

Monetary Policy in Italy from 1970 to 1978*

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I. Introduction

Economic Developments and Monetary Policy from 1947 to 1969

The level of economic activity, the external accounts and the inflationary process appear to have been very much influenced in Italy, throughout the period following the Second World War, by the development of the monetary and credit aggregates and by monetary policy interventions. The present work examines monetary policy in Italy from 1970 to 1978 and its role in controlling the economic cycle. The events are examined in chronological order within the framework of general economic developments in order to emphasize the motives and effects of the single measures.

The analysis of recent years is preceded by a brief description of economic developments and of the role of monetary policy during the period running from the end of the Second World War to 1969. In the concluding section it will be attempted to pinpoint the constant features and the dissimilarities of the role of monetary policy in the different periods. Almost all the statistical material used in this study can be found in the Reports of the *Banca d'Italia* for the corresponding years. For the interpretations of this material and for the explanatory schemes used the reader is referred to these Reports and in particular to the studies conducted by the Research Department of the *Banca d'Italia*, especially those relating to the econometric model¹.

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¹ Of particular interest are the essays reproduced in: P. *Baffi*, "Studi sulla moneta", Milano, 1965. Other works of interest are: G. *Cottarelli*, "Il modello econometrico nelle Relazioni della Banca d'Italia", University of Siena degree thesis prepared under the guidance of Prof. M. *Tonveronachi*, academic year 1976—77; G. *Mengarelli*, "Politica e teoria monetaria nello sviluppo economico italiano 1960—65", Venezia, 1970; F. *Bruni* — G. *Ragazzi*, "Sul controllo del credito in Italia", *Giornale degli economisti*, An nali di Economia, September-October, 1977.

The crisis of the early postwar years, which caused prices to double in 1947 compared with the previous year (in 1946 prices were 25 times higher than in 1938, although most of the increase occurred after 1943) stemmed from a liquidity surplus inherited from the war years and was fuelled by a Treasury deficit amounting to 15 % of national income and by a rapid expansion of bank loans and deposits (during 1947 loans increased by 75 % and deposits by 45 %). The disequilibrium in the trade balance, which was of the same magnitude as the Treasury deficit, led to a large depreciation in the external value of the lira, with the result that in May 1947, partly for political reasons, the dollar quotation on the free market stood at over 900 lire.

The crisis was brought to a halt in September 1947 by the introduction of a compulsory reserve requirement for banks amounting to 40 % of the increase in deposits. Free market quotations for the dollar dropped back to below 600 lire (in 1949, following the devaluation of the pound sterling, the exchange rate was settled at 625 lire to the dollar and remained at that level until 1971) which helped to bring about a 15 % decrease in both wholesale and retail prices between September 1947 and the middle of the following year.

The period of stabilization of 1947—48 was the prelude to almost fifteen years of considerable growth in production and employment under conditions of price stability. Between 1948 and 1958 industrial production rose on average by 9.3 % per annum. On the demand side the contributory factors to this development were the postwar cycle of reconstruction throughout Europe financed by the *Marshall-Plan* and subsequently the implementation of large-scale investment programmes in Italy, particularly in the southern regions and the islands; on the supply side this role was played by the high rate of rise of personal saving at a time when the public finances were gradually being redressed and by the increase in productivity connected with the introduction of modern technologies in industry². The foreign currency reserves made available by the *Marshall-Plan* (1.5 billion dollars between 1948 and 1953), a cyclical policy constantly aimed at keeping the balance of payments close to equilibrium and the stability of labour costs connected in turn with the abundant supply of labour³ made it possible, in a

² F. Vicarelli, "La funzione di produzione ad elasticità di sostituzione controllo del credito in Italia", *Giornale degli economisti*, *Annali di Economia*, 1967.

situation of stable world market prices, to achieve almost perfect stability of the exchange rate and of prices.

