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RFD 502

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

September 22, 1964

Recent Economic Developments in Italy:
April-August 1964

15 pages

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Summary

Italy's balance of payments has improved far more rapidly in the period under review than could be foreseen a few months ago, but serious internal problems remain.[1/] Production turned downward in the second quarter, while consumer prices continued to rise and thereby abet the still-too-rapid increase in wage rates. Government finances became more unbalanced and made necessary a very tight squeeze on credit supplies for the private sector. At the end of August, certain fiscal measures were taken to reduce labor costs, and these should also help to stimulate exports.

Balance of payments surpluses totalling $378 million were recorded in the four months April-July, and August reportedly yielded another substantial surplus. While seasonal factors helped these results, a more significant development was a big improvement in the trade balance. Exports continued to rise, while imports fell in response to higher agricultural production and declines in inventories, in industrial production, and industrialists' concern over the outlook for production. The capital account improved further with a decline in the bank note outflow and heavy foreign direct investment in Italian industry.

Monetary expansion continued to be modest, and far less than a year earlier, in spite of a sharp deterioration of government finances and a big increase in Treasury recourse to bank credit. The Bank of Italy kept commercial bank credit to the private sector severely in check, and limited the internal

1/ For a review of earlier developments, see Recent Economic Developments in Italy; January-May 1964, dated June 11, 1964.

monetary impact of the external surpluses. Notwithstanding recent actions and proposals to curb government spending, it is uncertain whether the fiscal balance will be redressed in the near future.

Industrial production fell some 6 per cent from March to June, but as of midsummer unemployment had reportedly not yet begun to rise. Even though wholesale prices were stabilized, consumer prices again pushed upward and, through the action of the sliding scale, contributed to further large increases in wage rates. Contractual wage increases also occurred, and in May wage rates in manufacturing were up more than 9 per cent in the six months since last November.

<u>External position shifts into surplus</u>

The Italian balance of payments shifted with unexpected speed from deficit to surplus in the second quarter, and surpluses continued in July and August. While seasonal factors were important in this improvement, a larger and more fundamental contribution was made by a sharp contraction of the trade deficit, in turn partly a consequence of the continuing monetary stringency imposed by the Bank of Italy. In addition, the capital account benefitted from heavy foreign investment in Italian industry and reduced clandestine outflows of Italian funds.

The over-all balance shifted to a $227 million surplus in the second quarter, from a deficit of $436 million in the first quarter of 1964 and a deficit of $412 million in last year's second quarter. (See Table 1.) The July surplus came to $151 million, and for August the surplus is thought to have been substantial. Although the external balance is seasonally most favorable in these two months, last year witnessed deficits of $46 million in July and $18 million in August.

Table 1. Italy: Balance of Payments, 1963-64
(In millions of dollars)

	1963 II	1964 I	1964 II
A. Trade	- 643	- 679	- 396
1. Imports c.i.f.	-1,820	-1,932	-1,727
2. Exports	1,177	1,254	1,332
B. Current Invisibles	367	252	452
C. Private Capital	- 141	- 23	204
1. Italian banknotes remitted	- 525	- 262	- 140
2. Other	384	285	344
D. Public Capital	5	15	- 34
E. Over-all Balance (A+B+C+D)	- 412	- 436	227
F. Monetary Movements	412	436	- 227
1. Official reserves	- 8	233	- 39
2. Other official	18	400	- 40
3. Commercial banks	383	- 198	- 147

Source: Ufficio Italiano dei Cambi

The factor of most far-reaching significance was the fall in the trade deficit, which fell to $396 million (payments basis) in the April-June quarter from earlier levels of $679 million in January-March and $643 million a year earlier. Both import payments and export receipts moved favorably, and changes in leads and lags had no effect on the quarter-to-quarter drop in the deficit. Import payments (unadjusted) decreased 11 per cent in the second quarter, to a level 5 per cent under a year ago. Export receipts (unadjusted) were up 6 per cent in the second quarter, and stood 13 per cent higher than in the second quarter of 1963.

Seasonally adjusted imports (customs basis), which had already begun to decline in February, fell sharply in both March and April. After a small rise in May, they were 12 per cent under the January peak. (See Table 2.)

