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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

June 17, 1974

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Enclosed for your information is a copy of a memorandum on the Italian economic situation by Mr. Lubitz of the Board's staff, dated June 12, 1974.

Enclosure

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 12, 1974

To Mr. Ralph C. Bryant

Subject: The Italian Economic Situation

From Raymond Lubitz

CONFIDENTIAL (FR)

Recent Economic Developments

The major features of the recent economic situation in Italy have been a strong recovery of output since mid-1972 (interrupted by work stoppages in the first four months of 1973), and a steady worsening of the balance of payments and the rate of inflation. After a period of slow growth since 1969, real GNP rose by 5.9 per cent in 1973 over 1972. Industrial production in 1973 Q-IV was over 11 per cent higher than a year earlier. Real wages rose sharply during 1973, and the unemployment rate fell. Real capital formation, which had stagnated for 3 years, increased by nearly 10 per cent over 1972. Consumer prices accelerated throughout 1973 and into 1974, except for a brief remission in August-October 1973, reflecting the price freeze imposed in July. In April 1974 the year-over-year increase in the CPI was 15.5 per cent, perhaps the highest in Western Europe. The February 1974 WPI was 39.3 per cent higher than a year ago.

With the resumption of economic growth, the balance of payments worsened dramatically last year. In 1972 the trade balance showed a slight surplus; and the current account, because of the usual surpluses from tourism and emigrant remittances, was very favorable. For 1973 the (estimated) deficit on trade account was $3.34 billion (at the conversion rate of 583 lire=$1), and that on current account[1] was $2.15 billion.

1/ After subtracting from the recorded deficit unrecorded capital flows through the current account (using the IMF calculations).

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The deterioration on trade account resulted from a strong increase in imports which was greater than a substantial export increase. On customs basis, imports rose by 44 per cent and exports by 19 per cent. The large increase in imports reflected both a strong growth in volume associated with the economic upswing and the sharp rise in the world price of food and raw materials.

In 1973 the official settlements deficit, adjusted for compensatory Euro-dollar borrowing by state-controlled enterprises of over $4.4 billion, was $4.8 billion. Despite the very large amount of intervention, the commercial lira, which has been floating since January 1973, depreciated about 15 per cent from January 1973 to February 1974 (on a trade-weighted basis).

The oil crisis has transformed a difficult situation into a critical one. The oil-price increases were expected to cause the current account to worsen by $5.5-6 billion. Thus the current account deficit would be about $7.5-8.0 billion in 1974. A U.S. current account deficit bearing the same relationship to our GNP as the Italian deficit to Italian GNP would be about $75 billion!

The trade data available so far this year are on a "foreign exchange basis" (with imports valued c.i.f.), and they are not seasonally adjusted. Therefore, they cannot be directly compared to the 1973 figures cited above or to the 1974 forecasts. Still, it is clear that they imply a substantial worsening of the trade account over last year's already serious outcome. In 1973 the deficit on the foreign exchange basis was about 3400 billion lire for the entire year, while for the first 4 months alone of 1974 the

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deficit is estimated at nearly 2800 billion lire, or 8400 billion lire at an annual rate. This deterioration of about 5000 billion lire (over $7.5 billion) in the trade deficit surpasses the most pessimistic forecasts for the 1974 deficit on current account. However, it should be noted that some of the deterioration is probably due to an increase in unrecorded capital outflows through the trade account as well as increases in the non-oil trade deficit. If the deficit does continue at the present level, the current account deficit for 1974 (on an economic basis and adjusting for unrecorded capital flows) would be about $9 billion at an annual rate. Official exchange-market intervention has been running so far this year at roughly $1 billion per month or $12 billion at an annual rate, implying an annual capital outflow of around $3 billion.

Economic Policy Issues

Economic policy in Italy in the last few years must be seen against the background of the stagnation of output and investment in 1971-72 (see table) and the social strife and widespread work stoppages of 1969 and later. To encourage recovery, the Government followed a monetary policy of extreme ease, increasing the money supply (M_1) by nearly 20 per cent per annum over 1969-72. The budget deficit (which has not primarily been used as an instrument of demand-management) was also permitted to grow as a proportion of GNP. In 1973 the Treasury cash deficit reached 7600 billion lire, about 9.5 per cent of GNP.

