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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/79

10:00 a.m., May 24, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe
	D. C. Templeman, Temporary
	H. G. Schneider
B. de Maulde	
M. Finaish	
	M. Sugita
	B. Goos
J. E. Ismael	Jaafar A.
	L. Leonard
	H. A. Arias
	H. Fugmann
	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	
C. R. Rye	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
	Chen J., Temporary

L. Van Houtven, Secretary
K. S. Friedman, Assistant
V. C. Wall, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; P. Alonso-Gamo, L. M. Beleza, A. Leipold, A. López-Claros, M. Mentini, D. C. L. Nellor, E. Spitaeller, H. O. Schmitt, T. M. Ter-Minassian. Exchange and Trade Relations Department: C. D. Finch, Director. Fiscal Affairs Department: V. Tanzi, Director; G. M. Bartoli, G. Blöndal. IMF Institute: R. Manfredi-Selvaggi, Participant. Legal Department: S. A. Silard. Advisors to Executive Directors: G. E. L. Nguyen, J.-C. Obame, M. Z. M. Qureshi, T. Sirivedhin, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, W.-R. Bengs, A. K. Diaby, V. Govindarajan, G. D. Hodgson, S. Kolb, K. Murakami, A. Mustafa, E. Olsen, W. K. Parmena, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, L. Tornetta, A. J. Tregilgas.

1. ITALY - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Italy (SM/85/119, 4/26/85; and Cor. 1, 5/23/85). They also had before them a report on recent economic developments in Italy (SM/85/127, 5/10/85; Cor. 1, 5/23/85; and Sup. 1, 5/22/85).

Mr. Zecchini made the following statement:

The picture of the Italian economy that emerges from the staff papers, particularly from the staff report and appraisal, justifies satisfaction for the results achieved on many fronts during 1984. Indeed, the areas of achievement in the Italian economy have certainly defied the gloomy scenario envisaged during the Board discussion of the 1984 Article IV consultation with Italy.

At the same time, the staff correctly points out that recent trends give cause for concern, regarding both the compatibility of some recent policy developments with the authorities' medium-term adjustment effort and the prospect that the ongoing expansion of economic activity and investment may soon meet the constraint stemming from the external account position.

The consultation discussions in Italy witnessed a broad convergence of views between the authorities and the staff on the above considerations. For their part, the authorities wish to confirm to the Board their commitment to the objectives of their policy strategy, intended to realize in the medium term a convergence of Italy's economic performance with that of its main European partners. Accordingly, despite the difficulties induced by the political climate within the country, they are prepared to take the corrective measures that will be considered necessary to ensure the success of this strategy, especially if it becomes apparent that the most recent developments are prejudicing the results of the entire year.

The economic performance in 1984

After three years of sluggish or negative growth, in 1984 the Italian economy experienced a marked recovery in domestic demand and output in an environment of decelerating inflation and abated inflationary expectations. The increase in demand, at 2.9 percent, was 1 percentage point higher than envisaged during the previous consultation, mainly owing to a strong turnaround in fixed investment (plus 4.1 percent against minus 3.8 percent in 1983 and minus 1 percent forecast in January 1984). The higher than expected growth of domestic demand was almost entirely accommodated by the increase in gross domestic product of 2.6 percent, while the contribution of the foreign balance of GDP growth was not far from the projected level.

The buoyant expansion of fixed investment constituted a major achievement, since it was realized under fairly restrictive monetary conditions, reflected in relatively high real interest rates. In fact, it was fostered by the strong rise in expected demand and facilitated by a pickup in business profit margins.

The resumption of growth and the improved business prospects were not reflected, in the short run, in significant gains in overall employment such as to accommodate the rise in the labor force. A decline in employment in industry and agriculture was compensated by the absorption of labor force into the service sector, in character with a process that has marked the Italian labor market since 1981. A remarkable aspect of this medium-term development is that the substitution of sectors on the demand side of the labor market has been such that Italy was able to maintain employment basically unchanged through the latest recession, unlike the other large European countries.

In the industrial sector, the cumulative reduction of dependent employment between 1980 and 1984 was 10.5 percent, with a decrease of 3.9 percent in the past year alone. Owing also to growth in the industrial sector's production of 3.1 percent, the gain in total productivity in 1984 stood at about 7 percent, and an even greater increase was recorded in manufacturing. These considerable, and largely unforeseen, advances in industrial productivity, in conjunction with a moderate increase in nominal wages due to a large extent to the incomes policy, constituted the main factors behind the success in containing the growth of unit labor costs in manufacturing to just 3.9 percent in 1984, the lowest since 1972.

This in turn compensated for a higher than expected increase in import unit and other costs and allowed an annual rate of inflation of 10.7 percent. If a lesson can be drawn from this disinflationary experience, it is clearly that important achievements can be realized by a multifaceted policy approach when it is applied consistently. In the face of widespread rigidities in the working of the economy, the consistency pursued in 1984 among incomes, monetary, exchange rate, public tariff, and administered price policies paved the way to success in decelerating inflation that would otherwise have been extremely difficult to ensure through the use of a single policy instrument, like, for instance, the monetary one.

On the external accounts, the developments in 1984 were dominated by faster than expected growth in both imports and exports, which resulted in an unfavorable net effect on the trade balance. On the export side, the volume increase was about 6.6 percent, some 3 percent more than in the previous year. Given the roughly stable level of competitiveness, this increase does not imply a substantial loss of market share.

The pattern of exchange rate changes strongly influenced the competitiveness of Italian products in different geographical areas and determined the conditions for a reorientation of export flows. The Italian producers responded to these price signals by increasing their exports to the United States by an estimated 42.4 percent in dollar terms, while flows directed toward the EC area virtually stagnated. Export performance would have been much stronger, had there not been difficulties in inducing some importers, mainly some countries belonging to OPEC and the Council for Mutual Economic Assistance (CMEA), to accept the financing of Italian exports under terms consistent with the internationally agreed consensus on export credit. On the import side, the increase of both quantities and unit values significantly exceeded those of exports, primarily as a result of an economic recovery more rapid in Italy than in its main European partners as well as the depreciation of the lira vis-à-vis the dollar. The larger than projected trade imbalance was reflected in a current account deficit of 5.5 trillion lire, or 0.9 percent of GDP, entirely financed through capital inflows above the line.

Main policy issues and the prospects for 1985

(a) Fiscal policy

With a multiyear approach in view, the Italian authorities' fiscal endeavor remains directed toward the objective of stabilizing the ratio of public sector debt to GDP over the medium term. In the face of a large component of interest payments in the state sector's current expenditures--about 21 percent in 1984--this objective has to be achieved mainly by compressing noninterest current outlays. Moreover, a strengthening of tax collection and some rationalization of the tax structure are required. According to a set of projections made by the Italian authorities, they can attain the goal of fiscal stabilization by both maintaining a constant ratio of public sector revenues to GDP and stabilizing current noninterest expenditures in real terms, while allowing for a rise of capital expenditures equal to nominal GDP growth.

The 1984 fiscal outcome constituted a considerable step forward toward fiscal stabilization. The state sector's deficit was contained at 94.6 trillion lire, down from 16.4 percent to 15.4 percent of GDP, and broadly in line with the Government's target. This improvement was partly due to the slight increase of revenues as a proportion of GDP through the enactment of new revenue-raising measures. It was also the result of a sharp deceleration in capital expenditures and transfers to state-controlled enterprises and to peripheral public entities. In turn, these reduced transfers resulted from the new measure requiring peripheral entities to shift back to the Treasury bank deposits in excess of 4 percent of their receipts. Faced with these constraints, the public entities financed their deficits by drawing on their deposits and increasing their bank borrowing.

As to the outlook for 1985, the initial budget was framed to be consistent with the medium-term strategy. Some restrictions on expenditure growth and revenue-raising measures adopted for 1984 were reconfirmed for 1985. Additional measures were taken to check the growth of current expenditures in the areas of pension benefits and health service. Furthermore, measures to rationalize the value-added tax (VAT) structure and to reduce tax evasion as well as the Government's proposal for granting amnesty on illegal construction against the payment of duties and fines have recently been approved by Parliament. Nonetheless, current trends in expenditures give some cause for concern, since, in the absence of corrective measures, they could lead to an expansion of the deficit incompatible with the authorities' fiscal objectives.

The authorities are well aware that continuous adherence to a multiyear fiscal adjustment program is necessary to redress the situation of public finances. To this end, it is important to avoid any reduction in the tax burden in terms of the revenue/GDP ratio. But it is even more important to intervene on the expenditure side, as well as on the issue of the dichotomy existing at some levels of government between the authority to decide on expenditures and the responsibility to cover expenditures.

(b) Monetary and credit policies

In 1984, monetary policy was aimed at containing an excessive expansion of domestic demand by checking the growth of credit to domestic sectors and by strengthening the propensity of the economy to hold additional financial assets. This policy was prompted by a higher than expected rise in the deficit of the General Government as well as by the weakening of the external account position.

Success was achieved in controlling monetary and financial aggregates, in spite of the overshooting that occurred in some of them. Two factors must be considered in this respect: first, the steep recovery in economic activity and particularly in fixed investment after two years of continuous decline, and, second, the transition from a system of direct control on bank credit expansion to a more market-oriented approach to monetary policy. After a decade of direct credit controls, 1984 constituted the first full year in which credit to private sectors was regulated mainly through indirect instruments.

The discount rate was adjusted three times in 1984, against an average of one yearly adjustment since 1980, and once again in the current year. In these instances, the monetary authorities have clearly shown their willingness to allow for more frequent fluctuations in short-term interest rates in response to changing patterns of credit expansion and to changing trends in the external current account balances. This was particularly the case after commercial banks returned to compete for market shares on both sides of their balance sheets. Then a brisk growth of bank lending emerged, which was not entirely due to the correction of accounting distortions previously enacted by banks to circumvent credit ceilings.

But, in following this strategy, the authorities have not been guided solely by their usual targets in terms of broad credit aggregates. Increasing attention has also been devoted to controlling monetary aggregates, particularly M-2, in spite of the apparent instability that the demand for money displayed in the early 1980s. This broadening of focus has been considered necessary for the purpose of monitoring not only the size but also the composition of the private sector's financial wealth. In this respect, it should be pointed out that the high and increasing ratio of financial assets held by the nonbank public to GDP constitutes a major constraint to the conduct of monetary policy. Given this constraint, efforts have been made and continue to be made to limit the increase of the monetary components of financial wealth and to lengthen the average maturity of the nonmonetary components. The M-2/financial assets ratio of the public has been reduced from 0.83 at end1979 to 0.65 at end-1984; the average maturity of outstanding government securities was stretched from 9 to 29 months between 1981 and 1984.

As to the outlook for 1985, the risk of a rekindling of inflationary pressures and the precarious state of the external current account do not leave room for any weakening of monetary restriction. A limit of 12 percent for the expansion of credit to the nonstate sector has been set, and an increase has been projected in the money supply equal to the forecast growth in nominal GDP. Compliance with these guidelines, also in the case of rises in costs and prices stronger than assumed, would imply a more restrictive policy stance. Furthermore, in order to accommodate the projected rise in the financial assets/GDP ratio, real yields on securities would have to be maintained at rates consistent with a higher propensity by households to acquire financial assets.

To strengthen control over credit, the authorities have recently taken two measures. First, tax deductions for interest received by businesses on purchases of newly issued government securities have been reduced. This has had the effect of lessening banks' propensity to substitute their holdings of old securities for additional lending, thereby leading to a near freeze of this component of their portfolio. Second, the Bank of Italy has introduced new regulations for its ordinary advances to commercial banks. As a consequence, the size of credit lines can be curtailed on very short notice (five days), and a fee is charged on the unused portion of the credit line.

