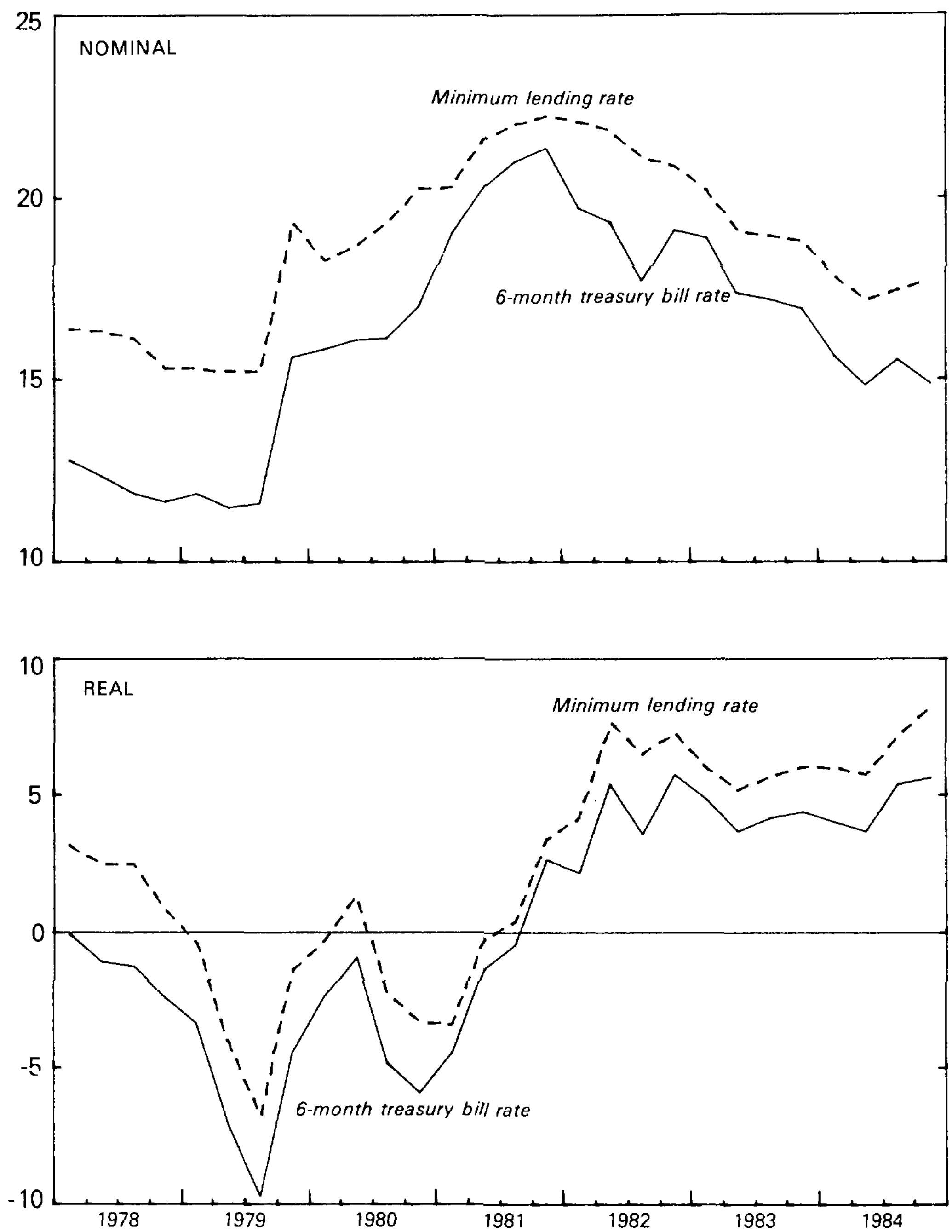




Source : Bank of Italy

[1] Growth rates over preceding 12 months

[2] In percent of GNP

CHART 3
ITALY
## SELECTED INTEREST RATES




Sources: Bank of Italy, IMF, Research Department.

[1] Real rates are nominal rates deflated by a measure of expected rate of inflation, approximated by a weighted average of inflation in the deflator of final domestic demand in the current quarter and the following two quarters.

At the same time contractual increases were agreed upon for the period 1983-85, and a general understanding was reached that the process of wage indexation should be reviewed taking into account the desirability of reducing the impact of changes in indirect taxes and in the exchange rate on the scala mobile index.

