L.5.2 RFD 575

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

April 4, 1966

Rodney H. Mills

14 pages

Recent Economic Developments in Italy:
October 1965 - February 1966

April 4, 1966. Rodney H. Mills

Recent Economic Developments in Italy: October 1965 to February 1966

Summary

Over the past year, Italian fiscal and monetary policies have clearly been stimulative.[1/] Efforts to shore up aggregate demand bore fruit in the second half of last year, when both total business outlays on equipment, and imports of such goods, turned upward after long and deep declines dating from 1963. Real GNP in the fourth quarter was up nearly 5 per cent from a year earlier. Depressed conditions in the construction industry, in part reflecting demand collapses in earlier periods, were the main drag on a speedier recovery, and brought on new efforts to revive housebuilding. The continuing large external surpluses find explanation not so much in the lag in recovery of some import groups as in the 35 per cent rise of Italian exports during 1964-65. The increase in the Italian external surplus from nearly $800 million in 1964 to $1.6 billion last year mainly reflected trade shifts occurring in 1964.

Budget expenditures (cash basis) in the 12 months ending last November were 24 per cent more than the 1964 total. This rate of gain constituted an acceleration of the rapid uptrend in outlays that began with the "opening to the left" in Italian politics in 1962. Yearly increases in 1962-64 averaged 14 per cent. The cash budget deficit of over Lit. 1,200 billion was more than three times larger than any other deficit of recent years, and its financing leaned heavily on the support of the banking system.

1/ For previous developments see Economic Developments in Italy, January-August 1965, September 17, 1965.

Monetary policy has remained easy, and long-term bond yields declined about 30 basis points from July to January. The money supply in November was 15 per cent more than a year earlier. The authorities allowed the large external surplus, together with central bank support of the Treasury, to swell bank reserves; although the banks placed a large amount of funds abroad last year, they also increased their loans and security holdings by 11-1/2 per cent in the 12 months to November. The increase in loans (under 6 per cent) was surprisingly small. The major beneficiaries of a 27 per cent rise in security holdings were the Treasury, the special credit institutes, and the nationalized enterprises.

I Italian experts now estimate that outlays on equipment goods dropped more than 35 per cent in the 21 months from III-'63 to II-'65, but staged a recovery of nearly 3 per cent in III-'65 and moved up further in the last quarter. Construction continued to decline in the second half of last year. Because of the long gestation period of construction projects, this industry has been feeling the effects of the earlier declines in starts on both dwellings and nonresidential buildings. Step-ups in public works (20 per cent of total construction activity) have helped to alleviate the situation to a small extent. To revive private outlays on housing, the government last September greatly liberalized the terms on which the Italian homeowner could obtain a mortgage.

Imports of finished investment goods, an important fraction of total Italian imports, are thought to have reached a low (seasonally-adjusted) last May, after falling more than 50 per cent from their end-1963 peak. From May to October, these imports recovered 9 per cent.

Imports of non-food finished consumer goods also began to rise again after May, following a drop of over 30 per cent from their peak. Total imports tended to rise more rapidly after mid-year; in November, they were 11 per cent above the second-quarter average, and only 3.7 per cent below their peak level of the third quarter of 1963. Because exports tended to be stationary from June to November, the Italian trade balance moved adversely.

The 1965 external surplus of $1,594 million was partly employed by the Italian commercial banks to place funds abroad and improve their net foreign position by $635 million. However, in the four months November-February, the banks' foreign position worsened by $142 million, suggesting some shift in policy. The banks had an almost balanced foreign position at the end of February.

A net outflow of $109 million on private capital account held the Italian surplus to $22 million in January-February.

Output rises further despite construction lag

The last half of 1965 saw further increases in Italy's overall production. On a seasonally-adjusted basis, the gross domestic product (at constant prices) increased 1.4 per cent in the third quarter and 1.1 per cent in the fourth, according to estimates made by ISCO for the National Economic and Labor Council. These rates of increase were below the sharp 2.1 per cent rise of the second quarter. But the evident slowing of momentum is hardly a cause for concern, since it reflected a slowing of export gains rather than of the pace of domestic demand. In fact, the latter quickened perceptibly in the second half of the year.