(c) Labor market policies

The action of the Italian Government in this area has been directed, in the past two years, toward the twin objectives of containing the growth of labor costs and increasing the flexibility of labor practices. On both fronts, the initiatives taken so far as well as the ones under study are to be viewed as part of a continuing process, directed toward creating the structural conditions for a reduction in inflation and an improvement in employment. In persevering in this course of action, the Government is encouraged by the success achieved in 1983-84, when incomes policy made a major contribution to slowing down inflation and eradicating inflationary expectations.

In relation to labor costs, policy choices could range between two alternatives: either employees' gross compensation or, at a minimum, unit labor costs should grow in line with the targeted inflation rate. Under the first alternative, productivity increases are directly translated into gains in business profitability and foreign competitiveness; under the second alternative, the result is at least consistent with stemming the inflationary pressures due to rising labor costs. In 1984, the actual outcome was close to the first alternative, thanks to the limit imposed by the Government on the salary increases triggered by the scala mobile. The degree of coverage of the indexation mechanism was, as a consequence, reduced substantially. This increased the flexibility of the wage formation mechanism and allowed for greater differentiation of wages.

As the staff points out, uncertainties are now arising on the prospects for 1985, especially in view of the referendum scheduled for June 9 on the restoration of four scala mobile points cut last year. It should be noted, however, that the Government intends to intervene, if necessary, to prevent significant departures from the projected trends. In this respect, government attention is focused on much broader issues than the referendum outcome, i.e., on the structure of workers' compensation and the new collective wage contracts.

As to labor practices, initial steps have been taken to improve the functioning of the labor market, particularly at the entry level. A law approved by Parliament in December 1984 introduced more flexible practices for work apprenticeship, fixed-term appointments, and various incentives for adopting work-sharing schemes.

(d) External policies

Owing to improved market confidence in domestic policies as well as to the overall restrictive stance of monetary policy, manifesting itself in high interest rates, the Italian lira remained relatively strong vis-à-vis the other currencies in the European Monetary System (EMS) during most of 1984. The authorities helped to make major advances in the process of liberalization of international transactions, on both current and capital payments.

The measures adopted in December on the purchase of foreign currency for travel expenses are particularly significant, in view of the recommendations of the Board in the 1984 consultation. These measures correspond, as the staff notes, to a "virtual elimination of restrictions." As to capital flows, the changes introduced in 1984 are to be seen in the context of a gradual integration of the Italian capital market with the rest of the world. Given the present circumstances, and particularly in view of the high and growing ratio of lira-denominated financial assets held by the public to GDP, the authorities feel that further liberalization of capital outflows cannot but proceed with the utmost caution.

The exchange rate policy of the Italian authorities has traditionally attempted to strike a balance between the need to preserve foreign competitiveness and the effort to induce moderation in the determination of prices. The response of Italian firms to these external price constraints and their ability to establish their presence in new foreign markets can be taken as evidence of the appropriateness of this policy. In 1984, external competitiveness remained stable on average in terms of both relative export unit values and relative wholesale prices for manufactured goods. Though the authorities are inclined to view current overall competitiveness as broadly adequate, and to attribute most of the recent trade deficits to a lack of cyclical synchronization, they believe that developments in this area should be kept under constant review.

Finally, I wish to recall that last December Italy reaffirmed its commitment to attaining the UN target ratio of official development assistance (ODA) to GDP of 0.7 percent in 1990. The actual ratio is estimated to have been about 0.41 percent in 1984 and should rise to 0.44 percent in 1985.

Mr. Templeman noted that the staff report described some long-standing fiscal and labor problems that over the years had jeopardized Italy's prospects for durable economic growth with reasonable price stability and a sustainable external position. Some positive developments had occurred in 1984--for example, economic recovery, deceleration of inflation, improvement in the financial position of enterprises, containment of the external deficit, and better coordination of monetary and fiscal policies; however, developments toward the end of 1984 and so far in 1985 had not been encouraging. Targets for inflation and wage increases as well as those for the fiscal and current account deficits might well be exceeded in 1985. The long-run threat was what the erosion of the adjustment effort implied for Italy's ability to bring its economic performance into line with that of other industrial countries.

Italy's economic recovery in 1984 and the prospects for continued moderate real growth in 1985 were positive factors both for the country and for world economic growth, Mr. Templeman said. However, the shift that had begun late in 1984 from export demand to the expansion of domestic demand had adverse implications for Italy's external position. On the one hand, the recovery of investment reflected improved profitability due to a sharp deceleration in unit labor costs. On the other hand, unit labor costs were likely to rise more rapidly in 1985, and restoration and maintenance of an adequate level of profitability were essential if Italy's employment problems were to be dealt with successfully. In that connection, the report on recent economic developments contained some interesting comparative figures for unemployment in the seven largest industrial economies in 1983: Italy had had the highest rate of youth unemployment--32 percent compared with a 17 percent average--but the second lowest unemployment rate for adults--4.8 percent compared with a 6 percent average.

Furthermore, even though long-standing labor market rigidities in Italy were among the most difficult in Europe, Mr. Templeman continued, plans for action were only in a preparatory stage. He wondered if Mr. Zecchini could comment on such issues as inflexibility in hiring practices, possibilities for expanding part-time work, relaxation of rules on dismissals, moderation in generous severance pay allowances, and the lack of mobility in the labor force due to rent controls and the high tax on real estate transfers. In recent years, the rapid increase in labor costs clearly had affected job creation negatively. The wage indexation system, or scala mobile, had played a negative role in that process and it continued to threaten the achievement of long-term price stability. However, since 1983 some attempts had been made to modify the system, it was understandable that in order to secure the cooperation of the labor unions, certain tradeoffs had been necessary. Those tradeoffs often had added to the fiscal deficit by reducing tax revenues or increasing transfer payments. If, in fact, such tradeoffs were unavoidable, he hoped that the net effect on the economy would still be positive. For example, some progress already had been made in reducing the automatic component of wage adjustments under the scala mobile system, diminishing its effective protection against inflation from roughly 81 percent in 1981 to about

46 percent in 1984. Such a reduction could open the way to more discretionary wage adjustments based on relative productivity growth and could roll back some of the wage compression that had occurred in the recent past. The 1983 modification in the scala mobile system aimed at permanently reducing adjustments by 15 percent and the 4 point reduction in the adjustment allowed in the first half of 1984 had been helpful reforms, if only partial ones. However, if the June referendum reversed the effect of the 1984 limits on indexation, further modifications would be necessary.

A comparison of the fiscal accounts of the General Government in Italy with those in other countries showed that the ratio of expenditures to GDP in Italy was similar to that in other EC countries, while the ratio of revenues to GDP was significantly lower, Mr. Templeman went on. Furthermore, the composition of current expenditures to GDP was rather different: while noninterest expenditures were relatively low, interest payments in Italy were much higher than in the United Kingdom, France, and Germany. Of course, the high interest payments reflected the large accumulation of deficits in recent years. The lower ratio of revenues to GDP was not so much the result of low tax rates as of chronic problems with tax evasion. With such a pattern of revenues and expenditures, naturally there had been correspondingly high fiscal deficits, which in both the state sector and in the General Government had averaged almost 15 percent of GDP in the period 1981-84. Moreover, although the share of the state sector in the economy had declined slightly in the previous year, there had been offsetting negative factors outside the state sector.

The high progressivity of direct taxes contributed to work disincentives and tax evasion, Mr. Templeman said. It was not surprising that the wage and salary workers employed in the official economy felt that they were carrying an uneven load or that tax evasion had contributed to the development of the underground economy--an economy, however, that Table 58 in the report on recent economic developments suggested might be more modest than some estimates had predicted. Thus, the authorities were to be commended for using the measures in the Visentini package to raise tax revenues and to improve tax equity by broadening the base of direct and VAT taxes in areas that had tended to escape taxation. As for a possible tax amnesty, he felt that, whereas it might generate some needed revenue on a one-time basis, it would not constitute a fundamental change.

There seemed to be little cause for complacency about the budget outlook for 1985 and beyond, Mr. Templeman cautioned. In fact, it appeared that the authorities might fall significantly short of reducing the state sector deficit from an estimated 17.6 percent of GDP to the 14.7 percent target. Indeed, revenues might fall short of the expected levels, and expenditures could exceed budget expectations in such areas as the wage bill, purchases of goods and services, and interest payments on a higher deficit. Moreover, rapidly rising capital expenditures by the autonomous agencies constituted a major source of increase in spending and hence in the deficit. He wondered what these expenditures were for and whether the pattern would continue. Finally, the medium-term fiscal calculations by the staff suggested that even with a decline in the ratio of the deficit of the General Government to GDP from 13.5 percent in 1984 to 5.5 percent in 1990, interest payments, which had been 9.6 percent of GDP in 1984, would still remain in the range of 8.2 percent to 9.7 percent depending upon the different scenarios. Presumably, interest payments would be significantly higher in the absence of such a sharp cut in the deficit.

Given the recent worsening of the fiscal accounts and the worrisome medium-term outlook, Mr. Templeman wondered whether the Italian authorities contemplated taking additional actions soon. Perhaps, with both local elections and the presidential election soon out of the way, it would be possible to make a renewed effort to reduce the fiscal deficit later this year.

Under the constant pressure of the need to finance the fiscal deficit, there had been some rather persistent but fairly moderate overshooting of monetary aggregates in the last four years, Mr. Templeman remarked. Nonetheless, there also had been some positive developments in monetary management; for example, residual lending to the Treasury by the Bank of Italy had ended in 1981, and the move away from reliance on direct credit controls had begun in 1983. The latter had been particularly important, because prior to that time the setting of a global credit limit, coupled with the need to finance budget deficits, had tended to crowd out credit to the private sector. Since then, controlling the monetary base and relying on flexible interest rates had helped to allocate credit more rationally. For example, following three years of negative credit growth, the private sector had benefited in 1984 from an increase of credit in real terms. No doubt the high real interest rates prelevant in Italy in 1984 had contributed to the relative strength of the lira, but other favorable factors, such as the deceleration of inflation and the recovery of economic activity and investment, also had played an important role in sustaining the lira.

In conclusion, Mr. Templeman remarked that early in 1984, fiscal policy had begun to complement monetary policy--a rather rare occurrence in Italy--and efforts at restraining the growth of labor costs had been bearing fruit. However, in the absence of a new major effort, the positive momentum of the 1984 adjustment effort might slip away. Therefore, it was important for Italy and for world economic growth that the authorities should pursue with determination their efforts to deal with the country's long-standing economic problems, especially its fiscal and labor problems.

Mr. Wicks pointed out that despite significant improvements in Italy's economic policies and performance in 1984, there had been little progress in tackling some of the key underlying problems in the economy, most notably the size of the public sector deficit, which remained large by the standards of most other countries. A combination of interest rate developments and a continuation of the present fiscal position risked a spiraling cycle of yet more deficits and yet more debt. Paradoxically, the welcome deceleration in the rate of inflation and higher real interest rates could actually worsen the fiscal problem. That point was made not to tempt the authorities to relax in their battle against inflation but simply to emphasize the need for radical fiscal action.

The state deficit had been held broadly to the 1984 target, even though the target itself appeared to have been revised upward in the course of the year, Mr. Wicks continued. However, that result had been achieved mainly through financial and statistical devices of somewhat doubtful relevance to the underlying fiscal problem rather than through the sounder methods of revenue boosting and expenditure cuts. In addition, the general government deficit had widened by 1 percent of GDP in 1984; the deficit of the state sector itself had increased sharply at the end of 1984; the 1985 target for the deficits was likely to be exceeded by a significant margin even after the implementation of the additional measures planned by the authorities.

On the medium-term fiscal prospect, Mr. Wicks wondered, was the target of maintaining the ratio of tax revenues to GNP sufficiently ambitious? The overall tax take was certainly high in relation to GNP, but the size of the fiscal imbalance suggested a need for more rigorous action on the revenue side. To minimize distortionary effects and tax avoidance, some further restructuring of taxation along the lines of the Visentini measures would be helpful. However, the better route of fiscal control was through more rigorous expenditure restraint. Such restraints were difficult with Italy's decentralization of expenditure decisions. For example, current expenditure had increased by almost 6 percentage points of GNP from 1981 to 1984. The question was whether that increase had reflected slippages in spending control or whether the increase had actually been planned.