Throughout the period bank credit and bank deposits expanded at a faster pace than production at current prices (bank loans and deposits rose by an average 17.4 % per annum between 1948 and 1958, compared with the above-mentioned annual rate of increase of production of 9.3 %, while wholesale prices remained absolutely stable and consumer prices rose by 3 % per annum). Long-term interest rates remained at sufficiently high levels compared with those on foreign markets and with the rate of inflation, thus encouraging inflows of capital and probably also the formation of saving. Bank lending rates were gradually brought down from the extremely high levels recorded at the beginning of the fifties.

From 1959 onwards there was an acceleration of the rate of rise of investment demand financed by the expansion in the volume of credit to the economy, which as a ratio of GDP rose considerably above the values recorded in the preceding years⁴. The gradual narrowing of the margins of unemployed labour led to a wage boom in 1962—63 in which political factors played a part. Total incomes from employed labour rose by 43 % in two years and in 1963 the current account of the balance of payments showed a deficit equal to 2 % of national income. The subsequent stabilization, which was first obtained by means of credit restrictions and later with fiscal measures, rapidly corrected the disequilibrium in the external accounts and made it possible to return to modest rates of inflation (less than 1 % per annum for wholesale prices between 1965 and 1968).

In the first half of 1966 a policy was introduced to stabilize bond yields in order to facilitate the placement of bonds with the public and banks and to provide finance to investment at the chosen interest rates and in sufficient quantity to satisfy fully the demand. The level of interest rates was chosen in relation to the domestic rate of inflation and to the level on world markets. The stability of yields was guaranteed by central bank intervention on the secondary market; however, owing

³ F. Modigliani — E. Tarantelli, "A Generalization of the Phillips-Curve for a Developing Economy", *Review of Economic Studies*, 1973.

⁴ An analysis of the most important financial ratios for the years running from 1951 to 1970 can be found in F. Cotula — M. Caron, "I conti finanziari dell'Italia", *Bollettino della Banca d'Italia*, 1971. Updated analyses for the years following 1970 are given in the Annual Reports of the *Banca d'Italia*.

stable prices, the central bank in fact ended up a net seller of securities on that market and accordingly the growth rate of monetary base creation to the good performance of demand connected with expectations of inflation and of the formation of bank deposits declined. The entire interest rate structure tended to adjust to the level of long-term rates.

The restrictive monetary policies adopted in the United States and in other countries led to a gradual rise in interest rates on world markets from 1966 and, over the next years, to the formation of a negative spread between short-term interest rates in Italy and rates abroad. Domestic demand for fixed-interest securities remained strong, but the comparative level of interest rates affected capital outflows. The policy adopted had favourable effects on investment which picked up to a considerable degree in 1966 (under the stimulus in particular of the rise in domestic demand) and then increased at a fast rate in the following two years. However, there began to be a tendency to direct investment mainly towards projects to increase efficiency and towards highly capital-intensive sectors. In line with this development the rate of employment tended to decline despite the increase in GDP which rose by over 6 % per annum between 1965 and 1968.

1969 saw an upswing in production and a deterioration in the external accounts, combined with price tensions, which made it advisable to abandon the interest rate stabilization policy and adopt measures to curb the rate of expansion of credit. On this occasion too the effect of the monetary measures on the balance of payments was rapid and large and the external accounts showed a clear improvement by the middle of 1970 on.

II. From 1970 to 1973: Modest Growth and Inflation

In Italy the second half of 1969 was also marked by labour conflicts in which 228 million hours were lost in industry (50 million in 1968) with the result that production declined by 8 % in the last four months of the year. In addition to raising considerable labour costs, the wage disputes led to the introduction of regulations and the assumption of certain attitudes in relations between industry and trade unions which had adverse effects on plant utilization and labour mobility (even within the same firm) and, in the final analysis, on productivity. The conflicts continued into 1970 with a loss of 85 million hours in industry.