Commodity details are not available beyond April. Seasonally adjusted data prepared by a highly-regarded Italian research organization, ISCO, show sharp and continuous declines from December through April in imports of foodstuffs, which fell nearly 20 per cent in this period, and in imports of investment goods (raw materials and equipment goods, excluding fuels and chemicals) which dropped 7 per cent. These changes coincide with reports of increased agricultural production in Italy this year, and of reductions in inventories and fixed investment outlays caused by the credit squeeze. Imports of nonfood consumer goods did not decline in this period, but their failure to rise contrasted with the steep rise that occurred up to that time, being affected by the consumer credit restrictions and the tax on automobile purchases applied at the end of February.

Table 2. Italy: Foreign Trade, 1963-64
(In millions of dollars; monthly average or month)

	Imports, c.i.f.		Exports		Balance	
	Unadjusted	Adjusted	Unadjusted	Adjusted	Unadjusted	Adjusted
Quarters						
1963 -- I	569	558	395	407	-173	-151
II	636	627	413	425	-224	-202
III	650	678	430	431	-220	-247
IV	671	671	454	433	-218	-238
1964 -- I	695	683	442	453	-254	-230
II	640	n.a.	485	n.a.	-155	n.a.
Months--1964						
January	718	715	420	471	-298	-244
February	699	691	451	448	-247	-244
March	669	642	454	440	-215	-202
April	650	623	490	484	-161	-139
May	634	631	459	471	-175	-160
June	635	n.a.	506	n.a.	-129	n.a.

Source: OECD

There has been a heartening continuation of the uptrend of exports. Seasonally adjusted shipments through customs rose sharply in April, regaining their high February level, and advanced again in May. For April-May combined, average monthly exports were up 4-1/2 per cent on the first quarter. During the first four months of this year, there were gains over the September-December period in all major commodity groups except foodstuffs, according to seasonally adjusted figures prepared by ISCO.

The surplus on current invisibles rose $200 million to $452 million in the second quarter. Although this increase was largely based on seasonally higher tourist receipts and emigrant remittances, the second quarter surplus was well above the $367 million of a year earlier because of favorable shifts in the "miscellaneous services" and "unallocated" categories.

Net receipts on capital account swelled to $169 million in April-June, following the slight deficit recorded in the preceding quarter. The amount of exported Italian banknotes returned for credit continued to diminish falling from $262 million in the first quarter to $140 million in the second, in reflection of the liquidity squeeze. But an even larger part of the improvement was caused by an exceptionally large rise in foreign investment in Italy, concentrated in June.

Use of surpluses reinforces tight credit policy

The greater part of the balance of payments surpluses totalling $378 million in April-July was made use of by the Italian commercial banks to make further reductions in their foreign indebtedness. The net foreign liabilities of the banks were cut $147 million in the April-June quarter and another $80 million in July. Such use of the surplus, as contrasted with increases in official holdings, did not supply the Italian banking system with lire for making internal loans and investments. This action by the banks, which reflects the desires of the Italian monetary authorities, reinforced the other monetary actions taken in this period to keep a tight reign on bank credit expansion. Official reserves of gold and foreign exchange rose $39 million in the second quarter and $40 million in July, and other official net foreign assets rose $40 million in April-June and $30 million in July.

Three-way swap transaction carried out

In mid-June, under a swap arrangement with the Swiss National Bank, the Bank of Italy drew $100 million equivalent of Swiss francs against which it opened a lira account in the same amount in favor of the Swiss central bank. The francs thus acquired were sold for dollars to the Federal Reserve Bank of New York (which used the francs to repay drawings under its swap with the Swiss National Bank). The transaction served initially to increase Italy's official reserves, but it had no effect on total Italian net foreign assets because the increase in dollar holdings was offset by the lira liability to the Swiss. Italy's obligation to repay Swiss francs drawn under the agreement will be reduced in accordance with Swiss National Bank lira requirements.

Transactions made with IMF

Two transactions with the International Monetary Fund were made in August and early September. On August 19 Italy made an additional $57.5 million gold subscription to the Fund in connection with the increase in its quota from $225 to $500 million. Second, with the pressure on official reserves removed over the past five months, on September 1 Italy repaid $65 million of the $225 million Fund drawing made last March. At the present time no further repayments need be made because other countries' outstanding drawings of lire amount to $160 million.