The shift from quantitative credit controls to a more market-oriented approach was beneficial to overall monetary policy, Mr. Wicks stated. However, he questioned the composition of the Italian monetary aggregates and the status of the monetary targets; specifically, he was concerned that treasury certificates and certificates of deposit (CDs) were included within the money aggregates. For example, a good deal of the shortfalls in actual money holdings below the predicted level could be attributed to nonmoney instruments. Consequently, he wondered whether the level of liquidity in the economy was adequately reflected by the existing monetary statistics. Furthermore, what status did the Italian authorities assign to the monetary target? He had been concerned to see that credit expansion to the nonstate sector in 1985 was projected at 12 percent, a roughly neutral figure in terms of nominal GNP, whereas overall credit expansion, including lending to the state sector, was projected at 16 percent. That outcome would not put further downward pressure on inflation.

He hoped that efforts to curb the scala mobile would not be reversed in the forthcoming referendum, Mr. Wicks added. The indirect tax changes and exchange rate fluctuations were still reflected in the indexation mechanism, and he wondered whether there was any prospect of abolishing those aspects of the system and in the long run eliminating indexation altogether. In many other European countries, indexation of wages had been scrapped or significantly cut back, and the Italian authorities should move in the same direction. At present, the rigidity of the formal labor market in Italy provided two disincentives to work: the social security benefits and the so-called Wage Supplementation Fund. A more favorable environment for business would be created by the plans announced in 1984 to increase labor mobility by releasing resources from declining industries and shifting them into high-technology areas. Because of the vulnerability of some of Italy's traditional exports to competition from lower-cost producers, greater labor mobility must be achieved.

The widening of the trade deficit in 1984 and the projection of a further widening in 1985 suggested that the current account might not yet be fully under control, Mr. Wicks said. Set against the relatively modest rate of GDP growth and the high level of unemployment, that projection was particularly worrying. Exports would be adversely affected by any slowdown in the U.S. economy, and the recent depreciation of the lira within the EMS had been insufficient to restore Italy's competitiveness within Europe. A moderation in cost and price pressures based on firm financial policies and a more flexible operation of market mechanisms would be needed if competitiveness were to be maintained. Those mechanisms, not repeated depreciation, were the way to enhance competitiveness. Partly because a significant segment of it operated largely outside state control, the Italian economy continued to demonstrate remarkable resilience. In spite of political difficulties, the Italian authorities had begun to tackle some of the more serious and long-standing imbalances in the economy. Yet perhaps even more needed to be done promptly, if serious problems were not to re-emerge and if Italy were to avoid an explosive interaction of interest, debt, and deficits.

Mr. de Maulde agreed that the performance of the Italian economy had certainly defied the scenario envisaged during the previous Executive Board discussion. In late 1983 and the first part of 1984, the authorities had succeeded in achieving increased growth, investment, and productivity as well as a decline in the rate of inflation and a tolerable external balance. At the root of that success had been a strong monetary stance, including an appropriate interest rate policy; the acceptance of the consequences of a tight control on the growth of the money aggregates; and an incomes policy allowing for a decrease in real wages. He was less impressed by what had been done in public finances. On one hand, according to the staff, "corrective measures [had been] 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." On the other hand, a closer look at the sources of the overall improvement implied that most of it might well have been due to certain accounting techniques. A number of decentralized public entities, as well as regional and local authorities, had been encouraged in 1984 to draw down their bank balances in order to minimize their financing by the central treasury, thereby bringing about an illusory improvement. However, the staff reported that "the deficit of the general government on a national account 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."

The Italian policy mix in 1984 reminded him of the policy mix in the United States in recent years, Mr. de Maulde remarked--strong monetary restraint associated with an expansionary fiscal stance. Currently, however, the problem was that things were unraveling rather quickly: the targets for the monetary aggregates had been significantly exceeded in recent months, and the rate of increase in wages in industry was likely in 1985 to exceed 11 percent, contrasted to the 7 percent target. Therefore, the two major sources of the 1984 improvement were no longer working in the right direction. Likewise, the state sector deficit once again was escaping from the authorities' control: it was currently expected to overshoot its Lit 100 trillion target by at least 6-7 percent. Because the economy had responded extremely quickly to the appropriate policies, it also could react extremely fast to the inappropriate ones. The conclusion was inescapable. The staff had reported that "the prompt implementation of a coordinated correction effort is especially needed to stave off the threat of an excessive and over the long run unsustainable deficit in the current account of the balance of payments." The Italian authorities had inherited two especially difficult problems--the extremely heavy burden of a huge public debt, deriving from past fiscal failures such as tax evasion and grossly inadequate procedures for the control of public spending; and the lack of a clear social consensus on the need and procedures for an effective incomes policy, an issue on which the authorities had shown great courage in the past.

The Italian economy had two particular assets, Mr. de Maulde concluded: the remarkable track record, unanimously admired in Europe, of the Bank of Italy; and the adaptability, ingenuity, and creativity at the root level of Italian enterprises, which had continuously demonstrated their ability to survive and prosper either on the surface or in a somewhat more underground fashion. Finally, he wondered exactly what was being done to limit the consumption of imported oil and gas and whether the authorities could develop alternative energy sources such as nuclear power.

Mr. Ismael noted the improvement in the overall performance of the Italian economy in 1984, both against the record of the previous year and against general expectations. Although the external sector had provided the main impetus to recovery in the early part of the year, a combination of favorable domestic factors had played a major role afterward; one had been a more balanced fiscal and monetary policy mix that had permitted private investment to increase, and another had been the incomes policy measures that had helped to contain the rate of inflation. If diligently pursued, those measures would have laid the groundwork for a broadly based recovery with price stability and increased convergence with Italy's main trading partners. Unfortunately, recent indications showed that overruns in fiscal policy might be imminent. Unemployment had refused to budge, and the external current account deficit was in danger of widening. Unless further measures were taken, the Government's medium-term objectives might be jeopardized.

The 1984 budget had introduced a number of corrective fiscal policy measures to contain the overall deficit of the state sector, Mr. Ismael said. As a result, a reduction in the rate of growth of the deficit as a proportion of GDP had been achieved. That reduction, together with various incentive measures, had prompted a revival in private investment and a lessening of the crowding-out effect that had been the subject of concern during the previous Article IV discussions. Further progress in that direction was required if private investment were to increase enough to stimulate additional employment while keeping price pressures at bay; hence, the slippages that appeared to be taking place in that area were a cause for concern. Since a great part of government expenditure consisted in unavoidable interest payments on public debt, attention must be focused on other components of state sector expenditure. Capital expenditures had already been postponed in 1984. Therefore, the remaining expenditures that must be trimmed were noninterest current expenditures and transfer payments.

Steps should be taken to improve coordination between revenue and expenditure determination and to raise the profitability of public enterprises, Mr. Ismael continued. The authorities could enhance revenue performance by broadening the tax base and reducing tax evasion. He noted a divergence between the expectations of the staff and those of the authorities concerning the outcome of the state sector deficit in 1985 and would welcome a repetition of the overshooting of the staff's expectation that had occurred in 1984. In that light, he noted the explanation in SM/85/127, Supplement 1 that the excess in the state sector deficit during the first four months of 1985 was traceable to temporary factors.

Monetary policy had been appropriately tight in Italy, Mr. Ismael remarked, moving away from direct controls in favor of market-oriented instruments, a trend that had reduced disintermediation. The flexible approach to interest rate policy had helped to moderate the impact of the borrowing requirement of the state sector in 1984, while encouraging capital inflows, thereby helping to offset the current account deficit. The size of the public debt made an increase in domestic interest rates burdensome on the budget. Nonetheless, monetary policy would need to remain flexible, allowing interest rates to rise further so as to keep domestic credit under control, particularly if the trend in the public sector borrowing requirement could not be reversed. Developments in domestic credit in early 1985 were a cause for concern.

Incomes policy in 1984 had been in the right direction, Mr. Ismael felt, resulting in a significant reduction in unit labor costs. Nevertheless, unemployment had remained high. He agreed with the authorities' intention to keep the rise in labor costs to the targeted rate of inflation. As evidenced by the previous year's record, however, measures with regard to indexation would not be sufficient to bring down the unemployment rate; they would have to be supported by measures to reduce the rigidities in the labor market. Greater efforts should be made to promote public understanding of the problem before the June 1985 referendum.

Italy's external position had remained fragile, Mr. Ismael noted. Improvement in the external sector during 1980-83 had been reversed in 1984 with the recovery of domestic demand. Although the authorities had taken action to mitigate upward pressures on the lira, a small real appreciation had taken place, a development not entirely harmful in that it had helped to stimulate sluggish demand for private investment in the face of a relatively comfortable reserve position and capital inflows. However, with the prospect of a widening current account deficit, the lira had been permitted to weaken in the early part of 1985. Whereas in time that weakening would have a positive effect on the current account, a firm stance of fiscal and monetary policies was also essential to maintain a strong external position. Finally, Italy's trading system was consistent with the European Communities' directives, and the authorities should continue their attempts to refrain from protectionist measures, particularly against developing countries.

Mr. Nimatallah considered that the Italian economy had performed well in many respects in 1984. Output and productivity had risen, the rate of inflation had declined, and the balance of payments had been in overall surplus. Those had been important achievements, especially after the prolonged recession. They had owed much to the more determined pursuit of coordinated adjustment policies by the authorities. In contrast to previous years, a firm monetary policy had been supported by fiscal restraint and wage moderation. The results spoke for themselves. However, the strategy was currently in jeopardy. The momentum of fiscal adjustment had slowed; monetary growth had exceeded the target; recent wage settlements had exceeded the official guidelines. There were risks that inflationary pressures would re-emerge and that the external accounts would weaken significantly in 1985. Furthermore, the weakness in the public finances put an undue burden on monetary policy and limited its effectiveness. Given those developments, the authorities should return to the balanced set of policies that had worked well in 1983 and 1984. Those policies offered the best chance for achieving Italy's medium-term objective of economic convergence with its main trading partners.

The main priority, Mr. Nimatallah continued, was to strengthen the public finances on a sustainable basis. There was an urgent need to improve expenditure control and to restrain the growth in current expenditures. Unless political constraints prevented them, the authorities should cut welfare payments and social security transfers. There was also scope to strengthen the financial position of local and regional governments. Action in those areas was essential to reduce the growth in interest payments on the public debt to a more manageable level. To increase revenues, there was also a need to broaden the tax base and reduce tax evasion. Strengthening public finances had to be supported by a continued, firm incomes policy. For example, there was no doubt that the 1983/84 reforms of the wage indexation system had contributed substantially to the deceleration in unit labor costs and the recovery in industrial profitability. Further reforms were currently needed to reduce the scope of wage indexation and to link wage increases more closely to productivity gains. Also, the authorities should implement their plans to introduce greater flexibility into the labor market, a step which in time should help to create new employment opportunities.

He commended the authorities for having moved to a market-oriented approach on credit controls as well as having financed a larger share of the public sector deficit by nonmonetary means, Mr. Nimatallah indicated. Such coordinated domestic policies should have two main benefits: to bring the growth of domestic demand in Italy more into line with that of its trading partners and to strengthen Italy's competitive position, the latter being particularly important at a time when the external accounts appeared to be weakening. Over the medium term, sustained efforts were needed to restructure the industrial base and promote exports in areas where Italy had a comparative advantage. In addition, the external position would benefit considerably from more determined measures to conserve energy. Further progress should be made in the liberalization of exchange controls, and the authorities should carry out their commendable intention to increase official development assistance relative to GDP in the years ahead.

