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

April 20, 1976

STRICTLY CONFIDENTIAL (FR)
CLASS I FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached for your information is a memorandum by Mr. Lubitz of the Board's staff entitled "Recent Italian Developments."

Attachment

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 19, 1976

To Mr. Reynolds

Subject: Recent Italian Developments

From Raymond Lubitz

STRICTLY CONFIDENTIAL (FR)

The Italian lira has continued to show weakness in the past few weeks and has fallen to new lows. On February 27, the last market day before the Bank of Italy resumed official exchange-rate quotations and began a policy of limited intervention, the lira traded at 771 per dollar. (On January 19 before the Bank of Italy withdrew from the market, the rate was 685). The lira was subjected to substantial downward pressure because of large capital outflows during March (when official quotations resumed and at the time of the franc crisis) and to extreme pressure in April, reaching a low of 912 per dollar on the European exchanges on April 12. (By April 19 it had recovered to 877.) The effective depreciation of the lira since mid-January has been about 15 per cent.

The proximate cause for the latest selling pressure is undoubtedly the political situation and the increasing likelihood of elections in June, a year earlier than required. The economic crisis is the underlying cause for the political crisis, and the capital outflows are probably due to fears of Communist entry into the Government.

The Current Economic Situation

As the exchange crisis has been unfolding, economic activity has been showing some signs of improvement. The industrial production index in the last quarter of 1975 was at 109.5 after having reached a low of 103.6 in the previous quarter. (Its previous peak was 122.9 in 1974 Q-II). In the first 2 months of 1976 industrial production continued to grow and the index averaged 111.9 in January and February; if such an improvement is sustained (but there are reasons to doubt it will be), it would indicate that recovery was quite strong.

The recovery in activity has shown up in the worsening of the balance of trade. The balance had actually moved into surplus in mid-1975 but recorded an average monthly deficit of 322 billion lire, about $470 million, (customs basis, NSA) in the fourth quarter of 1975 and an average monthly deficit of 390 billion lire, about $530 million, for January-February of this year. Since the recorded trade accounts do reflect illegal capital outflows (via overinvoicing imports and underinvoicing exports), part of this worsening trade deficit may reflect an intensification of capital outflow; but it is very likely that a good part of it reflects the improvement of activity and restocking.

The real causes for the gloom about the prospects for the Italian economy cannot be found so much in the above figures but in the course of wages (and unit labor costs) and prices, the public sector deficit and the political situation. As far as the political situation is concerned, the Christian Democrats are presently governing in Italy without a majority in Parliament and are dependent on the abstention of the Socialists. Because of a fight over the abortion issue, but more fundamentally because of disagreement over economic policy, the Socialists are unwilling to maintain the existing arrangements and have decided to push for early elections. The Communists are expected to make substantial gains in these elections, and the Christian Democrats may be forced to accept them in the government. Even if early elections are not held, the great political uncertainty now existing is likely to be harmful to confidence, discouraging investment and leading to capital flight.

Inflationary forces have begun to strengthen again. The WPI, which had been nearly flat during the second half of 1975, began to accelerate in December; it rose 6.3 per cent for February over December, and by 3.1 per cent in February alone. The CPI which decelerated from an annual inflation rate of 25 per cent (end-1974/end-1973) to about 10 per cent, has begun to accelerate again, although not yet as sharply as the WPI. Wage increases have outstripped the CPI, and wage rates rose by about 20 per cent in the 12 months ending in December 1975. The wage-escalator, which offsets about 90 per cent of cost-of-living increases, puts a floor under wage increases for 1976. The recent depreciation of the lira will also feed back on to prices, directly and through the wage escalator; (the IMF staff estimates that for every 10 per cent depreciation of the lira, prices rise, at a minimum, by 4-1/2 per cent). In addition, major wage negotiations covering a large part of the labor force, have been dragging on since the end of last year and may give another substantial boost to wages.

The Treasury cash deficit increased last year to about 14.2 billion lire (GDP was 112.3 trillion lire), and was perhaps appropriate in view of the weakness of aggregate demand. However, the central bank financed 8.8 trillion lire of this deficit, and this was the major cause of the large increase in monetary base which rose about 19 per cent in the 12 months ending December 1975. (For the same period, M_2 increased nearly 24 per cent). The Italian authorities have since January taken a series of steps to reduce the public sector deficit and liquidity of the economy. Fiscal measures (mostly indirect tax increases), which are expected to raise about 1.5 trillion lire, have been announced. Monetary policy has been continually tightened; discount rate has been raised in 3 steps from 6 per cent to 12 per cent and reserve requirements have been increased. Market interest rates have responded dramatically to the monetary tightening -- the 3-month interbank rate has risen from 7.7 per cent in January to 18 per cent in late March, and was 16.75 per cent on April 15.