Thus, at first glance, it might appear that the deterioration in 1973 of the external balance and the acceleration of inflation was due to overly expansive demand policy. And it is true that the strong rise in the volume

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Italy - Gross National Product and Components - Rates of Growth

	Percent Changes - Volume			
	Average 1965-70	1971	1972	1973
Private Consumption Expenditure	6.5	2.6	3.3	6.2
Public Consumption Expenditure	3.3	4.2	4.6	3.3
Capital Formation	7.3	-4.9	0.4	9.9
Exports (goods and services)	10.6	6.8	11.6	5.3
Imports (goods and services)	14.0	- .0	13.1	11.9
GNP	5.9	1.5	3.1	5.9

Source: OECD National Accounts of OECD Countries; Italian Sources.

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of imports was mainly caused by: (1) the substantial increase in consumer good imports, particularly food, reflecting the sharp increase in real wages, and (2) the increase in industrial materials imports accompanying the recovery of activity. But for most of the year the economy was still below its long-term trend growth of industrial production and GNP, and it would have been hard to justify demand restraint during that time. Also, the increases in world prices account for more than half the increase in the value of imports and a substantial part of the inflation. The depreciation of the lira worsened the inflation. Strong wage pressure resulting from the labor settlements of early 1973 was another significant cost element -- money wages rose by over 25 per cent in 1973. Give the militancy of Italian labor, it is highly unlikely that demand restraint would have significantly reduced the wage settlements.

Because of these cost pressures, and the still fragile recovery, Italy was probably not experiencing excess demand during most of 1973. However, by the end of the year the long-run growth path seems to have been regained and the unemployment rate was down to 3.0 per cent.[1/] The authorities probably continued the policy of rapid money supply growth too long. Their reluctance to moderate this policy sooner is understandable in the light of the earlier stagnation in 1971-72 and the disruptions in the first four months of 1973 (which made it very hard to gauge the strength of the boom).

1/ This is low by the standards of the last decade in Italy, but labor force participation has been falling (in absolute terms) and there is a sizable amount of underemployment so that labor scarcity (except perhaps for skilled labor) probably does not exist.

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A policy of demand restraint is now called for, and as we shall see below, credit tightening measures have been taken, although adequate fiscal policy measures have yet to be adopted. Overall demand restraint will cut the growth of demand for imports of food and raw materials. However, it might have little effect on exports. Manufactured exports did grow reasonably well in 1973, and although some officials have said that domestic consumption is keeping down exports, the major obstacle in 1974 to increasing exports (even if consumption growth slows) will probably be the slow growth of foreign markets rather than capacity pressures.

If the authorities reduce the growth of demand too sharply in the face of cost pressures from wages and raw materials, there may be a heavy cost in reduced output and employment. If social strife breaks out, the Italian economy will again suffer from stagnation and weakened confidence; these conditions will again lower domestic investment and intensify capital flight. Even at the cost of prolonging the inflation and external deficit, it seems more reasonable to follow a gradual policy of restraint.

The Italian authorities have taken a number of measures to deal directly with the balance of payments deficit -- such as tightening controls on capital outflows and the import deposit measure (to be discussed in detail below). However, they have not allowed the lira to continue to depreciate. They apparently want to finance the overall deficit in the balance of payments and expect that the past depreciation and slower growth will remove the non-oil deficit. The Italians have decided not to allow the lira to continue to float downward (and are paying a high price in the

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process), not because of any commitment to fixed rates as such, but apparently because they think the lira is now at a roughly correct level. However, they think that the benefits of past depreciation have not yet materialized, and any further floating will cause an unnecessary depreciation and further inflation. The Government's attempt to buy labor peace involves a promise to the unions to try to curb the rate of inflation; a further impulse to price increases through the exchange rate could touch off more wage claims and activate escalator clauses (which are widely used in labor contracts), thereby partly wiping out the favorable effect of the previous depreciation. Moreover, given the lack of confidence in the lira, a temporary further depreciation may be as likely to lead in the short-run to destabilizing capital outflows as to stabilizing inflows.