Mr. Leonard pointed out that although due to a variety of factors, the improvements recorded in the performance of the Italian economy early in 1984 had been brought about mainly by more determined economic management. Therefore, the erosion of policy and the associated deterioration in the economy after the first few months of 1984 were regrettable. Resources were again shifting to the nontrade sector, and imports were expanding rapidly. The rate of inflation, the rate of growth in unit labor costs, and the general government deficit as a proportion of GDP remained higher than in any other major industrial country. Those features were part of the fundamental weaknesses in the economy that had long existed and had given rise to serious strains which would continue to grow unless economic policy in Italy became more compatible with the rest of the EC. The authorities' objectives for 1985 and their plans for reshaping the economy over the medium term were well devised and clearly indicated a recognition of the problems that had to be overcome, but, on the basis of current trends, the outcome in 1985 was likely to fall seriously short of objectives, and the desired reform of the economy in the medium term could recede to a more distant horizon. Accordingly, he did not underestimate the political constraints facing the authorities but would urge them to take appropriate adjustment measures without delay.

It had long been recognized that the public sector deficit continued to be one of the central problems of the economy, Mr. Leonard went on. Therefore, it was worthwhile to note the efforts being made by the authorities to increase control over the general government deficit by action on both expenditure and revenue. A direct link between spending and revenue-raising responsibilities was needed. Until the authorities ceased to fund continually unexpected overruns in spending, there could be no proper management of the state finances.

The authorities needed to implement systematic control of expenditures, Mr. Leonard remarked. The case had been made for cuts in the pension and health programs; in addition, there was the deterioration in the financial position of certain public entities and the mounting problem of debt service. The measures under way to enhance revenues were welcome, particularly the Visentini package. However, what was being done might be less effective than envisioned by the authorities. At some point, they would have to take a tough stand to bring revenue collections more into line with the average of industrial countries, particularly insofar as noninterest expenditures--which in Italy were roughly average for an industrial country--could not be cut to the level that fiscal balance demanded.

The authorities wisely had moved away from relying on quantitative control over bank credit toward limiting the expansion of the monetary base and depending more on interest rates as a means of curtailing credit expansion, Mr. Leonard continued. Such a strategy would greatly assist efforts to improve the allocation of financial resources and the promotion of the banking system as a financial intermediary. However, the authorities could not continue to rely almost exclusively on monetary policy to restore economic equilibrium: a more balanced mix of monetary and fiscal policy was required--one in which monetary restraint was coupled with an adequate adjustment of public sector finances and an appropriate incomes policy.

For 1985, however, it looked as if effective monetary control would have to be the main instrument in containing the rate of inflation, Mr. Leonard considered. The authorities' success in that area--as indeed their success in reducing unemployment--would be greatly influenced by the extent to which they could pursue an effective incomes policy. In particular, a progressive reduction in the degree of wage indexation resulting from the scala mobile was essential to limit the rise in unit labor costs and promote competitiveness. At a limited cost to real wages, measures to reduce wage indexation had been implemented in 1983 and 1984, and those measures, along with a cyclical increase in productivity, had contributed to a sharp deceleration both in manufacturing unit labor costs and the rate of inflation. Applying only to 1984, those effects could not be seen as contributing to a lasting improvement in competitiveness. Indeed, much of the 1984 wage containment could be lost, depending upon the outcome of the June referendum to restore salary increases lost in the previous years' adjustments in the scala mobile. Although a rapid downgrading of the scala mobile at present was scarcely possible, indexation on an annual--not a shorter--basis, should be encouraged, and wages should not be adjusted for the effects of changes in indirect taxes.

The recent liberalization of capital transactions and exchange allowances for tourist travel abroad had been a positive development, Mr. Leonard said. The new system should be maintained in the face of any balance of payments problems that might arise from inadequate control of domestic demand in the period ahead.

Mr. Polak noted that a positive development was the authorities' increasingly clear focus on the need for medium-term adjustment in Italy's financial policies. The core of that adjustment effort was the objective of convergence between the Italian economy and its main trading partners. In 1979 when Italy had joined the EMS, the authorities had acknowledged the implication of that objective for exchange rate policy, an acknowledgment that had implied stable exchange rate relationships with the main European partners even though at that time the exchange rate was still at a 6 percent margin. In 1981, they had accepted the implications for monetary policy by means of a so-called divorce of the Bank of Italy from the Treasury. In 1984, the implications had been for medium-term fiscal developments. However, fiscal progress had been limited in 1984, and 1985 might mark a departure from the targeted medium-term path. The present fiscal situation was unclear on most fronts: the state sector deficit in terms of GDP might well show an increase over the performance in 1984; prospects for the general government deficit were unknown, but the first signs of a decline had yet to materialize; the rate of inflation was expected to remain at about 9 percent, well above the 7 percent target, while the external current account deficit might rise as high as Lit 5 billion. Consequently, instead of converging, economic developments in Italy were at present diverging from those in the economies of its main European partners. The serious situation required lasting and structural changes rather than stopgap measures.

Although a tighter monetary policy was required, such a policy alone was not capable of offsetting the effects of an increasing fiscal deficit and a faster growth rate of domestic demand in Italy than in its main trading partners, Mr. Polak maintained. Therefore, a tighter monetary policy must be accompanied by fiscal and incomes policy measures. As for medium-term and short-term fiscal policies, the important thing was to stabilize the ratio of public debt to GDP. The more the rate of inflation decelerated, the more the actual deficit in terms of GDP had to be reduced, because what was needed was a drop not merely in the actual deficit but also in the so-called inflation-adjusted deficit. If government receipts rose with rising real GDP, the Government's target of stabilization in real terms of noninterest expenditures would be able to produce the necessary reduction in the deficit. However, the prospective fiscal developments for 1985 were at variance with that scenario. The time was ripe for the basic institutional reforms that would end the separation between the authority for making expenditure decisions and the authority for financing the consequences of those decisions.

Income formation was another source of concern, Mr. Polak continued. Although in the previous year the authorities had intervened unilaterally and lowered the degree of indexation, there was the risk that the forthcoming referendum would reverse that reduction in the scala mobile. Because the scala mobile was but one of the many determinants of real wage developments, recently proposed modifications of it had focused increasingly on the need to allow greater wage differentiation. In the past, it had been the combination of indexation, wage drift, and salary increases--agreed upon by national leaders as well as by individual firms--that had repeatedly resulted in real wage increases unwarranted by the economic situation. When the rate of inflation had not caught up with those increases, the results had been labor shedding or reduced profitability--both having had negative implications for employment.

When financial policies were nonaccommodating, those were the effects, Mr. Polak indicated. However, were Italy's financial policies clearly nonaccommodating? He doubted that compliance with targets for credit and money--and also higher than expected costs and prices--implied a more restrictive policy stance. In that regard, the U.K. experience showed that, even when the authorities were as explicit as they possibly could be on their monetary policy stance, it took time for the social partners to believe what they had heard. Furthermore, when the message was not clearly heard, the likelihood of the social partners' believing it was even more reduced. The Italian authorities should keep the rise in labor costs to the 7 percent target for inflation. Could they attain that objective simply by excluding the effects of changes in indirect taxes from the scala mobile and shifting to an annual basis of adjustment? The authorities should at least set an example in the public sector, where civil servants' salaries were expected to rise by 11 percent.

Although steps had been taken in 1984 to liberalize Italy's exchange system, Mr. Polak said, even further progress, matching progress made in monetary and exchange rate policy, would be needed to integrate Italy further into the European economy. Those gradually strengthening disciplinary elements in the Italian system had to make the consequences of fiscal nonadjustment more directly visible and, in the end, should lead to necessary budgetary measures' being taken at an earlier stage.

Mr. Schneider stated that, because of a sensible combination of fiscal and monetary policies supported by an effective incomes policy, the Italian economy had recovered quite well in 1984. However, if those policies had addressed only the acute problems rather than the underlying structural weaknesses, the positive results would turn out to be temporary. Vigorously attacking the underlying structural defects in addition to fighting specific problems would assure a sound recovery, especially in the fiscal area. Although public sector finances had improved in 1984, those improvements had been accomplished chiefly through financial operations rather than through real adjustment. However, disregarding the effects of financial operations, the deficit of the General Government, including local entities, had grown substantially. In addition, Italy's public sector deficit was obviously too large, and the growing public debt was driving real interest rates very high. If that trend continued unchecked, it would threaten the indispensable effort to modernize the production sector.

The budget for 1985 was ambitious, Mr. Schneider pointed out, but chances were uncertain that its goals, foremost of which was the containment of the deficit, would be realized. The budget included measures designed to increase revenues, but substantial progress in that direction seemed difficult: in particular, there was the serious risk that substantial increases in indirect taxation would reinforce inflationary pressures. The so-called Visentini package reflected an awareness of that risk, as it called for a simplification of the tax rate structure, with increases for some commodities and decreases for others, rather than an across-the-board increase. The area of direct taxation provided much more room for maneuver, and there the Visentini package included measures that not only addressed symptoms but also promised some solutions to the deeply rooted problem of tax evasion. The Visentini measures could succeed in reducing the size of the underground economy. Therefore, the planned measures should not only have a short-term budgetary impact but also decrease the basic structural weaknesses of the tax system.

In addition, Mr. Schneider continued, emphasis should be placed on the curtailment of expenditures, of which an ever-increasing share was of the incompressible type such as debt service. Therefore, the authorities should concentrate on compressible expenditures, especially transfers and public sector wages. Initial budget projections for 1985 had had to be altered to include unexpectedly higher transfers to the national pension fund; however, there were plans for general reform of the fund.

It was an obviously fundamental structural weakness of the public sector that the authority for setting the expenditures of peripheral public entities was separated from the responsibility for funding them, Mr. Schneider pointed out. In addition, the large budget deficit affected the orientation of monetary policy, which remained the principal tool of economic policy in Italy. The authorities' shift from a system of direct control through credit ceilings to one of indirect control through interest rates had had a positive effect on the savings propensity of households and had permitted nonmonetary financing of the public deficit. However, that benefit had been obtained only at the cost of high real interest rates, which increased the real burden of the public debt, particularly during phases of declining inflation, as in 1984. Accordingly, the scope of monetary action was severely limited and was likely to remain so until the public finances could be brought under control.

Impressive results had been achieved in 1984 in the areas of prices and incomes, Mr. Schneider maintained. The social partners had been ready to accept the modified indexation system as well as a system of norms for price and wage determination. At the moment, it was important for Italy to consolidate its 1984 gains in competitiveness. It was also essential to continue the moderation of wage costs and increases in productivity in order to restore profitability. The containment of wage growth was a necessary condition for reducing unemployment. Consequently, it was to be hoped that the referendum on the scala mobile would not freeze the authorities' ability to act.

The present exchange rate policy was appropriate so long as the rate of inflation could be contained and the current account position did not worsen, Mr. Schneider said. In addition, in staff reports for countries where profound disparities existed among different regions, as between the north and the south of Italy, a detailed description of those disparities should be given.

Mr. Finaish commented that, after good export performance in the first part of 1984, reflecting growth in external demand, the Italian economic recovery had gathered strength and had become more broadly based with an upturn in domestic demand, including a rebound of fixed investment. The financial position of enterprises had improved substantially; the rate of inflation had fallen markedly; and the overall balance of payments outcome had been relatively favorable. The general improvement in economic performance had been supported by significant policy adjustments. The mix of financial policies had been improved by a tightening of the fiscal stance, reflected in the reduction of the state sector deficit relative to GDP for the first time in several years. Incomes policy measures together with a rise in productivity had been instrumental in bringing about a sharp deceleration of unit labor costs in manufacturing, thereby helping to dampen the rate of inflation and restore profit margins.

To consolidate and extend the improvement in economic performance, it would be necessary to sustain the move made during 1984 toward a better-coordinated mix of mutually reinforcing policies, Mr. Finaish indicated. Instead of adopting policy corrections along a broader front, the authorities had placed primary reliance in previous years on monetary policy to carry the burden of adjustment for the control of inflation and the preservation of the external balance. However, that reliance on monetary policy not only had imposed higher cost of adjustment on the economy but also had constituted a configuration of policies that could not be sustained in the longer run. Developments in the last few months of 1984 and in early 1985 pointed to some slippage in policy implementation that could reverse part of the progress made earlier in 1984 toward a more balanced set of policies. It was projected that without adequate corrective action the outcome in 1985 regarding costs, inflation, the external accounts, and the fiscal position would be significantly worse than targeted, although output growth could still be on target.

