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Recent Economic Developments in Italy,
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Recent Economic Developments in Italy: April-September 1963.

Summary

The further increase in the international payments deficit and continued rapid advance in wage rates characterized the further deterioration in Italy's economic position during the second quarter.^{1/} The lira began to decline in September but remained above parity in the foreign exchange market, in large measure because the Italian commercial banks were heavy borrowers in the Euro-dollar market. Monetary expansion, abetted by these foreign borrowings, by a rising Treasury budget deficit and by Bank of Italy credit to the banks, has continued at a very rapid pace. These developments led Mr. Marjolin (Vice President of the E.E.C.) in mid-September to characterize the Italian inflation as "serious" and to criticize the authorities for allowing the heavy borrowing abroad.

The adoption of strong measures by the Italian authorities is made more difficult than usual by the present political situation within the country. The break-up of a Center-Left coalition last spring has left the country with only a "caretaker" regime pending some more stable regroupment of political forces this autumn. A Socialist Party Congress scheduled for late October should determine whether the Socialists and the Center parties can re-establish a workable coalition over a broad political spectrum.

The absence of a strong government has made the monetary authorities the only possible source of action to help bring under control inflationary tendencies within the domestic economy. As yet, these authorities have not taken aggressively restrictive action.

^{1/} For a review of earlier economic developments in Italy, see "Recent Economic Developments in Italy, January-June 1963," July 1, 1963.

Through May, the money supply and private bank credit rose at the same rapid rates as they expanded in 1962. Commercial bank reserves have been supported by a heavy drawdown of Treasury balances at the central bank and by heavier accommodation to the banking system by the central bank. The banks also increased their net indebtedness to foreigners (all short-term in character) in the second quarter by \$383 million to an end-of-June total of more than \$1.1 billion.

Expansion of industrial production resumed in the second quarter, after the winter interruption. With demand for both investment and consumer goods rising, seasonally-adjusted output was 4.8 per cent higher in April-June than in the final quarter of 1962.

Payments imbalance worsens

Italy's balance of payments has continued to deteriorate and the deficit attained very large proportions in the second quarter. Seasonal influences made for an improvement in the summer months, but the underlying position is not

believed to have undergone any change for the better. The lira has weakened on the exchange markets since the end of August, though it is still above parity in relation to the dollar.

The over-all deficit increased to \$411 million in the April-June quarter, from \$268 million in the preceding three months, as deficits widened on both trade account and private capital movements. (See Table 1.) Seasonal factors and changes in leads and lags appear to have played little if any part in the further worsening in the second quarter. Because the second quarter (like the first) is seasonally weak, these results over-state the annual rate of deficit. However, making allowance for seasonal factors, it still appears that the second quarter deficit exceeded \$1 billion at an annual rate.

The most important change in the second quarter was the rise in the trade deficit (payments basis) to \$644 million, an increase of \$134 million over the first quarter. Since this increase was nearly the same as the \$141 million rise in the trade deficit as given by the customs returns (See Table 2), the net change in leads and lags in trade payments was negligible. Seasonal factors affected the trade balance adversely by \$41 million but were offset by a \$69 million improvement in invisibles receipts that was largely seasonal.

The large increase in the over-all deficit also reflected a \$57 million rise in net capital outflow from the first quarter level. No details are available on this adverse shift.

The widening of the trade gap was caused by the steeply upward trend in imports. Rising domestic costs, the continued internal expansion (both in monetary and in real terms) and recent tariff reductions have all contributed to heavier imports. After remaining unchanged between the fourth and first quarters, imports experienced another upward burst in the second, rising by 10-1/2 per cent on a seasonally adjusted basis. This put imports 30 per cent above a year earlier and 44 per cent higher than two years previous.