Official Reserves

The Italian external position as of the end of 1975 is shown in Table 1. While comparable details for 1976 are not available, major recent developments affecting the Italian reserve position can be identified. Since the beginning of the year Italy has drawn $500 million

Table 1
Italian Net Foreign Position
($ Million)

	End-1975
Net Official Reserves	4839
Gold 1/	3482
SDR's	97
Convertible Currencies	1297
Short-term Liabilities	-38
Net Medium and Long-term Position	-5926
IMF Stand-by 2/	-1200
IMF Oil Facility 2/	-1746
EC Credit	-1835
German Gold Loan	-1500
Other (Incl. Exch. Adj.)	405
Total (Bank of Italy/Italian Exchange Office)	-1087
Commercial Banks Net Foreign Position	-513
Total Position (Bank of Italy/Italian Exchange Office and Commercial Banks)	-1600
Compensatory Euro-currency Borrowing 1/	7050

e/ Estimate. Details may not add to totals because of rounding.
1/ Valued at official price of $42.22 per ounce.
2/ Valued at $1.20 per SDR.
3/ Borrowing by Italian state-controlled corporations for balance-of-payments purposes.

on the Federal Reserve swap, the $500 million of the German gold loan that was previously repaid was reborrowed, and $450 million from the $1 billion EC loan has been received. Also during this period, the Italians have spent about $1.5 billion in exchange market intervention. Presently, we estimate that Italy's foreign exchange holdings amount to about $1.2 billion.

While Italy is due to receive the remaining part of the $1 billion EC loan soon, these funds will be needed to repay the outstanding drawings on the Federal Reserve swap. The other source of official credit that appears to be available is approximately $520 million from the IMF stand-by.[1/] But negotiations between the IMF and the Italian authorities have not been concluded, and it is not clear whether the Italian authorities will be able to agree to the terms that the IMF staff thinks necessary concerning limits on the public-sector deficit and wage increases.

1/ We have received reports that European countries are putting together a $1.9 billion swap line for Italy, of which $750 million may be made available immediately.

Prospects

It is extremely difficult at the present time to determine the likely development of the Italian economy this year. The Italian authorities had made economic projections in March 1976 based on the conditions laid down by the EC.[1/] These conditions (which refer to the 12 months ending March 1977) and data for 1975 are shown below.

Table 2

Italian Financial Indicators: 1975 Actual and 1976 EC Conditions
Accepted by Italian Authorities
(Trillions of lire)

	Actual 1975	EC conditions March 1976
Central Government Expenditures	34.1	39.7
Treasury Cash Deficit	14.2	13.8
Domestic Credit Expansion	30.3[1/]	29.5
Bank of Italy financing of Treasury Deficit	8.8	5.7
Nominal GNP	112.3	

1/ Estimated by FRB staff.

Italian officials had estimated that these conditions would imply for 1976: 1 per cent real growth, a 15 per cent increase in the GDP deflator, a 5 per cent fall in real investment and a $500 million current account deficit. However, according to IMF staff members who participated in the Fund mission to Italy that is negotiating the new stand-by, there is a great deal of doubt concerning these estimates; the political situation and the uncertainties surrounding the labor negotiations make any forecast highly uncertain. The IMF staff also thinks that while it is not inconceivable that the Treasury cash deficit limit in the EC conditions can be met, it might only be done at the expense of a greatly enlarged deficit in 1977. (The Fund's desire for assurances that the 1976 deficit will not be at the expense of the 1977 deficit is a major stumbling block in the negotiations).

Although hard forecasts cannot be made, it appears very likely that the EC conditions would impose a substantial degree of tightness on the Italian economy and might eliminate the chances for any real growth this year. The domestic credit expansion (DCE) target had already implied a rate of monetary expansion which, with the GDP deflator increasing 15 per cent, would produce 1 per cent real growth; the current Fund staff guess for the deflator for 1976 (year-over-year) is 23-25 per cent and perhaps 30 per cent on an end-year basis! With the same DCE target this rate of price increase would imply that the degree of tightness would be greatly increased.

The Fund staff does not think that the Italian estimate for a $500 million current account deficit is unreasonable, although it might be a little too low. The lira's depreciation ought to stimulate exports; however, the Bank of Italy staff finds it difficult to make forecasts because of the great uncertainty whether wage increases will offset the price advantages of the depreciation. However, the real issue for the balance of payments is not current account but capital account, and here the political and economic uncertainties are the major determining factors.

Conclusions

The great fear now is that the Italian economy is caught in a cycle of depreciation and inflation. Lira depreciations feed back onto the price level making further depreciations necessary.

The economic case for substantial further assistance to Italy depends on the Italians' ability to set-up a credible economic program. Such a program would include limits on the public sector deficit and monetary expansion and a reduction of wage increases. The latter is essential if Italy is to avoid a cycle of wage and price increases and depreciations. The Italian authorities realize that wage restraint is essential and are trying to face up to the problem, particularly in regard to reducing or freezing the wage escalator. Success in this area and a more stable political situation are central to achieving economic stability. Without a credible program, there is a great risk that additional assistance to Italy used to support the lira would be dissipated.