If the domestic and external financial positions were allowed to weaken, it would be difficult to sustain the pace of growth necessary to check still-rising unemployment, Mr. Finaish noted. In order to safeguard the Government's domestic and external financial objectives for 1985 and the medium-term plan to cause Italy's economic performance to converge with that of its major trade partners, a prudent stance of monetary policy needed to be supported by appropriate corrective measures in two key areas--public finances and income determination. The multiyear fiscal adjustment plan envisaged by the authorities constituted a crucial link in their overall medium-term economic strategy. While the fiscal adjustment targeted in the plan was significant, stronger efforts were called for if the targets were to be realized and if the previous sequence--large deficits leading to still-larger deficits through the escalation of interest payments on the growing public debt--were to be broken. In the current fiscal year, additional measures to raise revenues and contain current expenditures were needed to avoid the revenue shortfall and sizable expenditure overruns that were in prospect. For a durable fiscal adjustment over the medium term, certain structural changes in public finances appeared necessary, including further measures to rationalize the tax base and improve tax collection, the establishment of better control over expenditures by local authorities and peripheral public entities, and adjustments in certain important spending programs.

The measures taken in 1983 and 1984 to restrain wage indexation had been significant, particularly against the background of the political difficulty involved, Mr. Finaish continued. However, since the measures taken in 1984 had been of a one-time-only nature, additional measures were needed for the current year to keep wage increases and inflation within the targets. In order to secure a sustained reduction of growth in labor costs and the rate of inflation as well as to allow greater wage differentiation in line with differential increases in productivity, the medium-term policy objective should be to work toward developing the necessary consensus between employers and unions for a reduction in the degree of wage indexation in the economy. In addition, measures to reduce other types of labor market rigidities and to promote more flexible hiring procedures would improve the prospects for employment.

There had been a turnabout in the energy area, Mr. Finaish pointed out: crude oil imports had decreased substantially in the previous few years, while exports of refined products had increased. A net exporter of refined products up to the late 1970s, Italy had been exporting over 20 million tons annually, and exports of refined products had exceeded imports by a factor of three. However, Italy had since become a net importer of refined products. The long-term viability of the approximately 20 major refineries in Italy was in doubt because, according to OECD figures, they had used only 44 percent of their capacity in 1983 and 48 percent in 1984. Italian refineries, particularly the two major ones in Sicily and Sardinia, had the advantages over other European refineries of deep-water ports--which afforded access to large tankers--and the ability to process a wider range of crude oils. Despite those advantages, there had been a substantial decline in the production of refined products, a decline that deserved some explanation.

Mr. Sugita commented on Italy's generally improved economy in 1984: domestic demand had recovered after declining consecutively for three years; the rate of inflation had decelerated further; the balance of payments position had improved in the second half of the year. In addition to favorable external conditions and a widening of profit margins in domestic private firms, those developments had been attributable to economic policies coordinated better in 1984 than in the previous years. However, the Italian economy had yet to overcome a number of weaknesses and rigidities. Although it had decelerated, the inflation rate in Italy remained high in comparison with the rate in other industrial countries.

Despite the rise in industrial production, total employment in Italy had not responded favorably, and the unemployment rate had been gradually increasing in recent years.

Public finances represented a major structural weakness in the economy, Mr. Sugita maintained. The deficit of the state sector--15 percent of GDP in recent years--was enormous by international standards. Effective budgetary planning was made difficult by both the decentralized authority for overall expenditure decisions and the division into two separate groups of those responsible for collecting revenue on one side and for spending it on the other side. In addition, interest payments on the public debt had accelerated the increase of the deficit itself, and large-scale tax evasion had kept revenues low. Those structural weaknesses needed to be tackled in the medium-term to long-term perspective; thus, the so-called Visentini package was a welcome first step in broadening the tax base. The introduction of presumptive income taxation was also interesting, although its effects on tax revenues remained uncertain.

In 1984, because of containment of capital spending and deferments of transfer payments to regional and local authorities, the state sector deficit had declined in relation to GDP for the first time in five years, Mr. Sugita continued. However, because the improvement in state sector finances in 1984 had depended more on deferments of expenditures than on corrective measures, the deficits of the General Government on a national accounts basis had widened in 1984. In the absence of corrective measures, the state sector deficit was projected to reach about 17.5 percent of GDP in 1985. Moreover, as had often occurred in Italy, there were serious risks of expenditure overruns. Therefore, it was crucial that steps should be taken to restrain expenditures, especially current expenditures. Further revenue-raising measures also might be required.

Although noteworthy gains had been achieved in 1984, the rate of inflation had stopped decelerating by the end of that year, Mr. Sugita noted. The growth of the monetary base had exceeded the target significantly in recent months, and if the rate of inflation were to resume a sustained deceleration, the growth of the monetary aggregates should be promptly brought back in line with the target. Needless to say, monetary restraint should be supported by an adequate fiscal policy and an appropriate incomes policy. The rise in labor costs should be kept to the target rate of inflation, and in that connection the authorities should take whatever steps necessary if the outcome of the referendum on the scala mobile resulted in significant departures from the intended course. In the longer run, however, difficult efforts had to be made to reduce the degree of wage indexation steadily over time in order to secure a sustained reduction in the growth of labor costs.

The current account had recorded a deficit equivalent to nearly 1 percent of GDP in 1984, compared with a surplus of 0.2 percent of GDP in 1983, Mr. Sugita said. Hence, there was a threat of an excessive and unsustainable current account deficit in coming years. Indeed, a lasting improvement in competitiveness could be achieved only when a change in the nominal exchange rate was accompanied by appropriate financial and structural policies. It was of the utmost importance that Italy's inflation differential with other industrial countries be reduced to a more acceptable level and that a restrictive monetary policy be supported by adequate fiscal restraint.

Further reduction of energy imports certainly would help to improve the balance of payments position of Italy over the medium term, Mr. Sugita pointed out. Energy conservation would be strengthened further by more realistic pricing of electricity and natural gas.

The relative importance and weight of large public corporations in the structure of the Italian economy was a major issue, Mr. Sugita went on. How efficient were those public corporations? To what extent were they the source of the public sector deficit? Exposing them to more competition and privatization would promote efficiency.

Mr. Goos said the Italian authorities should have taken the opportunity in the latter part of 1984 to build upon the quite favorable economic situation prevailing at that time. Indeed, until then, the distinct improvement displayed on various fronts in the Italian economy had given rise to the expectation that previous unsatisfactory performance had come to a definite end. Unfortunately, that expectation had been largely frustrated by more recent economic developments. Thus, unless forceful corrective measures were implemented immediately, the progress made in 1984 could be reversed before the end of 1985, thus putting further distance between the Italian economy and the economic conditions in other EC countries.

The Italian authorities had taken a number of commendable steps--a better harmonization of monetary and fiscal policies, a rationalization of monetary policy, corrective fiscal measures, and modifications of the scala mobile--all of which had contributed to 1984's improvement, Mr. Goos stated. However, more recent trends had suggested that they apparently had fallen considerably short of what was required to tackle the long-standing weaknesses in the Italian economy--the shortcomings of incomes policy and, especially, the lack of control over public expenditures, a problem that continued to be exacerbated by insufficient coordination between spending and revenue raising. Currently, developments in those areas were once again threatening to get out of control. As a matter of the highest priority, the authorities should tackle the fundamental weaknesses in their economy at present, when external and domestic circumstances were relatively favorable and, the economic and social costs of adjustment were relatively low. As suggested by the disquieting outlook for 1985, those costs could not but be greatly exacerbated by further postponement of necessary adjustment.

The liberalization measures taken in Italy's external sector had been steps in the right direction, Mr. Goos commented; however, further decisive steps should follow soon, particularly those to reduce controls on external capital flows. It was disappointing that the authorities, noting the existing weakness of the balance of payments and other constraints, envisaged only a limited scope for fuller liberalization of capital controls in the near future. That course appeared somewhat puzzling, given Italy's commitment within the EC to phasing out the remaining capital controls through the end of 1986.

Mr. Salehkhou observed that even though the prospects for 1985 seemed less promising than in 1984, economic and financial performance in Italy had significantly improved in the previous 18 months. The encouraging real rate of growth of GDP, which at 2.6 percent had been generally higher than in most other European economies, had compared favorably with the 0.7 percent cumulative decline recorded over the previous three years. Moreover, the rate of increase in the cost of living had decelerated from 12.5 percent in early 1984 to only 8.7 percent by the end of the year. Although the overall deficit of the state sector had remained very high in comparison with trading partners in Europe, it had registered a modest reduction for the first time since 1980. In addition, the balance of payments position had remained comfortable, despite a shift in the external current account position from a small surplus to a deficit, mostly as a result of weakening international recovery and stronger domestic demand toward the end of 1984.

Italy's performance had clearly benefited from the recovery of international demand in 1983 and 1984, Mr. Salehkhou noted. However, the two main factors contributing to Italy's improved economic performance had been the greater convergence in 1984 of the authorities' fiscal and incomes policies and the monetary restraint enforced by the Bank of Italy since 1981. Strict credit control had encouraged the manufacturing sector to seek major gains in productivity through modernizing production and significantly reducing unit labor costs. Those gains had been strengthened further in 1983 and 1984 by the wage restraint induced by changes in the scala mobile and by less crowding out of private investment following the decline, relative to GDP, of the state sector borrowing requirement.

The adjustment momentum had abated somewhat in late 1984, Mr. Salehkhou continued, and unless some corrective measures were urgently implemented--particularly with respect to state sector finances and more lasting wage restraint--the 1985 targets for inflation, real output, the fiscal deficit, and the external current account did not seem attainable. That concern had been confirmed by developments in the first four months of 1985. Indeed, in spite of the improved performance in 1984, Italy's financial imbalances and structural weaknesses remained significant and continued to call for sustained adjustment efforts to achieve greater convergence with major trading partners in Europe, particularly regarding fiscal and incomes policies.

The escalation of interest payments on the public debt had caused it to grow relative to GDP: the overall deficit of the state sector had soared to 15 percent of GDP during 1981-84, while corresponding proportions in 1984 in the United Kingdom, Germany, and France had been below 4 percent, Mr. Salehkhou remarked. Noninterest expenditures and, more significantly, current revenues, were below the EC average as proportions of GDP. Fiscal adjustment in Italy was being seriously constrained by structural rigidities in the control of expenditures--including transfers to local authorities and social programs--and by a deficient system of tax collection that encouraged large-scale tax evasion. However, in 1984 important savings and revenue measures had been adopted, including efforts to contain tax evasion and unveil part of the underground economy. Nevertheless, the reported decline in the overall deficit had been due mostly to a deceleration in capital spending and to financial operations. Despite the measures implemented in 1985--including restrictions on the growth of expenditures, rationalization of the VAT structure, and efforts to reduce tax evasion--fiscal developments in early 1985 had seemed incompatible with the authorities' targets. Economic developments were also affected by incomes and labor market rigidities. Even though changes in the scala mobile in 1983/84 had reduced the impact of wage indexation on inflation, the effects had been largely nonrecurrent, and a referendum would be held in June on the restoration of the points cut in 1984.

The authorities were aware of the corrective measures needed to strengthen fiscal and income policies and to achieve the 1985 targets with respect to inflation and the state sector deficit, Mr. Salehkhou noted. They were committed to their medium-term adjustment plan, and, furthermore, the positive showing by the coalition government parties in the recent elections should enable the authorities to accelerate implementation of adjustment measures despite the strong political resistance to many of the envisaged reforms. Also, fiscal and structural adjustment should help reduce Italy's excessive reliance on monetary policy, which had been successful in assuring the transition from quantitative monetary controls to a market-oriented monetary stance as well as in reducing inflationary pressures and strengthening the position of the lira among EMS currencies. The cost of that achievement was high real interest rates, which could adversely affect Italy's industrial recovery in the medium term and add to the burden of servicing the public debt. Although the Italian lira had weakened during the first four months of 1985, the maintenance of the large interest rate differential with EMS partners also would be putting considerable pressure on the Italian lira with effects on the economy's competitive position and external adjustment.