Table 1. Italy: Balance of Payments, 1962-63
(In millions of dollars)

	1962		1963	
	I	II	I	II
<u>A. CURRENT ACCOUNT</u>	<u>-28</u>	<u>10</u>	<u>-211</u>	<u>-275</u>
Trade deficit (payments basis, imports c.i.f. ^{1/})	-295	-343	-510	-644
Invisibles	267	353	299	368
<u>B. CAPITAL ACCOUNT</u>	<u>-84</u>	<u>-57</u>	<u>-57</u>	<u>-136</u>
Private capital (including remittances of Italian banknotes)	-93	-56	-57	n.a.
Public capital	8	-2	1	n.a.
<u>C. UNCLASSIFIED TRANSACTIONS</u>	<u>19</u>	<u>22</u>	--	--
<u>D. OVER-ALL BALANCE (A+B+C)</u>	<u>-94</u>	<u>-25</u>	<u>-268</u>	<u>-411</u>
<u>E. MONETARY MOVEMENTS</u>	<u>94</u>	<u>25</u>	<u>268</u>	<u>411</u>
Official reserves	110	40	115	8
Other official net foreign assets	-3	-29	-1	21
Commercial bank net foreign assets	-44	17	154	383

^{1/} Excluding freight and insurance paid to residents.

Sources: Istituto Nazionale per il Commercio Estero and U.S. Embassy, Rome.

Table 2. Italy: Foreign Trade, 1962-63
(In millions of dollars)

		<u>Imports c.i.f.</u>	<u>Exports</u>	<u>Balance</u>
<u>Unadjusted</u>				
1962 - Quarter	I	1452	1128	-324
	II	1470	1152	-318
	III	1517	1166	-351
	IV	1680	1258	-422
1963 - Quarter	I	1707	1188	-519
	II	1908	1249	-659
<u>Seasonally-adjusted</u>				
1962 - Quarter	I	1359	1143	-216
	II	1326	1191	-135
	III	1576	1174	-402
	IV	1684	1223	-461
1963 - Quarter	I	1685	1211	-474
	II	1859	1286	-573
	January	538	395	-143
	February	586	403	-183
	March	561	413	-148
	April	619	398	-221
	May	650	454	-196
	June	590	434	-156

Source: OECD

Exports rose by 6.2 per cent (seasonally-adjusted) in the second quarter, following a slight dip in the first. Since the start of 1962, when inflationary pressures first became strong, Italy's export performance has been highly satisfactory by most standards. Second quarter exports were nearly 12 per cent higher than 18 months before (the last quarter of 1961), a growth of 7-8 per cent at an annual rate. But this growth has not equalled the steep rise in imports, and has been below the rate for the years 1959-61 when Italy experienced an extraordinary export boom. In those years, productivity in the export industries increased even faster than in the economy as a whole (where the advance was very rapid), and export prices were reduced. With wage costs rising swiftly, the fall in export prices was halted in 1962, and they rose in the early months of 1963.

Because of the influx of tourists, a seasonal improvement occurred in the Italian position over the summer. Official reserves and other official net foreign assets were up \$65 million in July, and the official reserves rose \$100 million further in August. Two long-term borrowing operations were carried out in July. Autostrade (a State-owned company for superhighway construction) floated \$15 million of dollar bonds in London at an average yield to maturity (1969-78) of 5.62 per cent. The City of Milan raised \$20 million in New York with an issue of 5-1/2 per cent bonds sold at par. These bonds will be amortized in 1968-83.

Banks' foreign borrowing continues to soar

Since last fall when restrictions on foreign borrowing by Italian commercial banks were lifted, the banks have heavily inflated their foreign indebtedness, partly to meet the growing foreign exchange needs of Italian importers. Borrowings have also been used to reduce lira-dollar swaps with the Bank of Italy in order to increase loans in lire.