The national accounts estimates for the fourth quarter indicate clearly that Italy accomplished a more satisfactory rate of recovery of total production during 1965, despite continuous declines in activity in one major sector of the economy, viz., construction. Real gross domestic product in the fourth quarter was up 4.9 per cent from a year earlier. Gains in value added during these twelve months were 3.1 per cent in agriculture, 5.1 per cent in services, and 6.5 per cent in industry. However, a breakdown of the industry total is revealing: industrial output excluding construction rose 8.0 per cent, while the output of the construction industry declined 2.9 per cent over the year. The rate of decline in construction did slow as the year progressed. Declining construction activity during 1965 in large part reflected the earlier steep downturn in both residential and non-residential building starts, and it led to new and far-reaching measures (taken last September) to revive residential building. (See page 6.)

Business investment decline is reversed

Important and encouraging changes in demand patterns occurred during the second half of 1965. Up through mid-1965, by far the most important element in the Italian recovery was exports of goods and services. An extraordinary rise in the volume of exports, amounting to no less than 22 per cent, occurred between the third quarter of 1964 (the cyclical low point for GNP) and the second quarter of 1965; in fact, this rise even slightly exceeded (in absolute value) the increase in the entire GNP over those three quarters, when over-all domestic demand was still declining most of the time because of declining investment.

Two changes occurred in the second half of the year. First, the rate of rise in the volume of exports dropped off sharply, averaging only 1.6 per cent per quarter compared with over 7 per cent previously, perhaps because companies pushed exports less vigorously after domestic demand revived. Second, according to ISCO estimates, Italian investment, taken as a whole, began to pick up again. Total fixed investment expenditures (at constant prices) had been falling, or at least not increasing, for 21 consecutive months from the third quarter of 1963 to the second quarter of 1965, the decline totalling 21 per cent. The drop over this period was infinitely steeper for outlays on equipment goods (36 per cent) than for construction (5 per cent), a large category that includes the building of homes and public works as well as the building of industrial plants and commercial structures. Total fixed investment is estimated to have increased 2.8 per cent in the third quarter and 2.6 per cent in the fourth. A rise in outlays on equipment goods in the third quarter more than offset a further decline in construction, and ISCO believes the same thing happened in the fourth quarter. The real value of all remaining forms of expenditures--private consumption, public consumption, and inventory investment--tended to increase more rapidly in the latter part of the year. In the fourth quarter they are estimated to have been 5.7 per cent above a year earlier.

Most categories of Italian output and domestic expenditure were declining in 1964 from levels that were high at the start of the year. This fact makes the comparison of annual totals for 1964 and 1965 less favorable than the changes occurring during the course of last year. Real GNP in 1965 was 3.1 per cent more than in 1964 (compared with the estimated 4.9 per cent rise from fourth quarter to fourth quarter), and real gross fixed investment (including housebuilding) was down 9.7 per cent in spite of the second-half recovery, according to preliminary estimates in February 1966. Industrial production (excluding construction) in 1965 averaged 4.2 per cent above 1964, compared with the 10.6 per cent yearly rise as of last December.

New measures are taken to aid housing

Given the important role of construction in the total economy, and the somber outlook for that industry, the government has acted in a variety of ways to speed over-all economic recovery by aiding construction. The value added in the construction industry accounts for 19 per cent of total value added in industry, and 7.6 per cent of GNP; the gross value of construction equals 56 per cent of total gross fixed investment, and 11.8 per cent of GNP (1964 figures).

Expenditures at all levels of government on public housing and other public works (which comprise 23 per cent of total construction) were upped 18 per cent in 1964, and another 6 per cent in the first three quarters of 1965 relative to the same period of 1964. For the central government, the increases were 15 and 8 per cent, respectively. The authorities have also acted to try to revive private outlays on residential building. In March of 1965, the government suspended (for 25 years) the taxes on income from non-luxury dwellings completed in 1962-68, and reduced taxes on property transfers and consumption of building materials. More recently, in September of 1965, radical changes were made in mortgage lending practices. Until then, the Italian mortgagee could not obtain estimated 4.9 per cent rise from fourth quarter to fourth quarter), and real gross fixed investment (including housebuilding) was down 9.7 per cent in spite of the second-half recovery, according to preliminary estimates in February 1966. Industrial production (excluding construction) in 1965 averaged 4.2 per cent above 1964, compared with the 10.6 per cent yearly rise as of last December.