Despite a huge state sector debt, Italy's external indebtedness remained very low in terms of GDP and foreign reserves, Mr. Salehkhou commented. Liberalization of exchange controls had continued in 1984 with the easing and virtual abolition of a number of regulations. However, like other countries, Italy maintained large quantitative import restrictions that were particularly directed toward products from developing countries. The recent considerable gains in industrial productivity and overall improvement in external competitiveness should encourage Italy to start removing those restrictions.

Mr. Fugmann said that, after several years of unfavorable developments, economic performance in Italy had improved in 1984. However, the outlook for 1985 and beyond gave rise to concern, particularly about public sector finances, inflation, the balance of payments, and unemployment. As for the public sector, the fiscal deficits for the state sector and the General Government had for several years been very large compared with most other industrialized countries. Even though a more balanced policy mix between fiscal and monetary policies had been introduced in 1984, fiscal performance had weakened in the course of the year. There were serious risks of overruns in budgeted expenditures in 1984, and a significantly larger deficit than targeted could emerge--not a unique development in Italy, unfortunately. Over the years, successive Governments had announced reasonable targets but had had difficulty in bringing about much-needed adjustments. Experience strongly underlined the importance of giving priority to strengthening public sector finances. In addition, further and efficient revenue measures were required, if targets were to be met. Measures to restrain expenditure were crucial, and the link between spending and revenue-raising authorities should be strengthened.

In 1984, the rate of inflation had receded significantly, Mr. Fugmann continued. However, given the most recent developments, the 7 percent target appeared unlikely to be achieved. Moreover, relative unit labor costs remained comparatively high, despite the previous decline. To a large extent, the strengthening of competitiveness in 1984 could be related to productivity gains in the early phase of the recovery and could not be expected to continue. The authorities needed to take additional steps, particularly not allowing changes in indirect taxes to affect the indexation mechanism. That would still not be enough; other steps were required to introduce greater flexibility in wage formation.

The balance of payments was not a matter for immediate concern, even though the underlying trend, in contrast to the authorities' expectations, pointed in the direction of a deterioration, Mr. Fugmann stated. That trend clearly stressed the need for a more restrictive policy stance, including containment of costs and prices. There appeared to be no need for exchange rate action unless incomes policy produced substantially weaker results than expected and price competitiveness deteriorated.

The unemployment rate was still high and was unlikely to be reduced in the near future, Mr. Fugmann went on. It was particularly worrisome to note much higher youth unemployment in Italy than in other industrial countries.

In 1984, Italy's commitment to official development assistance had been .041 percent of GDP, internationally a rather low proportion even though it was on the increase, Mr. Fugmann commented. He wondered why the staff appraisal contained no specific reference to Italy's ODA contribution, and he was also surprised to find the standard statistical appendix missing from the staff report.

Mr. Pérez maintained that the Italian economy had deeper structural weaknesses than the economies of other major industrial countries. Those weaknesses severely damaged Italy's economic situation and had led to a departure from the path followed by its major trade partners. Since the previous Article IV consultation, the authorities had substantially corrected that departure and should be commended for the improvements achieved in growth and employment as well as for the decline in the rate of inflation by nearly 8 percentage points during the previous three years. In general, 1984 had been a favorable year for correcting the main imbalances and reorienting the policy stance. Nevertheless, much remained to be done, particularly at the present critical time in the decision-making process, which should be guided by a high degree of determination.

Despite the great efforts made by the authorities to correct the public sector imbalance, structural rigidities were still an obstacle to eliminating the fiscal deficit, Mr. Pérez continued. In fact, the state deficit had continued an upward trend, and the risk of overruns in expenditures was a major cause for concern. The gains obtained in 1984 were in danger of being lost in 1985. Indeed, the favorable performance during 1984 seemed to have been the result of an ad hoc package of measures that lacked the continuity necessary to consolidate the improvements already made. Whereas the Italian authorities' adjustment effort was based on increasing revenues, the true solution lay mainly in expenditure control. The Visentini package was probably a useful tool for introducing more discipline in tax collection, but it was not enough to offset the estimated deficit. Further measures were needed, especially to restrain expenditure.

The wage indexation system, or scala mobile, had been inflationary, Mr. Pérez pointed out. The policy change to implement indexation based on a projected rate of inflation instead of on the actual past inflation rate had been an important step that had contributed substantially to increasing profit margins by lowering labor costs. However, the expectation that the Government would forecast the correct rate of inflation was an issue that would play a more fundamental role in the future by putting additional pressure on the Government to keep inflation at or below estimated targets. The major threat to the continuation of the current policy was the national referendum on the restoration of the index points that had been cut in 1984. There was also a minor possibility that unions and employers would agree to maintain the current indexation system, or perhaps there would be a tripartite agreement if the Government entered the negotiations in order to make feasible a rate of increase in wages lower than the 10 percent projected in the absence of an incomes policy.

One of the favorable features of Italy's economic performance in 1984 had been the attainment of closer coordination between monetary and fiscal policy, Mr. Pérez commented. The use of credit ceilings as a major monetary instrument, as well as greater flexibility in the management of interest rates through shifts in the discount rate, had been major improvements. In setting the exchange rate policy, the Italian authorities were governed by their participation in the European Monetary System. Intervention policy during 1984 had been made easier by a sufficiently wide interest rate differential. At present, that differential was narrower, and maintenance of the lira's exchange rate within the limits established by the EMS might prove costly in terms of reserve losses. Finally, the authorities' actions so far had given them greater room for maneuver, but they should bear in mind the need to correct the path of public finances.

Mr. Doe observed that following three years of disappointing performance, the Italian authorities appeared to have taken steps in 1984 leading to an encouraging turnaround in the country's economic and financial situation. Because of the revival of private consumption and a significant recovery in fixed investment, domestic demand had strengthened, hence stimulating economic activity. The improvement in total output had been aided by decelerating prices and costs as well as higher business profits. Moreover, the 1984 fiscal deficit had been lower than projected and had compared favorably with the 1983 outturn. In addition, monetary expansion had moderated somewhat, reflecting in part the improvement in the balance of the state sector financial operations, and, on the whole, inflationary pressures had abated somewhat owing to the effects of the better demand management policies and supply performance.

However, in spite of those favorable developments, major weaknesses had remained, Mr. Doe went on. For example, despite the moderation in wage claims and the upturn in overall economic activity, significant gains had not been made on the employment front. The persistent rise in the rate of unemployment to 10.4 percent in 1984 had been a clear indication of the structural rigidities in the Italian economy. It was doubtful that there was any likelihood of a reversal in the uptrend of unemployment in the medium term.

The fiscal sector represented a long-standing weakness in the Italian economy, Mr. Doe noted. Although the state sector had performed better generally in 1984, the latest information indicated that the fiscal deficit could worsen in 1985 and would continue to impose a major constraint on the effectiveness of policies in several other areas of the Italian economy. Indeed, the current trend in expenditures was cause for concern. Resolute efforts should be made to secure the necessary political consensus in order to restrain spending growth. Expenditure control measures should be reinforced and implemented with vigor, and particular attention needed to be devoted to avoiding expenditure overruns. Institutional improvements were needed to bring together a tight relationship between the spending agencies and the revenue-raising agencies. Regarding individual expenditure items, the authorities should be urged to keep the public sector wage bill within targets. Furthermore, lower expenditures on social outlays such as health and pensions might need to be considered in view of the resource constraints. Likewise, improvements in the financial performance of public enterprises were called for in order to reduce their burden on the budget.

Efforts also should be made to improve the revenue base and collection, Mr. Doe continued. The measures to broaden the tax base and reduce tax evasion should be effectively implemented. The pursuit of prudent monetary policies and other income-restraining policies would be useful adjuncts to the more appropriate fiscal policies to be put in place. Finally, he was pleased that Italy had reaffirmed its commitment to attaining the UN target for ODA of 0.7 percent.

Mr. Rye remarked that Italy's economic performance in 1984 had been considerably better than most Executive Directors had expected at the previous Article IV discussion. The staff had concluded that while the improvement had reflected some external factors, it had been due also in no small measure to "better coordinated and mutually reinforcing" economic policies and "a multifaceted policy approach...applied consistently." Most notably, incomes policy had been relatively successful in containing indexation-related wage increases and the rise in administered prices. The reduction of wage increases by 4 index points and the freezing of administered prices and rents had been major influences behind the decline in the rate of inflation in the first half of 1984. In addition, the fiscal and monetary policy mix had been more balanced, and, in contrast to the record of earlier years, the outcome in 1984 for the state sector deficit had not been far off target; indeed, the deficit had declined in relation to GDP for the first time in five years.

The main economic objectives that the Italian authorities had set for the period to 1988--including a deceleration of inflation, a moderation in real interest rates, and a decline in the ratio of the public sector deficit to GDP to be associated with a decline in the ratio of total government expenditure to GDP as well as stability in the ratio of revenues to GDP--were appropriate, Mr. Rye considered. However, the staff had noted that those objectives were "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." Corrective action was clearly necessary in monetary, fiscal, and external policy. He stressed the risk of the authorities' possibly departing from the multifaceted approach and, particularly, of their giving too much weight to monetary policy in trying to bear down on prices and rein in domestic demand. He was concerned that, in the absence of other complementary measures, monetary policy might have to be excessively restrictive.

High real interest rates were necessary at present, mainly to generate sufficient financial savings to cover the General Government's borrowing requirement without increasing the money supply, Mr. Rye went on; high rates also played an important role in financing the current account deficit. However, very high interest rates carried substantial costs. One reason for not wishing to place too much reliance on monetary policy was the role that high interest rates already played in exacerbating the public debt problem in Italy. In fact, interest payments in 1984 had accounted for some 18 percent of general government current expenditure, compared with just 6 percent in 1970. The high, and perhaps increasing, real interest rates resulting from any overreliance on monetary policy carried the undesirable side effect of increasing the public sector debt burden and hence the general government borrowing requirement. Concerted efforts to reduce that borrowing requirement offered the only real long-term solution to Italy's large public debt, which had been nearly 91 percent of GDP at the end of 1984 and for which service payments had perhaps amounted to 10 percent of GDP over the year. As in many other economies, fiscal policies seemed to be the key, and the need was for radical action.

If present trends continued, further corrective action would be necessary to stave off the threat that the deficit in the external current account over the long run might grow to unsustainable levels, Mr. Rye continued. However, he doubted whether "demand convergence" was either a necessary or a sufficient condition for the restoration of a viable external position. Moreover, taken to its extreme, such a policy approach would exacerbate the business cycle if other economies were to move in unison. Of course, inflation rate convergence--downward--was another matter. It was important that the authorities not rely too much on monetary restraint but rather support it actively by making adequate adjustment in the public sector finances and by taking new action on incomes policy.

Neither financing deficits by drawing on deposits nor increasing bank borrowing was a viable long-term fiscal strategy, Mr. Rye maintained. As for wages, rapid increases would have to be brought under control quickly in order to restore Italy's competitive position. In the previous two years, the authorities had shown themselves prepared to move with determination in incomes policy: at no cost to real wages, the measures adopted had been instrumental in promoting a sharp deceleration in the rate of inflation as well as in unit labor costs. However, since the 1984 measures had been of a one-time variety, additional steps would be needed in 1985 if a further deceleration in labor costs and inflation were to be achieved. The prospects for incomes policy in 1985 were clouded by the failure of unions and employers to agree on wage determination and by the upcoming referendum, which could result in the restoration of the index points cut in 1984. In those circumstances, it was essential that the authorities should take a more determined and active stand in achieving wage moderation.