In 1984 the Government introduced a decree, approved by Parliament only after being submitted for a second time, aimed at linking the indexation-related component of wage increases to the target rather than the past rate of inflation. Specifically, the decree limited the increase in the scala mobile in 1984 to 9 points compared to a projected 12 points. This measure implied a reduction in the degree of coverage for price increases provided by the scala mobile in 1984 from the 63 percent that would have prevailed in the absence of government intervention to 46 percent. The decree was accompanied by a freeze in administered prices to midyear and a freeze in rents through the year. Further measures involved continued "fiscalization" of social security contributions by employers in exchange for price moderation.

The Italian authorities noted that the incomes policy measures, in conjunction with the marked cyclical increase in productivity, had been instrumental in promoting a sharp deceleration of unit labor costs in manufacturing and of the rate of inflation at no cost to real wages which, on a net of tax basis, fared better in 1984 than in previous years. The authorities recognized, however, that the once-over nature of the incomes policy measures of 1984 (as opposed to the modification of the scala mobile mechanism in 1983 which involved a permanent reduction in the degree of indexation) would make it necessary to take additional steps in 1985, if a further deceleration in labor costs and in inflation were to be achieved. It is estimated that in the absence of further modifications of the scala mobile, nominal wage rates would rise on average in 1985 by more than 10 percent on account of already agreed contractual increases, wage drift, etc. even if the increase in prices in 1985 remained close to the official 7 percent target. Over the longer run, if the current degree of wage indexation is maintained, it will be difficut to secure a sustained reduction in the growth of labor costs and in inflation while at the same time creating room for greater differentiation in contractual wage increases in line with differential increases in productivity.

Prospects for incomes policy in 1985 remain clouded as unions and employers remain far apart in their positions on wage determination, despite mediation efforts by the Government. The unions insist on the payment of one scala mobile point withheld by private employers last November. They reject suggestions that indexation be annualized, which would reduce wage increases by an estimated 1 1/2 percentage points, and that increases in indirect taxes and import prices be removed from the scala mobile index. Finally, there is the issue of the referendum to be held in June on the restoration of the index points cut in 1984, which if passed would raise the growth of wages by an estimated 1 1/2 percentage points. The employers, in turn, not only oppose the referendum, as does the Government, but are unwilling to discuss the scala mobile in isolation, insisting rather on negotiations of wage formation as a whole.

Projections of demographic trends over the next several years suggest that, even on the assumption of only a modest increase in the participation rate, the labor force will continue to grow significantly (by 0.8-0.9 percent a year on average) through at least the end of this decade. Given the constraints that the external environment is likely to pose on the growth rate of the economy, the prospects for stabilizing the rate of unemployment, let alone reducing it, seem poor. The industrial sector, under the pressure of external competition is unlikely to make a sizable contribution to employment creation in the foreseeable future. The scope for absorption of the growing labor force in the tertiary sector would be enhanced by relative wage moderation in this sector, to reflect the slower growth of productivity. Similarly, a reduction of entry-level salaries should help relieve the problem of youth unemployment.

The Italian authorities recognize that employment prospects would be helped by a reduction of wage and other labor market rigidities. Plans for action in this area are, however, still at a preparatory stage. They include more flexible hiring procedures allowing, for example, employers themselves to choose from among applicants rather than be assigned workers by the local employment office. Plans have also been voiced to increase possibilities for part-time work and to commit workers to the Wage Supplementation Fund on a part-time basis as a form of labor sharing.