Monetary restraint is maintained

Bank of Italy action again kept monetary expansion within modest bounds and much smaller than a year earlier. To do so, it had to restrict private credit very severely and act to nullify the internal impact of external surpluses, because a rising fiscal deficit injected new purchasing power into the economy.

The money supply rose 1.4 per cent from end-February to end-May, compared with 3.6 per cent a year earlier. Over the six months ending May, the increase was 2.4 per cent, down from 8.7 per cent in the year-ago period, which preceded last summer's decision to apply the brakes.

Commercial bank credit to the "economy" (all borrowers except the Treasury) increased less than 1.0 per cent in the four months ending June, and 2.0 per cent in the seven months ending June. Although the balance of payments swung into surplus, the authorities induced the commercial banks to use most of their net foreign exchange proceeds to make new reductions in their net foreign debts to limit the domestic repercussions of the external surplus.

Treasury situation deteriorates sharply

Efforts to restore over-all financial equilibrium in Italy by cutting the heavy imbalance of the Treasury suffered a sharp setback in March-May. Large cash deficits reappeared, leading to renewed resort by the Treasury to Bank of Italy credit. Consequently, over the first 11 months of fiscal 1964 the deficit was considerably larger than a year earlier. It seems plausible to assume that, if the Treasury would reduce its calls on bank credit, the Bank of Italy might be able to shift toward a less restrictive policy on credit to other sectors of the economy. The cause of the Treasury's total deficit has been not so much the budget itself but rather the extra-budgetary expenditures, much of which are to finance local authority deficits.

The over-all deficit for March-May is estimated at 327 billion lire, up sharply from an estimated 156 billion lire in the like period of last year,1/ and was financed mainly by bank credit, notably a 195 billion lire rise in the Treasury's overdraft with the Bank of Italy. (See Table 3.) These results came on the heels of a short-lived year-to-year reduction in the deficit in January-February. On budget transactions, the situation in fact improved greatly, as a surplus superseded the deficit of a year earlier, but estimated net extrabudgetary expenditures soared to almost 500 billion lire from virtually zero in March-May 1963.

1/ Budget figures are published monthly, but extrabudgetary outlays and the total balance must be estimated from figures concerning the financing. These latter are not complete but the omissions are minor.

Table 3. Italy: Treasury Cash Operations, 1962-64[1/]
(In billions of lire)

	3 Months Ending		11 Months Ending	
	May 1963	May 1964	May 1963	May 1964
1. Surplus (+) or deficit (-) on budget account	-159	+145	-458	-247
2. Surplus (+) or deficit (-) on extrabudgetary operations	+ 3	-482	-233	-730
3. Over-all balance (1 + 2)	-156	-327	-691	-977
4. Financing:				
Bank of Italy overdraft	88	195	513	627
Bank of Italy special advances	-	-	- 40	- 30
Treasury bills	30	25	18	- 93
Long-term internal debt	- 6	88	- 59	91
Postal savings	41	32	405	330
Other	3	- 13	-146[2/]	52

1/ Including the Cassa Depositi e Prestiti and some minor operations of autonomous organizations.

2/ Mainly a 110 billion lire foreign debt repayment in July 1962.

Sources: The three-months data are taken from Conto Riassuntivo del Tesoro and the Bank of Italy Bollettino (for postal savings). The figures for extrabudgetary transactions and the over-all balances are estimates obtained from the budget figures and the financing figures, which latter do not include some minor items. The 11-months data are a combination of the figures for the period July-March in the annual reports of the Bank of Italy, and the April-May data in Conto Riassuntivo del Tesoro and the Bank of Italy Bollettino.

Over the 11 months from July 1963 through May 1964, the Treasury incurred an estimated cash deficit of 977 billion lire.[1/] The bulk of the financing took the form of a 627 billion lire rise in the Treasury's overdraft facilities with the bank of issue. The importance of this figure can be appreciated by relating it to the

1/ Data for the first nine months published in the Bank of Italy's annual report, to which have been added the author's estimates for April-May.

fact that over the same period it slightly exceeded the rise in the money supply 622 billion lire.