Mr. Abdallah said that the performance of the Italian economy had improved in 1984. The reinforcement of a cautious monetary policy through fiscal restraint and supportive income policy measures had enabled 2.6 percent growth in GDP, reversing two years of declining output, while the inflation rate had been reduced by more than 4 percentage points to 10.7 percent. Growth in unit labor costs in manufacturing had fallen sharply to 3.9 percent, reflecting a deceleration in wage increases and a substantial improvement in productivity. The expansion of domestic demand in 1984, a welcome development, had helped to broaden the base of the recovery; in particular, the recent increase in business investment would provide momentum for sustained growth. However, the accompanying decline in foreign demand, with its adverse consequences for merchandise trade and the current account of the balance of payments, re-emphasized the need to improve the competitiveness of Italian manufacturing. That improvement could be brought about by an appropriate combination of financial and exchange rate policies coupled with continued moderation in costs and prices.

Progress had not been satisfactory in a number of areas where difficult problems persisted, indicating a clear need for continued corrective measures, Mr. Abdallah indicated. With the state sector constituting a dominant part of the economy and its deficit amounting to 15.4 percent of GDP, no lasting improvement could take place in the situation until that major imbalance was redressed. Thus, the urgent need for strong action on the fiscal front should be stressed. The recent revenue measures enacted by the Government were well conceived but needed to be strengthened by further measures to broaden the tax base in order to increase public revenue in relation to GDP; the ratio was significantly lower in Italy than in other EC countries. Furthermore, a lasting improvement in the fiscal position would require deceleration in the growth of current expenditure and a willingness to tackle institutional weaknesses that hampered effective control over expenditure.

Another issue of concern was high unemployment, Mr. Abdallah continued. Despite a considerable deceleration in wage increases and a noticeable fall in unit labor costs, the unemployment rate had accelerated in 1984 to 10.4 percent. While demographic factors and increased participation in the labor market might have contributed to rising unemployment, the persistence of such a high rate of unemployment might also indicate the existence of structural rigidities in the labor market. Achieving an ongoing improvement in employment would depend largely on addressing those rigidities, including a further reduction of indexation, liberalization of employment procedures, and improved wage determination mechanisms.

On the basis of recent policy developments, the outlook for 1985 was uncertain, Mr. Abdallah went on. While GDP was expected to grow by about 3 percent, inflation and wage increases were likely to exceed the targeted limits, thus contributing to a further worsening of competitiveness. To achieve their 1985 economic objectives, the authorities must maintain a constrained monetary policy supported by appropriate adjustment in the Government's fiscal position and additional measures in income policies. Finally, the Italian authorities were to be commended for progressively increasing the level of assistance extended to developing countries.

Mr. Sengupta pointed out that Italy's economic performance in 1984 had been in line with the trends in practically the entire industrial world. As an attempt to reorient policies and to sustain medium-term adjustment, Italy's economic record in 1984 contrasted with the negative or low economic growth performance in the three previous years. Positive growth rates often proved to be temporary, but many elements of Italy's 1984 economic performance constituted a potential for continued good performance in the coming years: the marked recovery in domestic demand, the buoyant expansion of fixed investment, the sharp deceleration in the increase in unit labor costs in manufacturing, the flexibility introduced in the conduct of a monetary policy that was basically restrictive, and the moderation in wage increases. After two years of negative real GDP growth, positive growth of 2.6 percent had been recorded in 1984, and the fall in the inflation rate to about 10.7 percent from 15.1 percent in 1983 had helped to abate inflationary expectations. Unfortunately, those developments did not seem to have made much of a dent in unemployment.

There were still some areas of concern to the authorities, Mr. Sengupta indicated. The state sector deficit had been brought down from 16.4 percent of GDP in 1983 to 15.4 percent of GDP in 1984, largely through a sharp deceleration in capital expenditures and transfers to public enterprises. If the reduction of transfers had caused public enterprises to finance their deficits through bank borrowing, then there had actually been no reduction of those deficits. Equally worrisome in 1984 had been the widening of the trade deficit by about Lit 8 trillion to Lit 19.2 trillion. Fortunately, Italy's competitiveness was stable, even though its exports to EC and some OPEC and CMEA countries had shown no improvement and most of the export growth had been due to the larger U.S. absorption helped by the high value of the dollar.

In the latter part of 1984 and in early 1985, some disquieting features had been in evidence, Mr. Sengupta commented. The external accounts had deteriorated, mainly on account of a steep increase in imports, and the deficit of the state sector in the first four months of 1985 had increased. There had also been a significant rise in liquidity; since the end of 1984, the inflation rate had remained high, with a tendency to move upward. Those developments, together with the uncertainty about the results of the referendum on the scala mobile in June, were worrisome. Nevertheless, the policy orientation for 1985 indicated that the authorities were on the right track, and, indeed, developing countries had a lot to learn from the outcome of the Italian experiment. The correct approach for medium-term adjustment and growth, not just stabilization, was a multifaceted policy framework covering fiscal, monetary, trade, and exchange policies. The multiyear plan for fiscal adjustment postulated improvement in the position of the public finances. The authorities' intention to check the increase in current expenditures and to raise additional revenues through rationalization of the VAT structure was a welcome signal. The approach was to stabilize current expenditures in real terms but to allow a rise in capital expenditures in pace with the increase in nominal GNP in order to provide the desired impetus for growth.

There had been considerable flexibility in monetary policy, as shown by the authorities' willingness to use interest rates as a way to deal with the evolving trends in credit growth and the external current account without losing sight of the need to influence broad monetary aggregates, Mr. Sengupta considered. A moderately restrictive stance was indicated by the intention to limit credit expansion to the nonstate sector and to keep money supply expansion in line with projected nominal GDP growth.

The authorities' objective of keeping the rise in labor costs to the target rate of inflation was commendable, Mr. Sengupta added. It would be interesting to learn the outcome of the referendum on the scala mobile.

Acceptance by the working class in Italy of an arrangement that might imply a fall in real wages, productivity growth, or a fall in the share of wages relative to profits would have repercussions far beyond the boundaries of Italy. Improvement in labor practices, however, would be pareto optimal: it would benefit both labor and capital, and efforts by the Italian authorities in that direction would be approved by many major industrial countries. The liberalization measures taken in 1984 affecting both current and capital outlays had likewise been beneficial developments. In addition, the trade policy remained generally consistent with EC directives. However, Italy maintained some quantitative import restrictions on some sensitive products, mostly from Japan and developing countries.

In 1983, Italy had reaffirmed its commitment to attaining in 1984 the UN target for ODA, and its assistance was projected to reach 0.44 percent of GDP in 1985, Mr. Sengupta pointed out in conclusion.

Mr. Chen said that the overall economic situation in Italy in 1984 had improved compared with the previous three years. Particularly significant had been the abatement of inflationary pressures and, after two years' decline, an increase in GNP. As a result, Italy's economic performance was converging with that of its main trading partners. However, the picture that had emerged from the developments of the past few months, taken together with the forecasts for the year 1985, did not indicate that the satisfactory trend in 1984 would continue. Under those circumstances, stronger adjustment policy measures were needed.

Economic policy in Italy during recent years had been characterized by its restrictiveness in intent but its ease in practice, Mr. Chen remarked. The state sector had been unable to reduce its borrowing requirement. With such a continued expansionary fiscal practice, the brunt of adjustment had had to fall upon monetary policy, which had become in fact the main plank of the short-term economic policy. Although there had been an active incomes policy, its implementation had not always been consistent with other policies. During 1984, the Government had again tried to coordinate its macroeconomic policies so as to have a more balanced mix of fiscal and monetary policies. The 1984 budget had been regarded as ambitious, and there had initially been some uncertainty about the extent to which it would be implemented. In fact, the implementation had been successful, and the borrowing requirement of the state sector had declined in relation to GDP for the first time since 1980. However, the situation appeared to have deteriorated toward the end of 1984. For 1985, the main objective of the Government continued to be the reduction of the budget deficit; it intended to contain the overall deficit of the state sector to the equivalent of 14.7 percent of GDP, 0.7 percent lower than the figure attained in 1984. That intention contrasted with an estimated increase in the deficit to 17.6 percent of GDP. If that estimate turned out to be correct, the state sector deficit and the rise in the real debt burden would continue to impose a heavy burden on the economy in 1985. In that eventuality, the main role would again be played by monetary policy, which would remain restrictive.

Experience had shown that to rely mainly upon monetary policy for adjustment purposes would have further unfavorable effects on other parts of the economy, Mr. Chen reported. That was particularly true in the present Italian situation. During 1984, there had been changes in the use and mix of monetary policy instruments. The monetary authorities had been moving increasingly away from control by applying direct credit restrictions to control by relying upon changes in interest rates. They hoped that, by raising real interest rates, they could induce households to save more, which would make nonmonetary financing of the public deficit possible. Although that policy was certainly welcome, it involved costs that should not be ignored. First, raising real interest rates would have an adverse impact upon the real burden of public debt, particularly in the present phase of disinflation. Second, the high rates would adversely affect private fixed investment and residential construction, which had begun to recover only in 1984 after declines in the previous three years. Third, higher real interest rates in Italy would tend to attract inflows of capital that would, in turn, lead to pressures on the exchange rate.

The main economic risk in 1985 remained inflation, Mr. Chen said. An improved mix of fiscal and monetary policies was required to preserve the present downward trend in inflation. However, to be effective, that mix would have to be supplemented by an appropriate incomes policy. Rates of increase in prices and wages had fallen substantially in 1984, and inflationary pressures had also fallen, as a result of the measures taken by the Government on the wage and price fronts such as the reform in the sliding wage scale and freezing of rents and public utility charges. It was hoped that the negotiations between the social partners in 1985 would make more progress than in 1984; otherwise, wage moderation might not be easily preserved. In the longer run, the achievement and maintenance of wage moderation would have to be built upon consistent measures to reduce structural rigidities in the labor market, increase tax equity, apply appropriate methods to determine incomes, and adjust prices in the services and commercial sectors. Naturally, an increase in labor productivity would always be an important factor in moderating the rise of wage costs; indeed, it had contributed significantly to the reduction in prices in 1984.

A prompt implementation of coordinated measures for internal adjustment would bring about the necessary adjustment in the current account deficit that had become excessive and unsustainable in the longer run, Mr. Chen reported. Those adjustment measures would have to reduce domestic demand for imports and increase the competitiveness of Italian exports. In contrast with other similar cases, devaluation had not been regarded as an important instrument for stimulating exports.

Mr. Jensen remarked that the Chairman's summing up of the previous Article IV consultation with Italy (EBM/84/17, 1/27/84) had reflected the Executive Board's concern that the Italian authorities in recent years had not dealt effectively with the structural problems or the distortions in the economy. At that time, the Executive Director for Italy had recognized that the situation of the public finances in Italy had indeed been serious but had stressed his authorities' readiness to implement the necessary measures to correct it. Adequate corrective measures needed to be implemented quickly to avoid a return to sluggish growth, rising unemployment, and an accelerating rate of inflation. There were some areas of improvement during 1984: output had recovered after three years of recession, with GDP growing at 2.6 percent; the rate of inflation had decelerated to 11 percent for the year, but had still remained substantially above that of the main industrial countries; and developments in the overall balance of payments and international reserves had been relatively favorable. Nevertheless, the fiscal imbalances and structural weaknesses were at the core of the economic problems in Italy, as well as those in many developing countries implementing adjustment programs.

In Italy, Mr. Jensen went on, the public sector deficit imposed a heavy constraint on economic policy: its weight had grown continuously since the early 1970s in spite of the authorities' efforts to stabilize or even reduce it. The results had been a mounting public debt--currently equal to over 90 percent, the percentage of GDP, compared with an average of 51 percent for the seven main OECD countries--that ultimately had restricted the room for policy maneuver by working against the reallocation of resources to productive sectors in the economy. Therefore, the excessive growth of public expenditure and the widening of the public sector deficit were the primary causes of Italy's unsatisfactory performance, particularly compared with other countries in Europe. In addition, the slight statistical improvement in the fiscal accounts in 1984 appeared to have been due to ad hoc procedures such as delays in disbursements and imaginative financial management. Once again, a decision was not being taken for more lasting action to eliminate the imbalance.