d. External policies

Italian exchange rate policy is guided by the aim of maintaining adequate competitiveness while at the same time attempting to preserve a measure of exchange rate stability in order to foster price discipline and contain inflationary expectations. Typically, therefore, the authorities have delayed their response to a widening of the inflation differential, thereby forcing producers to increase productivity. They have adjusted the exchange rate in the context of general realignments within the EMS, preferring to take advantage of the occasion rather than prompting it. The Bank of Italy habitually intervenes in the foreign exchange market and in 1984 and 1985 it intervened on occasion jointly with other central banks to dampen the rise in the U.S. dollar. All the same, in 1984 the Bank allowed relatively greater flexibility in the Lit/US$ rate than in the past, leaving it largely to the market to find its equilibrium. In order to preserve the lira's position and stability within the EMS and in order to avoid an unwarranted appreciation of the lira vis-à-vis the deutsche mark in particular, the Bank of Italy bought large amounts of deutsche mark throughout 1984. The relative strength of the lira, which remained around the midpoint of the upper part of its EMS band during most of 1984, was attributable to a favorable interest rate differential and to favorable expectations--following the restoration in 1983 of equilibrium in the current account of the balance of payments and the combination in 1984 of apparently improved control over the fiscal accounts, deceleration of inflation and recovery of economic activity. In response to a narrowing interest rate differential and a worsening of expectations in the early months of 1985, the Bank of Italy has run down official foreign exchange reserves from US$19.1 billion at end-1984 to US$16.7 billion at end-March 1985. At the same time, the lira has declined to its lower band within the EMS. This combination of intervention and exchange rate adjustment in recent months is in keeping with customary policy, prompted in this instance by a desire to reverse in part the real appreciation of the lira vis-à-vis the deutsche mark during 1984.

Italy's external debt is low in relation to both GDP and international reserves. The debt service ratio is also relatively low and is likely to remain so in the next several years, also in view of the favorable terms that Italian borrowers have typically been obtaining in international markets. The Italian authorities, nevertheless, consider that over the medium-term equilibrium or even moderate surpluses in the current account of the balance of payments are appropriate targets for an industrial country like Italy, and intend to gear the stance of economic policy to this objective.

The Italian authorities remain committed to a gradual liberalization of exchange controls in line with improvements in Italy's macroeconomic performance. Accordingly, in 1984 they took a series of liberalization measures ranging from the virtual abolition of controls on Italian tourist expenditure abroad 1/ to the easing of regulations concerning leads and lags in trade-related exchange transactions as well as those concerning capital transactions (see Appendix on the Exchange and Trade System in the recent economics developments paper). The authorities feel that the scope for a fuller liberalization of capital controls in the near term is limited by the current weakness of the balance of payments.

Trade policy has generally been consistent with the European Community's directives and with the OECD consensus on export credits. The Italian authorities recognize that a country as dependent on external markets as Italy would ultimately suffer from protectionist policies and hence they have generally refrained from unilateral action. In those instances where Italy does maintain quantitative import restrictions, as in the case of some sensitive products mostly from Japan and developing countries, the authorities claim that this is necessary to keep at bay pressures for even greater protection. As an indication of their commitment the Italian authorities refer to the heavy losses in employment that companies in the textile and other sectors have incurred because of the pressures on them to modernize and remain competitive. As for countertrade, the authorities consider it to be warranted in exceptional instances only and claim that it is relatively easily controlled, being confined to large enterprises.

1/ Residents traveling abroad may obtain foreign exchange equivalent to Lit 1.6 million per person and journey, and additional expenditures may be met by bank transfers or use of credit cards.

## 3. Prospects

The outlook for 1985 on current trends is disquieting, putting in jeopardy the medium-term plan for convergence of the Italian economy in an international context. In the absence of prompt and adequate corrective action, the outcome in 1985 is likely to be significantly worse than targeted in the areas of costs and inflation, the fiscal acconts, and the external accounts. Output may be on target but its prospective composition between domestic demand and the foreign balance casts doubt on whether its pace can be sustained, which would be essential to stabilize unemployment over the medium term.

The staff projections presented in Tables 2 and 3 are based on the following assumptions: (a) no new agreement is reached on incomes policy; (b) the state sector deficit exceeds the Lit 100 trillion target by Lit 6-7 trillion (about 1 percent of GDP), which on present trends appears an optimistic estimate; (c) monetary policy is tightened somewhat, in particular the rate of growth of the monetary base is brought rapidly into line with the 10 percent target of the monetary program, even if this were to require a rise in interest rates; and (d) the effective exchange rate remains broadly at the average level of the first quarter of 1985, implying an average depreciation on the order of 4 percent for the year as a whole.