This foreign borrowing rose very rapidly in the last quarter of 1962. (See Table 3.) It increased more slowly in the first quarter of this year but

Table 3. Italy: Commercial Banks' Foreign Position, 1962-63
(In millions of dollars; end of month)

	1962		1963	
	Sept.	Dec.	Mar.	June
ASSETS	<u>1,373</u>	<u>1,457</u>	<u>1,536</u>	<u>1,554</u>
1. In convertible foreign exchange	<u>1,310</u>	<u>1,384</u>	<u>1,420</u>	n.a.
a. Sight items	480	503	484	n.a.
b. Time deposits	648	673	730	n.a.
c. Short-term investments	52	47	51	n.a.
d. Short-term credits	129	162	156	n.a.
2. In inconvertible foreign exchange	3	3	3	n.a.
3. In lire	<u>60</u>	<u>70</u>	<u>113</u>	n.a.
LIABILITIES	<u>1,475</u>	<u>2,062</u>	<u>2,294</u>	<u>2,695</u>
1. In convertible foreign exchange	<u>1,126</u>	<u>1,747</u>	<u>1,847</u>	n.a.
a. Deposits	<u>1,024</u>	<u>1,570</u>	<u>1,766</u>	n.a.
b. Short-term credits	102	177	181	n.a.
2. In inconvertible foreign exchange	5	3	3	n.a.
3. In lire	<u>344</u>	<u>312</u>	<u>345</u>	n.a.
NET POSITION	<u>-102</u>	<u>-605</u>	<u>-758</u>	<u>-1,141</u>
1. In convertible foreign exchange	<u>184</u>	<u>-363</u>	<u>-527</u>	n.a.
2. In inconvertible foreign exchange	-2	0	0	n.a.
3. In lire	<u>-284</u>	<u>-242</u>	<u>-232</u>	n.a.

jumped sharply in the second quarter by \$383 million. This amount covered nearly all of the second quarter payments deficit. In the nine months from last September through June of this year, commercial bank borrowings exceeded the total balance of payments deficit of \$845 million, so that Italy's official reserves actually rose.

As a result, the banks' outstanding net borrowings from abroad have risen to a very high level, amounting to \$1,141 million at the end of June. This is all short-term debt, consisting primarily of foreign currency deposits and, to a lesser extent, short-term credits. (See Table 3.) About one-fourth of it is in lire.

This manner of financing the Italian deficit has meant in domestic monetary terms that the external imbalance has not slowed down the domestic credit expansion.

Despite the continued payments deficit, downward pressure on the lira in the second quarter was limited because of the Italian commercial banks' heavy foreign borrowing. The lira declined only slightly during the quarter and remained well above parity with the dollar throughout the period. On August 5, the lira was quoted at 0.74 per cent above parity but weakened in September as tourist receipts declined and stood at 0.43 per cent above parity on September 23.

Monetary policy remains expansionary

Italian monetary policy has tolerated, if not encouraged, rapid bank credit and monetary expansion, despite the rising internal price level and the emergence of a large external deficit. Monetary developments in recent months have continued to reflect the unrestricted freedom to borrow abroad given to the Italian commercial banks last October which was the most important of several monetary policy measures taken last autumn to stimulate an economy whose forward momentum seemed at the time to have greatly slowed down.^{1/}

^{1/} Industrial production (seasonally-adjusted) remained essentially unchanged in the first nine months of 1962.

The rapid growth in commercial bank foreign borrowing that has since occurred has prevented the external deficits from exercising any contractionary monetary effect. With the aid of this borrowing, the banks have been able to meet a rapidly rising demand for credit. While their position has tightened, they have received the reserves necessary for additional credit extension from two sources: (1) inflationary budgetary operations (which also have had their own direct effect on purchasing power), and (2) further extension of Bank of Italy credit to the commercial banking system.

The money supply has been rising at the same rate as last year, when the increase over the full twelve months exceeded 18 per cent. The 1-1/2 per cent increase in April-May of this year (latest data available) brought to 4 per cent the rise from end-January to end-May; because of the sharp seasonal decrease in January, the change since end-December is not indicative of the basic trend. However, the rate of expansion in February-May this year was the same as in the corresponding months of 1962.