New measures are taken to aid housing

Given the important role of construction in the total economy, and the somber outlook for that industry, the government has acted in a variety of ways to speed over-all economic recovery by aiding construction. The value added in the construction industry accounts for 19 per cent of total value added in industry, and 7.6 per cent of GNP; the gross value of construction equals 56 per cent of total gross fixed investment, and 11.8 per cent of GNP (1964 figures).

Expenditures at all levels of government on public housing and other public works (which comprise 23 per cent of total construction) were upped 18 per cent in 1964, and another 6 per cent in the first three quarters of 1965 relative to the same period of 1964. For the central government, the increases were 15 and 8 per cent, respectively. The authorities have also acted to try to revive private outlays on residential building. In March of 1965, the government suspended (for 25 years) the taxes on income from non-luxury dwellings completed in 1962-68, and reduced taxes on property transfers and consumption of building materials. More recently, in September of 1965, radical changes were made in mortgage lending practices. Until then, the Italian mortgagee could not obtain a loan equal to more than 40 per cent of the value of the dwelling. If the borrower is to occupy the house himself, the government will now guarantee an additional 35 per cent, so that the bank (or one of the institutions specializing in real estate credit) will lend up to 75 per cent. In addition, the government will pay 3-1/4 per cent interest subsidy, with the result that the effective interest rate for the borrower is reduced from 8-3/4 to 5-1/2 per cent.

Declining construction activity at a time when output was reviving vigorously in the other major areas of production is partly the result of the long gestation period of construction projects. Declining "demand for construction" in 1964 had serious effects throughout 1965 on the volume of work in progress. The major source of the weakness in construction is private residential building, which currently accounts for 57 per cent of the total gross value of construction (1964 data). The statistical data on housing in Italy are grossly inadequate[1/] but it is evident that a severe decrease in housing starts has occurred. Housebuilding permits issued for the larger towns in 1964 were 28 per cent under 1963, and in the first 10 months of 1965 they were down another 33 per cent from a year earlier. As of October, it seems the trend was still downward. This two-year decline in permits probably over-states the extent of the drop in actual starts, because the rise in permits during the housing boom of the early 1960's had outraced starts, but experts believe that starts in 1965 were probably down 15 to 25 per cent from 1964.

1/ For a survey of the construction industry and the many problems posed by data insufficiencies, see Banca Nazionale del Lavoro, Italian Trends, no. 12, December 1965.

Residential construction in 1965 was in fact still being buoyed up by completions of dwellings begun during the boom, because in January-October the number of occupancy permits issued in the larger towns (a "proxy" for completions) was identical with the year-earlier total. But the immediate outlook for house construction is bleak: the trend of completions (i.e., occupancy permits) turned downward during 1965, while the trend of starts (i.e., building permits) had yet to turn upward as of last fall.

The steep decline in investment outlays by Italian business enterprises also has had its effects on construction. Nonresidential building construction represents 20 per cent of construction activity. This type of construction activity declined in 1964; apparent starts fell sharply, and by more than apparent completions rose, implying a drop in work in progress. In 1965, the declining trend of starts may have reversed itself in the latter part of the year, concomitantly with a general revival of business investment. But the trend of completions seems to have turned downward in 1965, and the volume of work in progress will be adversely affected for a long time by the prior decline in starts.

Budget expenditures rise 24 per cent in 1965

A major factor helping Italian recovery has been the continuation of the rapidly rising trend of government expenditures which began in 1962 with the "opening to the left" in Italian politics. Budget expenditure obligations voted by the Italian Parliament rose 30 per cent in the two years from fiscal 1962 to fiscal 1964. For 1965, the amended budget as of last November 30 showed obligations totalling 19.6 per cent more than for fiscal 1964, these two periods averaging 18 months apart because of the shift in the fiscal year, starting in 1965, from July-June to the calendar year. For 1966, the administration has submitted to Parliament a budget 6.3 per cent higher than the initial estimates for 1965. (The 1965 initial estimates were raised by 11 per cent after 11 months of amendments.)