Under these assumptions, the rate of increase in wages per employee in industry is likely to exceed 11 percent, in contrast to the 7 percent target (Table 2). Half of the projected increase stems from carry-overs from last year and from adjustments under national contracts signed in 1983. The remainder is likely to come from contracts at the firm level, wage drift, the scala mobile--accounting for 2 1/2 percentage points on the assumption of a 7 percent rate of inflation--and from the referendum on the restoration of the scala mobile points cut in 1984, which appears increasingly likely to be held. Real disposable income of households is projected to increase by about 1 1/2 percent, leading along with a likely decline in the savings ratio to an increase in private consumption of around 3 percent in real terms (Table 2). In view of the current phase of the cycle and the current prospects for domestic orders and business expectations, fixed investment is projected to sustain its pace while the contribution of stocks should weaken slightly. Finally, public consumption spending is projected to decelerate although not as much as implied by the budget. All in all this should involve an increase in domestic demand on the order of 3 1/2 percent and, in conjunction with a negative contribution of the foreign balance, a rate of growth of GDP of just under 3 percent.

Inflation is projected to exceed its 7 percent target by some 2 percentage points, reflecting the "acquis" of 3 1/2 percentage points from 1984, the prospective excess of labor costs over the target and the ad-ustment of domestic prices to import prices. In view of the projected developments in prices and costs, Italy's competitive position may be expected to worsen following relative stability in 1984. In conjunction with the projected excess in the growth of domestic demand in Italy over that in its main trade partners, this is expected to lead to a loss in export market shares and to a continued relatively rapid growth of imports. The associated deterioration in the trade deficit is expected to be only partially offset by an improvement in the invisibles balance, leading to a current account deficit about double that in 1984 and equivalent to 1.6 percent of GDP, which is one point above target (Table 2).

## IV. Staff Appraisal

On the occasion of the 1983 Article IV consultation with Italy, Executive Directors exhorted the Italian authorities to seek greater convergence of Italy's economic performance, particularly as regards inflation, with those of its main trade partners. The Directors expressed the view that, to this end, the maintenance of a prudent stance of monetary policy would need to be supported by efforts to correct long standing weaknesses in the public finances and income determination.

The economic record of 1984 is one of general improvement, particularly when contrasted with developments in the preceding three years. Year-on-year output and real disposable income rose and there was a considerable improvement in the financial position of enterprises and in investment. Inflation decelerated markedly and the current account deficit of the balance of payments was held within tolerable bounds. Several factors contributed to these developments. First, the economy benefited from the flexibility of Italian enterprises who had been pushed to increase efficiency and exert much greater control over costs by the pressures exerted by the constraining monetary policies in earlier years. Second, despite some unfavorable consequences stemming from the strength of the dollar, external conditions were favorable in that Italian export markets grew in 1984 significantly faster than in any year since 1980. Third and foremost, economic policies were better coordinated and mutually reinforcing in the early months of 1984. Corrective measures were taken in the public finances, aimed at containing the deficit of the public sector at the same nominal level as in 1983, implying a significant decline in relation to GDP. The relative fiscal restraint created the room for a moderate easing of credit policy to accommodate the recovery of output and investment. The improved mix of financial policies was complemented by incomes policy measures which helped dampen inflation while allowing real disposable income to grow.

The cohesion of policies diminished, however, during the course of the year. Fiscal policy, taking the public sector as a whole, was more expansionary than had been planned even though this did not become apparent until late in the year. More importantly, the improvement in the state sector finances was largely offset by a further deterioration in the position of peripheral public entities, and the basic structural weaknesses in the public finances remained largely uncorrected. The agreement on incomes policy held, but it incorporated no permanent changes which would foster a sustained deceleration of inflation beyond 1984. Thus, despite the relative strength of the lira vis-à-vis EMS currencies, the rate of inflation stopped decelerating by end-1984. The marked upturn in domestic demand, at rates significantly in excess of those of other European countries, along with a weakened competitive position especially vis-à-vis other EMS countries, led to a sharp deterioration of the current account of the balance of payments in the last months of 1984, which appears to have continued in the early months of 1985.

For 1985 the Italian authorities have set as main economic objectives the containment of the rate of inflation to 7 percent and of the current account deficit of the balance of payments to below 1/2 percentage point of GDP, along with a growth in real output on the order of 2 1/2 percent. In support of these objectives the authorities target a limit of 7 percent to the growth of current public expenditures excluding interest payments, which should allow a decline in the ratios of total government expenditures and of the deficit to GDP. The staff believes that these targets, if achieved, would represent an important step toward the convergence of the Italian economy with its major industrial partners, which is rightly a main objective of the Government's medium-term economic policy strategy, in particular of its multiyear plan for fiscal adjustment. The achievement of these objectives is, however, threatened by the trends apparent in the economy in the last few months and by clear risks of slippage in the implementation of the announced policy stance unless adequate corrective measures are taken very rapidly.