The Italian Government declared in the March 1974 letter of intent to the IMF in connection with the IMF standby credit, that the then current exchange rate was sufficient to maintain Italy's competitive position; however, the authorities did not want to preclude further exchange rate changes if they should be needed, and therefore also stated that, "it is necessary to continue the flexible exchange rate policy." In fact, the effective exchange rate, after falling sharply in January and early February, has remained fairly stable since mid-February, i.e., since the time of the discussions between the Fund staff and the Italian authorities.

It is, of course, still highly uncertain whether the current exchange rate is the "correct" one (defined, say, as the rate which would in time eliminate the non-oil deficit and some part of the oil deficit). The factors

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causing the 1973 deterioration of the trade account -- the world price increases and very strong Italian growth -- are not operating this year on the same scale (excluding oil), so that a restrictive demand policy and the present exchange rate might reduce the deficit to an acceptable level. It seems to me preferable to test such a policy before risking further inflation through further lira depreciation.

Domestic Policy Measures

The Italian authorities have taken a series of measures this year to slow the expansion of the economy. In the letter of intent to the IMF the authorities agreed to limit the Treasury cash deficit in 1974 to 9.2 thousand billion lire.[1/] Control over Government expenditure and taxation is difficult to achieve in Italy, and the authorities' undertaking to limit the growth of the deficit will not be easy. There is agreement across a wide range of the political spectrum in Italy that the expansion of non-productive Government spending must be controlled and that taxes, including taxes on wages, must be raised in order to curb consumption and promote investment. In an attempt to achieve this task the authorities have been trying: (1) to increase tax collections by accelerating some tax payments, improving the collection of existing taxes, and increasing tax rates; and (2) to reduce Government expenditures by reducing the deficits of local authorities, the social security administration, and state-owned enterprises. Before the last Government fell, the cabinet was discussing

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1/ This deficit will probably be around 10 per cent of GNP in 1974. It should be noted that the deficit on National Income basis (which excludes Government capital formation) would be smaller. Also, the Italian authorities argue that given the very high household savings rate in Italy -- 21 per cent of disposable income in 1970-72 -- a large Government deficit (although not of the present excessive size) is needed as an offset.

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a series of measures that would have significantly tightened fiscal policy by raising Government revenues by an amount which has been variously estimated to be between 2000-3000 billion lire. There were proposals to increase the Value Added Tax as well as the income tax. In addition, public utility rates were to be increased. The status of these proposals is now unclear, but it seems likely that any successor Government will have to adopt a tighter fiscal policy.

In the present situation, the main burden of restraint will continue to devolve on monetary policy. In the letter of intent to the IMF, the authorities agreed to restrain the growth of domestic credit (defined as total credit extended to households, enterprises and Treasury for own use) to 22.4 thousand billion lire for the year ending March 31, 1975. The financial program of the authorities includes a projected increase in the broadly defined money supply of about 18 per cent for the year ending March 1975. Although this increase is greater than the forecast increase in nominal GNP of 14-15 per cent, the Italian authorities argue that since the ratio between the two rates of growth is below the post-war average ratio this implies a fair amount of credit stringency.

The authorities have taken a number of credit-tightening steps consistent with the letter of intent. On March 20, the basic discount rate was raised from 6.5 to 9.0 per cent (it had been previously raised in September 1973). The penalty rate for repeated borrowing remains 3 percentage points above the basic rate, thus the marginal borrowing rate has increased to 12 per cent. On April 8, the authorities set a global

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limit on the expansion of bank credit of 15 per cent for the year ending March 1975.[1/] The impact of these measures, especially if the GNP deflator does increase at the expected rate of about 10 per cent, seems likely to be a slow down of the rate of growth of real output from the 5.9 per cent of 1973. These measures (as well as the import deposit measure to be discussed below), have had a noticeable effect on interest rates. For example, the commercial bank prime lending rate which was 11.5 per cent in March reached 15.5 per cent in June and other interest rates have also climbed. There is a great deal of financial comment about the tightness of credit. The Socialists within the previous governing coalition and the unions expressed strong opposition to the policy of demand restraint and one center-left government fell over this issue. The Government and the unions were on a collision course as widespread strikes had begun again in protest against the restrictive policy.