The largest element in monetary expansion has continued to be commercial bank lira credit to the economy (all borrowers but the Treasury), which rose 6 per cent in February-May 1963, or at the same rate as in the corresponding period last year. (For the full year 1962, the rise in this credit reached 25 per cent.) Nearly all of this additional credit to the economy was in loans. Bank holdings of securities (excluding Treasury obligations) were little changed. Earlier, in the four months ending January 1963, they had increased sharply in response to the credit-easing measures of last October which augmented their investible funds.

Over the past year, the financing of Italian budget expenditures has also injected a significant amount of new money into the economy. In particular, the Treasury has drawn down its once-large balances with the Bank of Italy to meet a rising cash deficit. In the twelve months ending May 1963, Treasury deficit

financing accounted directly for more than one-fourth of the rise in the money supply. Moreover, the drawdown of Treasury balances has abetted credit expansion by banks through its effect on bank reserves.

Bank of Italy operations encouraged credit expansion through the first half of 1963. Rediscounts and advances to commercial banks rose 115 billion lire in February-May, and advances increased further by 93 billion lire in June. (See Table 4.) This additional credit provided the banks with most of the funds needed to meet their rising reserve requirements.

Budget operations add to inflationary pressures

The financing of Italy's budget deficit has recently become an important contributory factor in the current phase of rapid monetary expansion. An increase in the deficit itself has been accompanied by changes in the means of financing designed to increase the liquid resources of the economy. This change in fiscal policy dates from the autumn of 1962, when a variety of monetary measures were also adopted to promote expansion.^{1/} Initial budget estimates for fiscal 1964 make likely another big increase in budget expenditures and a still larger deficit.

The budget deficit for the fiscal year ending June 30, 1963, was amended by the Fanfani government to provide a deficit of 832 billion lire, up from 389 billion lire in the final budget for fiscal 1962. (See Table 5.) On a cash basis, the deficit has also risen although it has been below the administrative deficit (because of large carry-overs of expenditures from year to year). The cash budget deficit for the twelve months ending May 31, 1963 was 329 billion lire compared with 177 billion lire for both the preceding twelve months and for fiscal 1962. (See Table 6.)

In fiscal 1962, the inflationary impact of the deficit was modest. Net

^{1/} See "Recent Economic Developments in Italy: July to November 1962," January 3, 1963.

Table 4. Italy: Selected Monetary Statistics, 1962-63
(In billions of lire; end of month)

	1962			1963	
	Jan.	May	Sept.	Jan.	May
<u>MONEY SUPPLY</u>	<u>8,366</u>	<u>8,713</u>	<u>9,287</u>	<u>9,937</u>	<u>10,336</u>
<u>COUNTERPARTS OF MONEY SUPPLY</u>	<u>8,366</u>	<u>8,713</u>	<u>9,287</u>	<u>9,937</u>	<u>10,336</u>
A. <u>Credit to Economy</u> ^{1/}	<u>9,012</u>	<u>9,563</u>	<u>10,199</u>	<u>11,273</u>	<u>11,929</u>
1. <u>Commercial banks</u> ^{1/}	8,786	9,337	9,952	10,977	11,640
a. <u>Loans</u> ^{1/}	(7,819)	(8,252)	(8,756)	(9,557)	(10,199)
b. <u>Securities</u>	(967)	(1,085)	(1,196)	(1,420)	(1,441)
2. <u>Bank of Italy</u>	226	226	247	296	289
B. <u>Credit to Treasury</u>	<u>3,003</u>	<u>2,911</u>	<u>2,945</u>	<u>3,235</u>	<u>3,322</u>
1. <u>Bank of Italy</u>	590	413	392	824	812
a. <u>Gross credit</u>	(853)	(841)	(853)	(861)	(839)
b. <u>Treasury balance</u>	(- 263)	(- 428)	(- 461)	(- 37)	^{2/} (- 27)
2. <u>Commercial banks</u>	2,413	2,498	2,553	2,411	2,510
a. <u>Bills</u>	(1,725)	(1,793)	(1,851)	(1,743)	(1,840)
b. <u>Bonds</u>	688	705	702	668	670
C. <u>Official Net Foreign Assets</u>	<u>2,574</u>	<u>2,487</u>	<u>2,685</u>	<u>2,812</u>	<u>2,797</u>
D. <u>Savings Deposits in Banks</u>	<u>-6,426</u>	<u>-6,690</u>	<u>-6,992</u>	<u>-7,566</u>	<u>-7,790</u>
E. <u>All Other Counterparts</u>	<u>203</u>	<u>442</u>	<u>450</u>	<u>183</u>	<u>78</u>
<u>BANK OF ITALY CREDIT TO</u>					
<u>COMMERCIAL BANKS</u>	<u>384</u>	<u>440</u>	<u>496</u>	<u>583</u>	<u>688</u>
A. <u>Advances</u>	127	135	124	154	^{3/} 269
B. <u>Rediscounts and other</u>	257	305	372	429	419
<u>COMMERCIAL BANK NET FOREIGN</u>					
<u>LIABILITIES</u>	<u>82</u>	<u>101</u>	<u>64</u>	<u>348</u>	<u>649</u>