In the view of the staff, if the rate of inflation is to resume a sustained deceleration, it is essential that monetary policy be geared to containing the monetization of the public sector deficit. In this respect the staff would urge the authorities to ensure that the rate of growth of the monetary base, which has exceeded significantly the target in recent months, is brought into line even if this were to require an increase in interest rates. It is clear, however, that relying primarily on monetary policy to secure a measure of economic equilibrium is becoming increasingly costly. The level of real interest rates required to ensure the absorption of a growing stock of government debt by the public may have to rise further relative to rates prevailing abroad, thus putting undesirable upward pressure on the lira and raising the costs in terms of output and employment of the needed external adjustment. Over the longer term, real rates of interest in excess of the rate of growth of real GDP are bound to lead to an explosive interaction between interest payments, public sector deficits and the public debt, with severe costs to productive investment and growth.

It is therefore crucial that monetary restraint be supported by adequate adjustment in the public sector finances and by new action in the area of incomes policies at least on the scale of that undertaken in 1984. As regards the finances of the public sector, it seems that on current trends the state sector deficit may well rise in relation to GDP in 1985 rather than decline, even if the revenue measures already enacted are taken into account. The staff welcomes the recent changes in income and VAT taxes which seek to broaden the tax base and distribute the tax burden more equitably. Nevertheless, further measures are required if the revenue targets are to be achieved. They will need to be complemented by measures to restrain expenditures, for, on current trends, sizable overruns seem likely. Steps should be taken promptly to keep the growth of personnel and other current expenditures within the 7 percent targeted in the government program, thus also setting an example for wage increases in the private sector. In a longer-term perspective, there is an urgent need to tackle some structural weaknesses, especially the excessive separation between spending and revenue raising authorities, and to cut important spending programs, especially those for health and pensions which lack adequate financing and threaten to escalate in future years.

In the area of incomes policies, the staff supports the authorities' objective to keep the rise in labor costs to the target rate of inflation. Within this constraint it is important to provide adequate room for contractual and plant level increases in wages so as to allow greater wage differentiation in line with productivity. In this respect a shift of indexation to an annual basis and the exclusion of the effects of changes in indirect taxation from the scala mobile would be useful. Such an approach, if accompanied by a reduction in labor market rigidities and greater flexibility in the hiring of labor, should improve prospects for employment and help reduce the very high rate of youth unemployment.

The prompt implementation of a coordinated corrective effort is especially needed to stave off the threat, which is now real, of an excessive and over the longer run unsustainable deficit in the current account of the balance of payments. It is necessary to ensure that the expansion of domestic demand in Italy is kept more in line with that of Italy's main trade partners and to promote the competitiveness of the economy. A lasting improvement in competitiveness could not be secured through a change in the nominal exchange rate unless supported by a firm stance of financial policies and by moderation in costs and prices. The prospects for the balance of payments over the medium term would also be helped by a reduction of the energy deficit. It is important to ensure that the use of energy in Italy decline in line with the record of other industrial countries by maintaining realistic prices for all energy products.

The staff welcomes the virtual elimination of the restriction on foreign exchange allowance for tourist travel and the measures taken in 1984 to liberalize capital movements and urges the Italian authorities to proceed further in this direction as the balance of payments improves, since this would tend to impose greater fiscal discipline while at the same time promoting financial integration. As regards trade policy, a reduction in existing unilateral import restrictions on selected products would certainly be desirable. So would be greater initiative by the Italian authorities in promoting liberalization at the EC level.

The stakes in the Italian economy are high but already the momentum that seemed to have been achieved in 1984 is being dissipated. The staff fears that, unless adequate corrective measures are implemented quickly, the Italian economy could return in the not too distant future to a path of sluggish growth, rising unemployment and accelerating inflation. If a rapid adjustment in policies were not to be implemented then the burden of exercising restraint would again fall on monetary policy with the attendant costs outlined above. It would then be most important that the position be reviewed again before the end of the year with a view to implementing a cohesive set of policies both rapidly and determinedly.