Prior Import Deposits

The Government has taken steps to deal directly with the external deficit. It has imposed limits on the imports and exports of Italian banknotes and on the amount of foreign exchange that Italian tourists can purchase. The most important measure, prior import deposits, was announced on April 30 and modified at the end of May.

Originally, Italian importers were required, for all goods covered by the measure, to deposit for 6 months a sum equal to 50 per cent of the value of imports in a non-interest-bearing account at the Bank of Italy.

1/ Within the overall limit, certain sectors are exempt -- electricity, railways, and imports of raw materials by state enterprises; also various sectors have different ceilings within the global 15 per cent.

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Capital goods and raw materials have been excluded from both versions of the measure. The plan was originally supposed to apply to a wide variety of agricultural goods. However, the Italians agreed to an EEC proposal to exclude most agricultural goods except beef (and a few other agricultural goods) which will be subject to a 25 per cent deposit requirement. The 50 per cent requirement now appears to apply mostly to manufactured consumer goods. In the original version the Government calculated that 41.5 per cent of the value of last year's imports would be covered; no new caluclation has been made public, but probably a much smaller proportion of imports now comes under the scheme. When the measures were modified the EEC Commission devalued the agricultural lira (i.e. the exchange rate used under the Common Agricultural Policy to calculate the lira price of agricultural goods) raising the Italian local-currency price of the goods and discouraging consumption. The Italians stressed originally that the deposit scheme would not discriminate between EEC and non-EEC imports; and the EEC Commission has said that the new agricultural provisions are also non-discriminatory. Italian officials have said that the measures are intended to be temporary, but have not given a specific time limit.

The Bank of Italy announcement of the import deposit plan gave three reasons for the action: (1) to absorb domestic liquidity, (2) to reduce imports, and (3) to discourage capital flight occurring through the overinvoicing of imports. In addition to the stated reasons, other consequences (e.g. short-term capital inflow through foreign financing of imports) could also result from the measures. However, it should be noted

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that there are trade-offs between the different objectives of the scheme; e.g., the more that the value of imports is reduced, the smaller the liquidity effect, and the greater the foreign financing, the smaller the effects on trade and domestic liquidity.

The deposit requirement can be translated into an equivalent *ad valorem* tariff. The cost to importers of the deposit is the interest paid to raise the money, or foregone earnings. Assuming that the borrowing rate is 16 per cent (slightly above the prime rate), the interest cost of a 6-month deposit of 50 per cent of the value of imports is (1/2) (1/2) (.16) or 4 per cent of the value of the imports. A 4 per cent tariff surcharge on even 40 per cent of total imports is not likely to have a very great effect on the level of imports. The Bank of Italy originally estimated the effect to be 350 billion lire, less than 2 per cent of the 1973 level of imports, and 10 per cent of that year's trade deficit.

However, the direct trade effects may be stronger than the tariff calculation would suggest. The deposit requirement must be seen in the context of the overall credit restraint program. If credit is tight already, the need to raise additional loans to finance imports may have a very substantial effect, not through the increased costs of imports, but through the unavailability of credit to finance them. The complaints from the business and financial community about the measures indicate that they will intensify an already tight credit situation.

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Italian authorities have been arguing that the deposit scheme is primarily intended to absorb liquidity. This effect can be quite strong. The measure would tie up funds equal to 25 per cent of the annual value of covered imports (once the scheme was in effect for 6 months). Before the scheme was modified the Bank of Italy estimated that about 2000 billion lire would be affected which is about 2.5 per cent of the broadly defined money supply and 4.0 per cent of M_1 (both percentages for end-1973 money supply).