Actual cash outlays have followed the sharply upward course of obligations. They rose at an annual average rate of 14 per cent in the three calendar years 1962-1964, including over 9 per cent in 1964 when the public finances reflected a "slowing" of expenditures as part of the stabilization plan adopted in the closing weeks of 1963. The Bank of Italy's reclassification of expenditures from administrative to economic categories shows rising trends in most types of outlays. The largest single category, wages and salaries of government employees, rose 40 per cent from 1962 to 1964.

The rate of increase in total expenditures accelerated very sharply in 1965; outlays in the 12 months ending November 1965 were 24 per cent more than in calendar year 1964. Increases in all categories of government enxpenditures have aided the economy, either directly or indirectly through respending. Public consumption was the largest direct beneficiary, inasmuch as compensation of employees and purchases of goods and services from the private sector accounted for 36 per cent and 5 per cent, respectively, of total cash expenditures in 1964. But current transfers (pensions, social security, interest, etc.) constituted a further 34 per cent of expenditures, and increases here have directly stimulated private consumption. Increases in investment expenditures (15 per cent of the total) would appear to have been felt mainly in the public works area.

Budget deficits (cash basis) were small previously, but the deficit widened greatly in 1965. The upsurge in expenditures was one cause, and a notable lag in receipts--for which no explanation is apparent--is another. A major means of financing the Lit. 1,240 billion deficit incurred in the 12 months to November 1965 was a big increase, to Lit. 450 billion lire, in net flotations of Treasury bonds and bonds issued for Treasury account by the Credit Consortium for Public Works. The Treasury also sold Lit. 100 billion (net) of 1-year Treasury bills, increased its overdraft at the Bank of Italy by Lit. 203 billion, and issued Lit. 10 billion of currency. How the remaining Lit. 477 billion of the deficit was financed cannot yet be determined.[1/] However, the support of the banking system was heavy, as seen from the increases of Lit. 500 billion in commercial bank holdings of Treasury bonds and bills and a Lit. 174 billion rise in total net credit from the central bank.

Easy monetary policy allows 15 per cent money supply increase

Monetary policy and monetary conditions in Italy did not undergo important changes in the latter part of 1965, except as regards the banks' operations abroad. The Bank of Italy has wanted to encourage the expansion of economic activity since the summer of 1964. The degree to which they have allowed monetary developments to help sustain demand can be judged by the rate of money supply expansion. In November, the money supply was 14.7 per cent larger than a year earlier. After seasonal adjustment by the International Monetary Fund, the money supply rose erratically by 32 per cent (annual rate) in the fourth quarter of 1964, and at annual rates of 4.6, 17.5, and 11.7 per cent in the subsequent three quarters.

1/ A clear and complete picture of the Italian public finances is found only in the annual report of the Bank of Italy issued at the end of May of each year.

Italian monetary policy has been to allow the large external surplus to provide the banks with additional reserves, and let the banks "run with the ball" in response to market incentives. In the year ending last November, the balance of payments surplus supplied the banks with Lit. 1,072 billion of cash reserves which were further supplemented by the Lit. 174 billion of additional Bank of Italy credit to the Treasury. The banks used Lit. 295 billion of these reserves to purchase currency. Because the internal demand for bank credit increased only slowly, the banks had an incentive to improve their net foreign position which they did to the extent of Lit. 616 billion. They also reduced their rediscounts and advances from the Bank of Italy by Lit. 87 billion, although the downtrend in recourse to central bank credit seems to have halted now. The above operations left about Lit. 250 billion of cash reserves to serve as a base for a Lit. 2,009 million rise in loans and security holdings.

The demand for bank credit has continued to show a surprisingly slow rate of advance when compared with the pace of recovery of industrial production. Outstanding loans rose 5.7 per cent in the year ended last November, compared with a 9 per cent rise in industrial output. In contrast, the banks' security portfolios increased 27 per cent, and even in absolute terms the rise in securities (Lit. 1,270 billion) outstripped by a wide margin the rise in loans (Lit. 732 billion). (The yearly rise in securities was about evenly distributed as between the first and second six months.) The public sector was the main direct beneficiary of the expansion of security holdings. In addition to the Lit. 500 billion rise in their holdings of Treasury bonds and bills, the increase in other issues mainly involved bonds of the government-run special institutes for medium- and long-term credit (e.g., IMI) and the bonds of the nationalized enterprises (IRI, ENI, and ENEL). These purchases of non-Treasury public-sector bonds also materially eased the Treasury's financing problems, because in recent years the extra-budgetary operations of the Treasury have involved large indirect purchases of bonds issued by the public sector, through the intermediary of the Cassa Depositi e Prestiti. (The Cassa made net bond purchases totalling Lit. 335 billion in 1963 and Lit. 286 billion in 1964.)