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

Table 1. Italy: Selected Financial Indicators, 1981-85

| | 1981 | 1982 | 1983 | 1984 1/ | 1985 2/ |
|---|---|---|---|---|---|
| | | | (As percent of GDP) | | |
| Fiscal indicators | | | | | |
| State sector | | | | | |
| Revenues | 30.0 | 35.1 | 35.4 | 35.9 | 34.8 4/ |
| Expenditures | 42.8 | 50.2 | 51.8 | 51.3 | 52.4 4/ |
| Overall balance 3/ | -12.8 | -15.1 | -16.4 | -15.4 | -17.6 4/ |
| Share of deficit financed through: | | | | | |
| Medium- and long-term bond | 11.1 | 32.7 | 77.1 | 60.0 | ... |
| Short-term paper | 58.5 | 45.0 | 18.4 | 22.8 | ... |
| Monetary base creation | 30.4 | 22.3 | 4.5 | 17.2 | ... |
| General Government | | | | | |
| Tax revenue | 37.2 | 39.9 | 42.9 | 42.8 | ... |
| Total revenue | 39.8 | 42.5 | 45.4 | 45.4 | ... |
| Current expenditures | 46.4 | 49.5 | 51.5 | 52.0 | ... |
| Of which: | | | | | |
| Interest payments | 7.2 | 8.5 | 9.0 | 9.6 | ... |
| Total expenditures | 51.7 | 55.1 | 57.8 | 58.9 | ... |
| Current balance | -6.8 | -7.2 | -6.4 | -6.8 | ... |
| Financial balance 5/ | -11.8 | -12.5 | -12.4 | -13.5 | ... |
| | | | (End of period; percentage change except as otherwise indicated) | | |
| Monetary variables | | | | | |
| Monetary base | 13.3 | 14.1 | 15.1 | 12.5 | 10.0 |
| M2 | 9.9 | 16.9 | 13.3 | 12.1 | 10.0 |
| M3 | 16.0 | 17.2 | 14.6 | 14.2 | ... |
| Total domestic credit | 18.0 | 20.9 | 20.8 | 19.3 6/ | 16.2 |
| Bank lending to nonstate sector | 13.5 | 13.4 | 13.2 | 14.9 6/ | 12.0 |
| Share of credit to the state sector in total domestic credit expansion | 61.6 | 68.7 | 70.9 | 66.3 6/ | 68.8 |
| Total financial assets 7/ | 19.2 | 20.1 | 20.3 | 19.9 | 16.5 |
| | | | (In percent; period averages unless otherwise indicates) | | |
| Interest rates | | | | | |
| Discount rate (end of period) | 19.0 | 18.0 | 17.0 | 16.5 | 15.5 8/ |
| Three-month Treasury bills | 19.6 | 19.4 | 17.8 | 15.3 | 13.9 9/ |
| Prime rate | 21.4 | 21.6 | 19.4 | 17.7 | 17.2 9/ |
| Average deposit rate | 12.6 | 13.4 | 12.5 | 11.8 | 11.4 9/ |

Sources: Data provided by the Italian authorities

1/ Provisional estimates.

2/ Official forecasts.

3/ Including net lending but excluding debt liquidations.

4/ Trend official forecasts. The Government's objective is to contain the overall deficit of the state sector to the equivalent of 14.7 percent of GDP.

5/ Excluding net lending

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

7/ Domestic component of financial assets, net of shares.

8/ As of end-March 1985.

9/ January 1985.

Table 2. Italy: Main Economic Variables, 1981-85

(Percent changes)