The scheme will still have a significant effect on liquidity, but certain questions arise concerning the use of import deposits as a monetary device. There are more straightforward methods available to the Bank of Italy to achieve the goal of reducing liquidity -- e.g. raising reserve requirements -- which would not have raised the international storm of criticism that import deposits have. The measures have also dealt the European Economic Community another blow[1/] and perhaps ran afoul of international rules (particularly GATT's) concerning trade restrictions as well as the letter of intent to the IMF.[2/]

1/ The original version of the import deposit scheme met with a great deal of criticism from Italy's EEC partners. There was also considerable unhappiness over the unilateral nature of the action. The French and Germans were in particular upset by the restrictions on agricultural imports because they rely heavily on the Italian market. Presumably, when the Italians agreed to revise the deposit scheme and have it placed within a Community framework, it was in return for promises of financial help from the Community. Such help would probably be tied to an Italian undertaking to engage in further credit tightening and other restrictive demand-management policies.

2/ Paragraph 9 of the letter says, "it is the firm intention of the Government not to introduce new restrictions on payments and transfers, or new multiple currency practices, for current international transactions, or new restrictions on imports."

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However, this form of monetary restraint may have been suggested by political considerations. The Socialists in the Center-Left coalition were already very critical of the degree of credit restraint the Government accepted in the letter of intent, and seemed to be more willing to accept further restraint in the form of an indirect measure and one that strikes at large importers. (The Socialist argument is not really accurate -- as large importers bid for the limited amount of total credit available, the cost to other business will be driven up and the availability reduced.)

Moreover, the international consternation caused by the measures may not have been totally unwelcome to the Italian authorities. They have been a dramatic way of calling attention to the Italian plight and place in a prominent position the need for international assistance. The Italians probably have several objectives in mind: mobilizing their gold reserves, creating an IMF oil facility, and receiving longer-term credits (on concessional terms?) from the EEC and others. (The problems of external financing and the international implications of the Italian measures are discussed at greater length below.)

The import deposit scheme may also affect capital flows. It is believed that a large amount of capital leaves Italy through the overinvoicing of imports (and the underinvoicing of exports). The deposit scheme requires 50 per cent of the full stated cost of the imports to be deposited, and the interest loss caused by an overstatement should produce a disincentive against overinvoicing.

When the import deposit measures were originally announced, no restrictions were placed on allowing foreign exporters to finance the imports. Such foreign finance would have constituted a once-over short-term

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capital inflow. The stock of foreign export credits would have increased to pay for the deposits, but after 6 months repayments and new credits (abstracting from any increase in total imports and interest payments) would have balanced. After the deposit scheme was terminated, this inflow would have reversed itself. The capital inflow would have increased the reserves of the Bank of Italy, but since the deposits would have been kept at the Central Bank, it would not have increased domestic liquidity. However, insofar as foreign exporters rather than Italian importers financed the deposits, domestic liquidity in Italy would not have been reduced. Since the Italian Government later issued new regulations prohibiting Italian banks from guaranteeing exporters' loans to Italian importers, a measure which is expected to create a significant disincentive to foreign financing, it appears that a major purpose of the import deposits is indeed to reduce domestic liquidity.

External Financing

Some of the roughly $5.5 billion of intervention in 1974 has been financed by a drawing down of foreign exchange and swaps with commercial banks, but most has been financed by further borrowing, private and official. So far this year about $2.3 billion more has been raised on the Euro-currency market, bringing the outstanding Euro-currency debt (making some allowance for an unknown amount of repayment), to about $8 billion. The most recent part of this borrowing, a loan of $1.2 billion by Mediobanca (signed April and drawn in April and May), ran into resistance from the financial community; and the interest spread paid over the

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London interbank rate has been widening. It is feared that future Euro-currency borrowing would only be available on more onerous, and perhaps unacceptable, terms. Thus, in the near future, the authorities may decide no longer to tap the private capital markets.