The Italian monetary expansion in 1965 had important effects on bond yields. Following their sharp decline of around 85 basis points in the second half of 1964 and the early weeks of 1965, bond yields were nearly stable for six months. But, from July 1965 to January 1966, the composite yield on all bonds (except Treasury bonds) dropped 34 basis points to 6.39 per cent (monthly average) in January. Over this period, there was a 20-basis point decline in yields on Treasury bonds.

Trade position deteriorates but external surplus remains large

Italy's trade balance improved continuously throughout 1964 and the first half of 1965, but the process was reversed in the second half of 1965. After June, seasonally-adjusted exports tended to move sideways and in November they were a shade under the June level. The rate of rise in seasonally-adjusted imports quickened after mid-year, when the long declines in imports of finished consumer and investment goods imports gave way to recovery in those categories. Italy's trade balance (imports valued c.i.f.) shifted from a $39 million surplus in the second quarter to a $119 million deficit in the three months September-November.

A study by ISCO of Italian import trends since late 1963 sheds much light on the developments which have occurred. ISCO has adjusted the separate large commodity group for both seasonal and accidential factors. As of last October, total imports were still 14 per cent under their high reached in December 1963. In October, imports of foodstuffs, raw materials, and fuels had reattained or exceeded their previous peaks, but imports of non-food finished consumer goods were 30 per cent under their peak (set in December 1963) and imports of finished investment goods were only 50 per cent of their amount in November 1963, their peak month. The latter group is quantitatively very important, such imports having accounted for over one-third of total imports in 1963. These investment goods imports did not stop declining until after May of 1965. They recovered 9 per cent from May to October, a movement coinciding with the recovery of domestic spending for equipment goods. Imports of finished consumer goods also hit bottom in May, after which a slow recovery ensued.

Italy's balance of payments surplus for 1965 was $1,594 million, up from $774 million in 1964. The quarterly surpluses last year were $63 million, $468 million, $796 million, and $250 million, and the quarterly changes were caused for the most part by changes in tourist receipts. The rise in the annual surplus last year principally reflected an improved trade position, the improvement having occurred during the course of 1964 rather than in 1965. The trade deficit (imports partly c.i.f.) was reduced $1,018 million from one year to the next. Substantial increases in net tourist receipts and in emigrant remittances also occurred, but they were somewhat more than offset by the shift in private (nonbank) capital flows from a $432 million net inflow in 1964 to a $96 million net outflow last year. Details on capital movements for the first three quarters show little change in recorded Italian investment abroad, but large declines in direct investment in Italy and in loans from abroad.

The main use of the surplus was to reduce the Italian banks' net foreign liabilities by $635 million, to $178 million at the year-end. The banks' gross liabilities increased, but by less than assets abroad. The banks' foreign position improved continuously in January-October, but deteriorated $328 million in November-December (mostly the latter) when the banks borrowed heavily abroad to meet year-end liquidity needs. Among the official accounts, Italy's IMF (including GAB) position rose $403 million; gold holdings were increased $297 million; foreign exchange holdings were drawn down by $107 million; and other official net foreign assets rose $366 million.

In the first two months of 1966, Italy had a small $22 million overall surplus which reflected the seasonal low in tourist receipts. It was smaller than the $77 million surplus of a year earlier because of a shift in private capital flows; a large $109 million net outflow occurred in January-February of this year, compared with a $32 million net outflow a year earlier.

A change in commercial bank practices regarding foreign operations is evident from the recent data on this area of operations. The banks improved their net foreign position by $187 million in January-February (nearly all in the former), after the year-end liquidity needs were no longer present. But this increase failed to make up for the deterioration in the foreign position which had occurred in the final two months of 1965. Thus, from end-October to end-February the banks' position deteriorated $142 million. At the end of February the foreign position was almost in balance, showing net assets of $9 million.