| | 1981 | 1982 | 1983 | 1984 | 1985 1/ |
|---|---|---|---|---|---|
| Real demand and output | | | | | |
| Private consumption | 0.5 | 0.5 | -0.3 | 1.8 | 3.0 |
| Public consumption | 3.3 | 2.6 | 2.4 | 2.7 | 1.5 |
| Fixed investment | 0.6 | -5.2 | -3.8 | 4.1 | 4.0 |
| Stockbuilding 2/ | -3.1 | -- | -0.7 | 0.6 | 0.5 |
| Total domestic demand | -2.2 | -0.3 | -1.2 | 2.9 | 3.4 |
| Exports of goods and services | 5.2 | 0.4 | 3.3 | 7.0 | 4.0 |
| Imports of goods and services | -5.3 | 1.5 | 0.1 | 9.6 | 7.0 |
| Foreign balance 2/ | 2.3 | -0.2 | 0.8 | -0.3 | -0.5 |
| GDP | 0.2 | -0.5 | -0.4 | 2.6 | 2.8 |
| Industrial production | -1.6 | -3.0 | -3.2 | 3.1 | 3.0 |
| Wages, costs and prices | | | | | |
| Wage rates in manufacturing | 19.2 | 17.9 | 15.0 | 12.3 | 11.6 |
| Productivity in manufacturing | 1.0 | -0.2 | 0.8 | 8.1 | 4.4 |
| Unit labor costs in manufacturing | 18.0 | 18.2 | 13.9 | 3.9 | 6.9 |
| Cost of living index | 18.7 | 16.3 | 15.1 | 10.7 | 9.0 |
| GDP deflator | 18.4 | 17.9 | 15.1 | 10.7 | 9.0 |
| Unemployment rate (levels) | 8.3 | 9.6 | 9.8 | 10.4 | 10.7 |
| Disposable income of households | 20.9 | 17.7 | 12.1 | 15.2 | 10.8 |

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

1/ Staff projections
2/ Changes in stockbuilding and the foreign balance are expressed as percentage of GDP in the previous year.

Table 3. Italy: External Developments, 1981-85

| | 1981 | 1982 | 1983 | 1984 1/ | 1985 1/ |
|---|---|---|---|---|---|
| Trade developments (percent changes) | | | | | |
| Imports, c.i.f., customs basis | | | | | |
| Unit value | 36.6 | 8.6 | 3.3 | 11.3 | 11.0 |
| Volume | -11.3 | 3.2 | 1.6 | 9.1 | 7.0 |
| Exports, f.o.b., customs basis | | | | | |
| Unit value | 23.2 | 15.0 | 5.7 | 9.6 | 11.0 |
| Volume | 4.7 | 0.3 | 5.3 | 6.6 | 4.1 |
| Balance of payments summary (in billions of lire) | | | | | |
| Trade balance, f.o.b.-f.o.b. | -12,032 | -10,739 | -4,676 | -10,784 | -17,000 |
| Services | 1,945 | 2,159 | 4,072 | 3,365 | 4,000 |
| Private transfers | 1,639 | 1,987 | 2,131 | 2,261 | 2,500 |
| Official transfers | -777 | -819 | -369 | -362 | -500 |
| Current balance | -9,225 | -7,412 | 1,158 | -5,520 | -11,000 |
| (As percent of GDP) | -2.3 | -1.6 | 0.2 | -0.9 | -1.6 |
| Nonmonetary capital | 11,386 | 5,185 | 2,022 | ... | ... |
| Errors and omissions | -628 | -294 | 613 | ... | ... |
| Overall balance | 1,533 | -2,521 | 3,793 | 498 | ... |
| Gross official reserves (excluding gold) 2/ | 20,134 | 14,090 | 20,105 | 20,774 | 19,460 3/ |
| Net foreign position of commercial banks 2/ | -13,391 | -10,631 | -12,870 | -15,028 | ... |
| External debt outstanding 2/4/ | 47,600 | 50,400 | 54,900 | 57,100 | ... |
| (As percent of GDP) | 14.2 | 14.7 | 16.9 | 18.0 | ... |
| Memorandum items: | | | | | |
| Average exchange rates | | | | | |
| Italian lire per U.S. dollar | 1,136.8 | 1,352.5 | 1,518.8 | 1,757.0 | 2,022.8 5/ |
| Percent change in lira/US$ rate 6/ | 32.7 | 19.0 | 12.3 | 15.7 | 15.1 7/ |
| Effective exchange rate (MERM weights, 1980 = 100) | 86.7 | 80.2 | 76.1 | 71.1 | 68.3 5/ |

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

1/ Provisional estimates for 1984, staff projections for 1985.
2/ End of period, in millions of U.S. dollars.
3/ End-February 1985.
4/ Includes the net external liabilities of commercial banks.
5/ Average of first quarter of 1985.
6/ Positive sign indicates a depreciation.
7/ Average of first quarter of 1985, compared with average of 1984.

## Fund Relations with Italy

(As of March 31, 1985)

I. Membership status

(a) Italy became a member of the Fund on March 27, 1947.

(b) Italy is an Article VIII member.

### A. Financial Relations

II. General department (General Resources Account)

(a) Quota: SDR 2,909 million.