Official financing arrangements are currently as follows:

European Monetary Co-operation Fund	$1.87 billion (drawn)	
International Monetary Fund	$1.20 " (standby)	
Central bank swap lines, of which:	$4.00 "	
U.S.		$3.00 billion
Germany		$0.50 "
Switzerland		$0.25 "
Canada		$0.25 "

(A previous $500 million swap line with France was withdrawn when the French left the snake.) Of the official credit, only the IMF credit is not short term. The European Monetary Co-operation Fund (EMCF) credit is for 3 months, renewable once. However, the EEC may agree to convert it into a two-year credit. This possibility has been discussed, but such a decision would probably only be taken when the short-term credit is nearing expiration. The EEC apparently has decided to renew the credit until September. If the maturity of the EMCF credit is extended beyond this year, then the sum of non-short-term credit available this year thus far is nearly $5.4 billion: Euro-currency borrowing ($2.3 billion), plus IMF ($1.2 billion), plus EMCF ($1.87 billion). If the IMF standby is drawn total external debt would be about $11 billion.

Italy's gross reserves (gold, Reserve Position in the IMF, SDRs, and foreign exchange) are currently probably about $5.0 billion, of which $3.5 billion is in gold (valued at the official price of $42.22) and

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about $750 million is in SDRs and Reserve Position in the Fund. The non-gold reserves that can be considered resources additional to the non-short-term borrowing given above are less than $2 billion ($5.5 billion less 3.5) because the roughly $350 million Reserve Position in the Fund is already subsumed under the IMF standby. Italy's foreign exchange holdings appear to be under $1.0 billion.

Given the size of the financing needs and the inadequacy of non-gold reserves, the reasons for the Italian desire to mobilize and revalue gold are clear. If gold were revalued to a market-related price, over $10 billion would be added to Italian reserves.

International Implications

Among industrial countries the oil crisis has so far shown itself most sharply in Italy. The Italian case may thus be the first specific test of how the payments implications of the oil crisis can be handled.

One view is that the OECD countries individually must not try to bring their current accounts into balance because the OECD oil deficit is (roughly) fixed in the short-run and an individual country's success in reducing its own oil deficit will simply add to the deficit of other OECD countries. If the Italians do succeed in eliminating the non-oil deficit (as agreed in the letter of intent), they will still have an oil deficit of $5-6 billion. If this deficit is financed in the private capital market an enormous external debt will be incurred at very high rates of interest.

Moreover, the view that the "oil deficit" should be financed and not eliminated, does not take account of the relative ease of borrowing among industrial countries. It is implicitly assumed that the countries

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with the largest current account deficits will be able to raise the most capital -- when in reality the larger the deficit the more suspect a country's credit may be. The Italians may already have reached the feasible limit of borrowing. If official finance on concessional terms is not forthcoming the Italians might justly claim they have been put in a double-bind -- do not engage in beggar-thy-neighbor depreciation or import restrictions, but also do not expect any substantial assistance from your neighbors.

On the other hand, a reduction in the Italian current account deficit by an amount greater than the non-oil component means a shift of resources abroad (in effect, to the richer OECD countries, if the aggregate oil deficit remains the same) to pay for the higher price of oil.

Both private financing and the elimination of a large part of the oil deficit seem out of reach in the next few years. However, to the extent that Italy <u>can</u> reduce its current deficit (including the oil component), without producing substantial internal difficulties, these efforts should be met with understanding from the other industrial countries rather than accusation of beggar-thy-neighbor.

The alternatives before the international community and the United States are either to make the Italians deal with their situation with their own measures, or provide international assistance. If the Italians are denied assistance, they must choose among some combination of the following: (1) further lira depreciation, (2) attempts to finance

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the deficit on the private capital market, (3) a severe restrictive aggregate demand policy, or (4) additional trade restrictions. My own conclusion is that at present the Italians should not be forced into any of these alternatives. Therefore, there is a case for assistance which goes beyond short-term credits as in the swap lines (although these may have to be drawn on in the short run). This assistance, however the package is assembled (and it may include a plan which allows the Italians to mobilize their gold reserves at a market-related price), should be tied to an insistence that the Italian Government adhere to the degree of restraint in the letter of intent, and agree to some fiscal tightening on the order of the increase in Government revenues and taxes that the previous cabinet was considering. Since the reduced coverage of the import deposit measure will decrease the scheme's liquidity effects, perhaps the Italians should also be requested to agree to some other restrictive monetary measures. If the balance of payments does not respond to such policies, it would then be necessary for the Italians to consider even greater restraint and a further depreciation of the lira.