The budget balance improved notably in fiscal 1964, when the deficit for the first 11 months was nearly cut in half to 247 billion lire. But extrabudgetary expenditures increased threefold to an estimated 730 billion lire. A breakdown of these expenditures is not available for this period.1/

Treasury cash deficit may not be reduced soon

The Italian government has taken steps in the past nine months to curb the rate of growth of budget expenditures and deficits, and Prime Minister Moro has stated that the rate of rise in budgeted outlays in 1965 will be far smaller than in the recent past. But it is uncertain how soon these measures and proposals will be effectively translated into a reduced over-all Treasury cash deficit. For the budget does not cover extrabudgetary expenditures which by now have assumed very large proportions. Furthermore, the budget figures are administrative bookkeeping transactions of expenditure obligations and revenue assessments which in the past have offered no clue to the near-term course of actual cash operations on budgetary account.

The budget deficit in fiscal 1964 will apparently show little increase over fiscal 1963 because of the policy of expenditure restraint adopted by the first Moro government installed last December. (See Table 4). This contrasts with previous large increases in the deficit. In June of this year the Parliament

1/ In the calendar year 1963, the Cassa Depositi e Prestiti, which incurs nearly all the extrabudgetary expenditures, spent 532 billion lire, of which 311 billion lire were advances to local authorities. The remainder was used almost entirely to purchase new issues of public sector bonds, especially those issued by the National Electricity Board (ENEL) and those issued to finance the Green Plan for agricultural development. The Cassa's own resources (almost entirely postal savings) came to only 441 billion lire, and its resulting deficit was in essence covered by creating new money via Bank of Italy credit to the Treasury.

passed an interim budget for July-December 1964 in which the deficit is well under one-half of the forecast deficit for fiscal 1964. (The fiscal year is being shifted to coincide with the calendar year beginning in 1965.) Prime Minister Moro stated in a speech to Parliament on July 30 that in 1965 the rise in budgeted expenditures would not exceed 5 per cent (compared, for example, with 17 per cent in fiscal 1963). While the receipts side is a question mark, presumably the deficit will fall considerably.

Table 4. Italy: Administrative Budget and Treasury Cash Operations, 1961-64
(In billions of lire)

	Fiscal year ending June			July-Dec.
	1962 2/	1963 2/	1964 3/	1964 4/
Administrative Budget 1/				
Receipts	4,624	5,296	5,322	2,996
Expenditures	5,005	5,834	5,881	3,212
Balance	- 381	- 538	- 559	- 216
Treasury Cash Operations 5/			(11 mos)	
Budget receipts	4,401	4,916	4,975	---
Budget expenditures	4,572	5,214	5,222	---
Budget balance	- 171	- 298	- 247	---
Balance on Extrabudgetary operations	- 210	- 327	- 730(est.)	---
Over-all balance	- 381	- 625	- 977(est.)	---

1/ A budget of expenditure obligations and revenue assessments.
2/ Final results.
3/ Bank of Italy estimate as of end-March 1964.
4/ Initial budget.
5/ Including the Cassa Depositi e Prestiti and some minor operations of autonomous organizations.

Source: Annual reports of the Bank of Italy for 1962 and 1963; sources cited in Table 3 for 1964 Treasury cash operations.

These actions and intentions do not tell us, however, what will happen the extrabudgetary outlays, which will depend inter alia on steps to cut local authority deficits. In addition, cash operations on budgetary account could depart markedly from the administrative budget figures. In the recent past, the cash budget deficit has been smaller than the administrative deficit because lags in spending have exceeded lags in receipts. But a speed-up of unspent obligations could change this.

Industrial production turns downward

Italian industrial production (seasonally adjusted) turned downward last spring after remaining essentially unchanged from November to March. The index dropped 3.2 per cent from March to May and provisional estimates show a further decline of more than 3 per cent in June. (See Table 5.)

Table 5. Italy: Selected Economic Indicators, 1963-64
(1953=100)

	Industrial Production (seas. adj.)	Wholesale prices	Consumer prices	Wage rates in manufacturing
Quarters				
1963 -- I	230	106.0	130.1	169
II	241	106.7	131.9	176
III	243	107.0	132.5	180
IV	250	109.6	135.4	183
1964 -- I	250	110.7	137.5	190
II	244 1/	110.4	139.1	n.a.
Months -- 1964				
February	246	110.6	137.4	190
March	252	110.7	137.8	197
April	247	110.5	138.0	198
May	244	110.4	139.2	201
June	236 1/	110.4	140.1	n.a.