^{1/} Excludes bank loans in foreign exchange.

^{2/} The Treasury's balance with the Bank of Italy was in overdraft by 70 billion lire at the end of July.

^{3/} Advances rose to 365 billion lire at the end of June.

Sources: Bank of Italy, Bollettino and Supplemento al Bollettino.

Table 5. Italy: Administrative Budget, 1961-64
(In billions of lire)

	<u>Fiscal year ending June 30</u>				
	<u>1961</u> <u>Final</u>	<u>1962</u> <u>Final</u>	<u>1963</u> <u>Initial</u>	<u>Amended</u> ^{1/}	<u>1964</u> <u>Initial</u>
Receipts	4,026	4,635	4,516	4,769	5,315
Expenditures	4,481	5,005	4,905	5,601	5,817
Deficit	-460	-381	-389	-832	-502

^{1/} As of May 31, 1963.

Sources: Bank of Italy, Annual Report for 1962 and Bollettino for May-June 1963.

Table 6. Italy: Cash Budget and Financing, 1961-63
(In billions of lire)

	<u>Fiscal year ending</u>		<u>12 Months ending</u>	
	<u>June '61</u>	<u>June '62</u>	<u>May '62</u>	<u>May '63</u>
CASH RECEIPTS	3,948	4,388	4,302	4,882
<u>CASH DISBURSEMENTS</u>	<u>4,015</u>	<u>4,565</u>	<u>4,478</u>	<u>5,211</u>
CASH DEFICIT	-67	-177	-177	-329

COVERAGE OF DEFICIT:

A. Use of cash balances:

1. Balance with Bank of Italy

-94	-144	-139	2/401
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2. Cash on hand

3	-2	-3	2
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B. Issue of securities: ^{1/}

1. Treasury bills

56	124	92	113
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2. Long-term bonds

124	66	160	-60
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C. Bank of Italy advances^{1/}

-78	--	-64	-40
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D. Issue of Treasury Coin

14	11	11	8
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E. Miscellaneous Treasury debts and credits with non-banking institutions, and suspense items

24	55	57	423
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^{1/} Outstanding gross bank credit to Treasury increased by:

236	260	n. a.	11
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^{2/} A further crowdown of 97 billion lire occurred in June-July, 1963.

Source: Ministry of the Treasury, Conto Riassuntivo del Tesoro.

sales of Treasury bills and long-term bonds were accompanied by an increase in bank credit to the government but a large build-up of Treasury cash balances immobilized much of the borrowed funds. By contrast, the most notable feature of fiscal policy during 1963 has been the heavy drawdown of these cash balances without any reduction in bank credit to the government. In the twelve months ending May 31, the Treasury's account at the Bank of Italy fell by 400 billion lire and there was also a large redemption of long-term debt; but the bank credit to the government increased 11 billion lire as the banks continued to acquire Treasury bills as part of their required reserves.