Expected developments for 1985 were worrisome; the rise in the public sector deficit to 17.6 percent of GDP, compared with a targeted 14.3 percent, was particularly disappointing, Mr. Jensen indicated. The growth of the public sector deficit continued unabated, as total expenditures were again increasing in real terms and were expected to reach 60 percent of GDP; and as a consequence, the state sector's share of total credit was expected to be nearly 70 percent, thus continuing the crowding out of the private sector. Those major imbalances had an important effect on economic vitality, public perception, and business confidence. Needless to say, such significant financing requirements negatively affected interest rates and growth.

As for exchange controls and trade policy, the virtual abolition of controls on Italian tourist expenditure abroad as well as on some foreign capital transactions were welcome, but little progress had been made in adapting trade policies, Mr. Jensen remarked. Italy's general support of an open multilateral trading system contrasted with its lack of action to reduce trade barriers, which not only had detrimental effects on Italy's adjustment efforts and domestic resource allocation but also were damaging to the adjustment efforts and growth prospects of many developing countries. Even more worrisome were the authorities' claims that the existing import restrictions were necessary to contain pressures for even greater protection and that an improved international environment was a prerequisite for more liberal trade policies. If those excuses were used by other industrial countries, the prospects for improvement in developing countries would definitely be gloomy.

The effort to increase official development assistance in spite of Italy's economic difficulties was a feat well deserving other countries' emulation, Mr. Jensen said.

The Director of the European Department remarked that fiscal policy was the core of the economic problem in Italy. At the heart of that problem was a central, two-sided question: what could be done to secure more effective control of expenditures and more efficient collection of revenues? In the abstract, it might be easy enough to contemplate what could be done if the decision-making process on both the tax side and the expenditure side could be brought together within one ministry, under a single minister, who would retain overall responsibility and be supported by the Prime Minister. In that case, a better result could be hoped for. However, that was not the position in Italy and was unlikely to be so in the coming period. Therefore, any changes would have to be obtained on the tax side through the Visentini package, which had been bitterly attacked in Parliament but had emerged largely unscathed, a significant achievement. In the process, a lobby against tax evasion had been built up on the scale that had been practiced by certain groups in the economy, a positive development. The next step, of course, was to see what, in fact, the package would produce, and that would not be known for some time.

The lack of control by the Ministry of the Treasury on major expenditures had been emphasized correctly, the Director said. For example, if nothing were done to change the trend, pension payments would not only rise, but rise quite noticeably as a proportion of GNP in coming years. Interestingly, a blueprint to change the pension system had been drawn by the minister responsible, but it had not secured the necessary backing. The Government, having refused to accept a much weaker substitute, had insisted on its withdrawal.

The estimate of a budget deficit of 17.6 percent of GDP was based on present policies and was not the target of the Italian authorities, who were determined to seek to reduce the state sector deficit to 14.7 percent--a figure 1 percent lower than he thought possible--the Director continued. It was difficult to judge the prospects for 1985 and to know what measures would get the budget back on track in the current year. In some sense, it would not be at all unusual--even before the elections--if some measures were anticipated and pushed forward. It was also difficult to know the extent to which some of the recently taken expenditure decisions would affect developments in 1985 and 1986. The target in the medium-term plan was for no real increase in noninterest payments; however, it was questionable whether that target was sufficiently ambitious. Indeed, it was questionable on two fronts. First, outlays in such important areas were clearly going to rise unless quite drastic action were taken; consequently, the overall expenditure target could be achieved only if real reductions were secured in other areas of current expenditure. Second, the target of no real rise in noninterest payments was predicated on certain basic assumptions, including rates of real growth and real interest; however, for the period until 1988--the period covered by the projections--it was doubtful that real growth and real interest would behave as predicted. Indeed, all the calculations were extremely sensitive to those two particular assumptions.

It would not be fair to be entirely negative as to what had happened on the budgetary situation in the last two months, the Director maintained. The move to a central Treasury had had its cost, as was obvious in the different trends in the state budget and the general government budget. Nevertheless, it must be regarded as a positive step, and it did promise to provide in the future a better control by the Ministry of the Treasury over expenditures of peripheral public entities.

A question had been raised as to what extent the current expenditures were discretionary, the Director continued. That was a difficult question to answer because of what should be seen as "discretionary"; for instance, the initial projections had assumed changes in the pension plan that had not actually been made. It was at least debatable whether such changes constituted a discretionary action or not. What was clear, however, was that the increases over the last several years had been due mainly to automatic mechanisms and to some extent to inadequate control over the peripheral public sector institutions. Another worrisome cause for the increases had been the failure to keep wage increases in the public sector within the original targets.

The central question of monetary policy was how to characterize the stance of that policy, the Director remarked. To begin with, the targets had regularly been exceeded. Nevertheless, it would be correct to regard monetary policy as having been less than accommodating over the past several years--particularly considering the level of real interest rates. However, the monetary authorities in Italy had constantly been faced with the fact that the initial projections for public sector credit had been exceeded during the course of the year. Sometimes, as in 1984, the excess had become visible and quantifiable only in the latter months of the year. Still, the dilemma was a very real one: it was whether to seek to meet the overall targets by constraining credit to the private sector at a time when it already might be too late in the year to do so; even if constraining credit were successfully accomplished, the private sector would then be squeezed through interest rates, which had a direct effect on the fiscal position. Executive Directors should, however, avoid an alarmist view, as many public sector expenditures seeped out in one way or another to the productive private sector, albeit to the less productive parts of that sector.

Questions had been raised whether the correct aggregates had been looked at, the Director commented. In Italy, there were a considerable number of medium-term and long-term financial instruments whose interest rates were tied to short-term instruments. Therefore, it was questionable to what extent such instruments were liquid. No doubt they were important instruments used by the public sector--which to some degree must be regarded as partly liquid--but the authorities' ability to control the evolution of those instruments during the course of the year was limited. The Central Bank was correct in looking at the monetary base with a careful eye on developments in the credit aggregates as the data became available. Of course, as the external position weakened, the importance of credit aggregates grew. Furthermore, the Bank of Italy was correct in worrying considerably about the development of the overall financial assets ratio. Recently, the public had been increasing its holdings of financial assets, particularly government paper. There had been concern for some time about how much further that increase could go and about its implications for interest rates.

The credit targets for 1985 had not looked particularly restraining when they had been formulated, the Director pointed out. However, given the developments that had occurred since then--developments partly in the policymakers' minds at the time--they had become restraining.

As regards the effects of the scala mobile, the Director remarked that with rates of inflation between 8 percent and 10 percent, a degree of indexation of 50 percent did not hinder real wage flexibility. However, there was increasing concern about the compression of wage differentials that resulted from that mechanism. In addition, first, in a period of decelerating inflation, even with 50 percent indexation the carry-over from the previous year of higher inflation to the next year absorbed a large share of the targeted increase in wages. Second, as in many countries with wage indexation, the scope for maneuver and bargaining of trade unions was limited in Italy. Therefore, the trade unions' energies were concentrated on nonwage compensation. It was not at all clear whether that was a satisfactory result in the end.

There had been a number of possibilities for change widely discussed in Italy, such as the exclusion of direct taxation or import price changes from the scala mobile index, the Director went on. Indeed, all suggestions for change in the scala mobile would move it to longer intervals or even eliminate it. However, it was difficult to envisage much being done in 1985, except in the form of a package deal, as had been done in the previous year. Clearly, the danger of a package deal was that those responsible might decide to give away on the fiscal side more than was justified. Nevertheless, the experience in 1984 had been a positive one, in that long-standing discussion of indexation had reached a stage where all the social partners had accepted the argument that the system as it had once existed had had pernicious effects.

Even though there was no legal minimum wage, there was extensive youth unemployment in Italy, the Director indicated. However, there was a series of contractual agreements--covering particular sectors of the economy--that included minimum wages. Consequently, making that system more flexible might be a way to reduce youth unemployment. However, the prospects for overall employment remained uncertain. The demographic pressures, the rising participation rates, and the prospects for the growth of the real economy were not such as to hold out any hope of change in the unemployment situation in the short to medium term. Although it was acknowledged that employment in industry had fallen by perhap 10 1/2 percent over the previous four years, the figure would have been larger still if the people covered by wage supplementation had been taken into account. Moreover, the decline in employment in industry had been largely compensated for by an increase in employment in services. On a more precise level, the unemployment figures were likely to be overstated and did not take into account employment in the underground economy.

Figures indicated a rise in investment of the autonomous public agencies, the Director reported. However, total public investment had fallen. Investment had been particularly strong at the local level and perhaps in some of the public enterprises. In addition, there were plans to privatize some of the public agencies.

The overall deficit of state-owned enterprises had not changed greatly in 1984, the Director noted: it had been equivalent to 1 percent of GDP, after taking into account transfers for the budget equal to another 1 percent of GDP. In 1983, enterprises with some state participation had recorded an overall deficit of about 1 percent of GDP; transfers from the state budget to these enterprises had been equal to about 3/4 of 1 percent of GDP. However, there had been a marked improvement for the enterprises with state participation in 1984, when both the deficit and the budgetary transfers had been approximately halved. Administered prices had risen in 1984 over 1983 more or less in line with the increase in the consumer price index. However, during the year they had grown something like 1 percentage point less than the consumer price index because of restraints imposed during 1984. All together, the public tariffs had been rising from a rate of about 20 percent in the CPI; so the effect in the CPI had been minor. Also, the effect on the budget was minor, perhaps equivalent to 1/4 of 1 percent of GDP.

A case could be made for looking more closely at the striking regional diversities in the Italian economy, the Director remarked. That case would become stronger because the whole approach to the development of the south was being changed. It seemed best to analyze the diversities when that new approach was properly in place.

Foreign trade had increased markedly as a percentage of GDP, from 10 percent in 1981 to about 50 percent at present, the Director continued. In the previous ten years, exports had been concentrated in products for which demand had been weakening somewhat; for example, footwear accounted for over 50 percent of Italy's total exports to other OECD countries, and clothing for 25 percent. However, in the most recent past, there had been a shift in the Italian exports of those and other items toward the higher price ranges. Consequently, the development of new export industries was important because Italy had been shifting the concentration of its production into areas where prices were higher and profits were higher.

The current account developments were not alarming, the Director said. The swing between 1983 and 1984 had been equivalent to 1 percentage point of GDP. However, another deterioration of approximately 3/4 of 1 percentage point was forecast for 1984-85. Although that trend could not be sustained for long, it needed to be contrasted with the weakness in the balance of payments in 1980, when the swing had been equivalent to more than 3 percent of GDP.

Except for diesel oil, energy prices in Italy exceeded those in all other countries for which a comparison had been made, the Director remarked. Because of difficulties in the development of nuclear power plants, the Italian Government was far behind in its energy development plans. However, since the opposition to the construction of nuclear power plants was not as strong in some areas as it had been, that situation was changing somewhat. Regarding energy prices, the Italian authorities had exerted control over production prices of the refineries, a practice that at times had led to some bitterness between the main refining companies and the Government, with the companies claiming that the margins in Italy were significantly less attractive for them than in other countries.

Nineteen eighty-four had been a positive year in many respects, and important achievements had been recorded, especially with regard to indexation and the Visentini reforms, the Director of the European Department commented. Unfortunately, expectations appeared currently to be worsening, possibly placing in jeopardy the achievements of 1984.

The Executive Directors agreed to resume 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/85/78 (5/22/85) and EBM/85/79 (5/24/85).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 84/124 through 84/126 are approved. (EBD/85/129, 5/17/85)

Adopted May 23, 1985

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/133 (5/21/85) and by an Advisor to Executive Director as set forth in EBAP/85/134 (5/22/85) is approved.

APPROVED: March 4, 1986

LEO VAN HOUTVEN
Secretary