1/ Preliminary

Source: OECD; press reports for June production.

Details by industrial sectors are not available beyond April. According to the research organization ISCO, seasonally adjusted production of investment goods, following small increases in January and February, dropped nearly 6 per cent from February to April; production of iron and steel, electrical machinery, precision instruments and metal-working products fell appreciably in these two months. In the consumer goods industries, production of nondurables increased throughout the first four months of the year but in April was still slightly below the levels of October and November. But production of consumer durables, which peaked in January, decreased continuously in February-April by more than 5 per cent. Automobile production was especially hard hit; continuous declines from January to April totalled about 15 per cent. The decreases in auto output were sharpest in March and April after the late-February imposition of the special purchase tax.

Throughout the first five months of 1964, the volume of unfilled orders declined in both the investment and consumer goods industries, as did the degree of producers' optimism over future levels of activity. ISCO reports that in May the number of companies who expected lower levels of production in June-September far outweighed the number expecting a rise.

Weakness in the construction field is evidenced by declines in the number of building permits issued. In county seats of over 20,000 persons, the number of permits issued for residential construction in January-April (unadjusted) was down almost 8 per cent from a year earlier, and the comparable drop in permits for nonresidential building was 27 per cent.

Unemployment has fortunately not yet become a problem. Seasonally adjusted unemployment in April was in fact a bit less than in January, and reportedly fell slightly further in May-June. On the other hand, there have been widespread reductions in hours worked, especially in the second quarter.

Price-wage spiral continues

Prices and wages still pose serious problems. Wholesale prices remained stable in the second quarter, but the rise in consumer prices and the cost of living continued. This touched off a new round of automatic wage increases in August. In March-May, contractual wage rates once again rose with extreme rapidity, in part because of earlier cost-of-living increases. Suggestions have been made that the sliding scale system be modified in order to facilitate the task of achieving price stability, but the unions are firmly against any changes.

Consumer prices advanced in each of the three months of the second quarter, so that in June they were up 1.7 per cent from March and 2.9 per cent from December. (See Table 5.) The sliding wage scale based on a cost-of-living index rose 3 points from April 15 to July 15, equal to 2.55 per cent.[1/] As a result, contractual wage rates were increased 2.55 per cent on August 1. Minimum contractual wage rates in manufacturing rose in each of the months March-May a total of 5.8 per cent, of which 1.70 percentage points was caused by the rise in the cost of living between mid-February and mid-April. Earlier, these wage rates increased 3.3 per cent from November to February, of which 2.55 percentage points reflected the cost of living factor. The continuing rise in prices has been important in the further rise of wage rates, but these comparisons show that other factors have been of equal importance. Unfortunately, it is not known in what degree these remaining wage advances grow out of contracts signed in past periods, or result from new agreements.

1/ A point is 0.85 per cent. A one per cent increase in the cost of living means a 1 per cent rise in the originally agreed wage, the adjustment taking place quarterly.

Fiscal measures will reduce labor costs and spur exports

At the end of August, the Italian government took steps in the fiscal field designed to lower labor costs, and these measures should also stimulate exports. Taxes have been increased, but it appears that this set of measures will not serve to redress the imbalance in the Italian public finances.

Tax revenues will be increased immediately by about 240 billion lire per year, or by around 4 per cent, mainly by a hike in the turnover tax rate from 3.3 to 4 per cent. (Exempted from this rise were food, bank charges, and many products used in agricultural production.) Income tax rates were increased in the higher brackets, and a special 20 per cent tax was levied on income from luxury housing.

At the same time, social security contributions made by employers and employees were slashed 35 per cent, or by about 210 billion lire a year. This will directly lower employers' labor costs by about 3 per cent. This action was taken to maintain employment at a time when a downturn in production could lead to dismissals of workers.

Exports should be aided. Exporters receive a rebate of the turnover tax, and the rise in the turnover tax rate should increase the relative profitability of selling abroad as compared with the home market. Also, exporters, like all other producers, will benefit from the cut in social security contributions.

These measures leave practically unchanged the total collection of taxes and social security contributions. Therefore it appears they will not affect the fiscal balance and the rate of private spending.