(b) Total Fund holdings of Italian lire: SDR 1,814 million (62.4 percent of quota)

(c) Reserve tranche position: SDR 1,095 million.

(d) Current operational budget: maximum net use of Italian lire equivalent to SDR 25.6 million--involving purchases in the amount of SDR 63.6 million and repurchases in the amount of SDR 38.0 million--is planned under the current budget.

(e) Lending to the Fund: under the GAB Italy has undertaken to lend the equivalent of SDR 1,105 million; nothing has been called to date.

III. Stand-by or extended arrangement and special facilities

None.

IV. SDR department

(a) Net cumulative allocation: SDR 702.4 million.

(b) Holdings: SDR 734 million or 104.5 percent of net cumulative allocation.

(c) Current designation plan: Italy is included in the current plan for a maximum amount of SDR 36.3 million.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None

## B. Nonfinancial Relations

VII. Exchange rate arrangements

Since March 13, 1979 Italy has participated in the exchange rate mechanism of the European Monetary System with a 6 percent margin. The central rate of the lira was reduced by 3.25 percent in relation to the other EMS currencies on June 14, 1984 and again by 2.5 percent on March 21, 1983. From the end of March 1979 to end-December 1984, the lira depreciated by 32 percent in effective terms and by 57 percent with respect to the U.S. dollar in nominal terms. The exchange rate of the lira on December 31, 1984 was US$1 = Lit 1,935.9 while the MERM index stood at an average December level of 69.4 (1980 = 100).

VIII. The last Article IV consultation was concluded on November 8, 1983 and the staff report (SM/83/269, 12/30/85) was considered by the Executive Board on January 27, 1984.

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

## Basic Data

| | |
|---|---|
| Area (thousand square kilometers) | 301.3 |
| Population (mid-1984) | 57.00 million |
| Labor force (1984 average) | 23.03 million |
| GDP per capita (1984) | Lit 10,738,807 |

| Use and supply of resources (1984) | In billions of lire | In percent |
|---|---|---|
| Private consumption | 388,869 | 63.5 |
| Public consumption | 122,239 | 20.0 |
| Gross fixed investment | 109,714 | 17.9 |
| Change in stocks | 4,268 | 0.7 |
| Gross domestic expenditure | 625,090 | 102.1 |
| Exports of goods and services | 149,225 | 24.4 |
| Imports of goods and services | -162,203 | -26.5 |
| Gross domestic product | 612,112 | 100.0 |

| Selected economic indicators (annual percentage change) | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| GDP (at constant prices) | 0.2 | -0.5 | -0.4 | 2.6 |
| Private consumption (at constant prices) | 0.5 | 0.5 | -0.3 | 1.8 |
| Gross fixed investment (at constant prices) | 0.6 | -5.2 | -3.8 | 4.1 |
| Industrial production | -1.6 | -3.0 | -3.2 | 3.1 |
| Exports of goods (in lire) | 29.0 | 15.3 | 11.4 | 16.7 |
| Imports of goods (in lire) | 21.2 | 12.1 | 5.0 | 21.5 |
| Unit labor costs in manufacturing | 18.0 | 18.2 | 13.9 | 3.9 |
| Cost of living | 18.7 | 16.3 | 15.1 | 10.7 |
| GDP deflator | 18.4 | 17.5 | 15.1 | 10.7 |
| Money and quasi-money (M3; end-year) | 16.0 | 17.2 | 14.6 | 14.2 |
| State sector overall deficit (as per cent of GDP) | 12.8 | 15.1 | 16.4 | 15.4 |

| Balance of payments (in millions of SDRs) | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| Exports of goods, f.o.b. | 63,419 | 65,611 | 67,388 | 70,968 |
| Imports of goods, f.o.b. | -72,395 | -72,803 | -70,268 | 76,956 |
| Net services and transfers | 2,094 | 2,228 | 3,593 | 2,923 |
| Balance of goods, services, and transfers | -6,882 | -4,964 | 713 | -3,080 |
| Net capital movements | 8,026 | 3,276 | 1,623 | 3,357 |
| Overall balance | 1,144 | -1,688 | 2,336 | 277 |
| Gross official reserves (excluding gold, end-year) | 17,298 | 12,773 | 19,203 | 21,193 |

1/ Official forecasts.
2/ As of first half of 1983.
3/ As of end-June 1983.
4/ As of end-September 1983.