Partial data show a continuation in June and July of the use of cash balances and bank credit to finance the cash deficit. The Treasury's balance with the Bank of Italy, which had dropped to 27 billion lire at the end of May, fell to zero during July, and at the end of July was in overdraft by 70 billion lire, making a net reduction of 97 billion lire in the two months.

For fiscal 1964, the prospects at this time are for another big increase in expenditures and a higher deficit than in the fiscal year ended last June. Initial estimates in the administrative budget presented to Parliament earlier this year place expenditures nearly 19 per cent above the initial estimates for fiscal 1963, and show the deficit rising to 502 billion lire from the 389 billion lire given by the initial estimates for fiscal 1963. (See Table 5.) These initial estimates do not include outlays for the "Green Plan," a large-scale five-year agricultural development program begun in 1961, for which Parliament will authorize expenditures during the course of the fiscal year. And on the basis of past experience, substantial additional amounts, over and above initial expenditure estimates, will also be voted for other purposes.

No letup in wage rate rise

Wage costs continued to rise at a rapid rate through mid-year. After remaining unchanged in April, hourly wages in manufacturing rose 3-1/2 per cent

in May and held at that level in June. For the second quarter, rates averaged 4.1 per cent above the first quarter. This increase approximated the average quarterly rise that has occurred in Italy since the beginning of 1962, when the present rapid uptrend began. In manufacturing, hourly rates in April-June were 17 per cent above a year earlier, and 24 per cent higher than in the last quarter of 1961.

Price pressures abate in April-July

Upward pressure on prices slackened off in April-July. In part, the slowing of the rise was caused by favorable seasonal influences affecting the supply of foodstuffs. Furthermore, the unusual severity of the winter had placed additional strains on prices. Consumer prices continued to move up through April, when the rise was 0.6 per cent, but then practically levelled off. A further but moderate increase in wholesale prices after March was followed by a dip in July, the net increase from March to July amounting to but 1/2 of 1 per cent. In July, increases from July 1962 were 6.6 per cent for consumer prices and 5.0 per cent for wholesale prices.

Industrial production rebounds vigorously

Output of Italian industry, adjusted for seasonal variations, rose to new record levels in the second quarter. Over-all internal demand continued to increase. In addition, production benefited from both the ending of the extra-severe winter and the termination in February of the long labor dispute in the metallurgical and engineering industries. Output rose 3.5 per cent in March and 1.7 per cent in April, and a further fractional gain in May was retained in June. For the second quarter as a whole, production was up not only 4.8 per cent from the fourth quarter of 1962 but also 9.6 per cent from each of the first three quarters of 1962, when output was failing to rise at all.

These recent results thus show a resumption--after the winter delay-- of the revival which began in the fourth quarter, following nearly nine months of pause in 1962. Production of both investment and consumer goods have shared in the progress made since last autumn. In April-May (latest data available) increases over the fourth quarter average came to 6.2 per cent for investment goods, 3.7 per cent for consumer goods, and 4.2 per cent for a third broad category comprising fuels, electricity, and chemicals.

September 26, 1963

Postscript

Since preparation of this review, it has been reported that on September 25 the Italian Cabinet acted to approve an anti-inflationary program, apparently consisting of the following four measures which are not spelled out in any detail in the press reports:

1. Selected increases in sales taxes on certain luxury goods;
2. Action to reduce the budget deficit by using \$128 million equivalent of budget receipts specifically for this purpose;
3. Special measures (unspecified) to stimulate investment in new plants and the modernization of existing productive facilities; and
4. Measures to promote rapid construction of low-cost housing.

This limited program seems to be as much as the present "caretaker" government is prepared to initiate at this time. Hence, it still seems to be true, as the attached review suggests, that the main burden for controlling domestic inflation in Italy at this time continues to rest on monetary policy.