1. The Period of Slow Growth 1970—72

The rise in minimum wage rates in industry reached 18.6 % in 1970, compared with 6.6 % in 1969 and 3 % in 1968, while the increase in actual earnings was slightly higher. The cost of labour per unit of output in manufacturing industry rose by 13.6 %. The first half of 1970 and more especially the first quarter saw a sustained upturn in production which was partly due to the recovery of the losses in output during the previous year. On an annual basis industrial production rose by 8 %, but during the year the trend was almost stationary and the level of output was lower in the last quarter than in the first. The performance of the Italian economy reflected similar movements in the main industrialized countries. In West Germany wages per unit of output increased by 9.5 % and in the United Kingdom by 9.7 %, while in the other countries the rise was smaller. The effect of the slack in world demand on the Italian economy took the form of a limited rise in exports. The level of aggregate demand was also adversely affected by the trend of investment in construction which, after the upswing of the previous year (the increase in real terms was 15 %) in 1970 declined by 6 %. The increase in productive investment was again large on average for the year and higher than that recorded in the previous year (8.5 % in 1970 compared with 7.6 % in 1969) but the statistical results revealed the decline in the second half of 1969 and subsequent recovery. The trend during the year was negative.

Still in 1970, personal consumption also showed a substantial increase (7.2 % in real terms) although the rate of rise was not comparable with that recorded at the time of the major wage rises of 1962—63. The greater purchasing power associated with the increases in pay was in part offset by the rise in prices, which continued along the upward trend already observable in the second half of 1969. Consumer prices rose by an average 4.9 % in 1970 from the previous year while wholesale prices, which were more directly affected by the movements in production costs, increased by 7.3 %. There was a substantial increase in inventories which helped to sustain economic activity, but the accumulation of stocks of finished goods in excess of the desired level paved the way for a subsequent slowdown in production.

Consumption and demand were affected by a package of fiscal measures and changes in public utility charges introduced during the summer, which provided for increases in public revenues equivalent to

over 1 % of national income. This measure was designed to make good in the future the deficits of the social security bodies which had been caused in part by the new system of calculation and indexation of pensions adopted in 1969. However, from a cyclical point of view the measure was badly timed.

During 1971 there were also clear signs of a phenomenon which reappeared during later years in presence of accelerating prices and of deteriorating employment prospects, that is to say an increased propensity towards personal saving. In that year consumption of households increased by only 3.0 % in real terms. Investment in construction showed an even sharper downward trend in 1971 and remained at low levels in 1972. Productive investment was affected by the smaller earning capacity of firms owing to their increased wage bill, which continued to rise at a fast pace during 1971 although not as rapidly as in the previous year (costs per unit of production rose in 1971 by 10.1 % while wholesale prices rose by 3.4 % and consumer prices by 4.8). The standstill in production continued throughout most of 1972. In 1971 GDP rose by 1.6 % in real terms and in 1972 by 3.1 %.

The current account of the balance of payments, seasonally adjusted, was close to equilibrium at the beginning of 1970 and moved back into surplus during the year as a result of the slackness of economic activity and the slowdown in the rate of rise of imports. For 1970 as a whole the balance on current account was appreciably smaller than in the previous year, but owing to the larger decline in capital outflows (from minus 2,265 to minus 140 billion lire) the overall balance was in surplus once more (222 billion lire compared with a deficit of 870 billion in 1969). Illegal capital outflows under the form of bank-note exports, in particular decreased, from nearly 200 million dollars per month in 1969 to less than 50 million per month in the second half of 1970 (the total figures were 951 million dollars in 1970 and 2,256 million in 1969). Capital outflows, and hence the overall balance of payments, were influenced to an important extent by the increase in interest rates in Italy and by the decision to centralize at the head office of the *Banca d'Italia* all operations to credit banknotes remitted from abroad. The policy adopted as regards movements of medium and long-term capital however was still not to impose any constraints, in line with the overall aim of promoting trade and the international circulation of resources.

Monetary policy, which had been kept on a restrictive course until almost the middle of 1970 with bond yields rising until July (at which

time they stood 3 to 4 % above the 6.5 % levels held from 1966 to mid-1969), underwent a clear turnaround from the summer onward as a result of the improved foreign exchange situation and the halt in the expansion of economic activity. The change of course was immediately reflected in bond yields which declined, but bank lending and deposit rates continued to increase throughout the whole of 1970.

It became clear during 1971 that the rate of rise of the monetary and credit aggregates was accelerating; the ratio between total financing, to both the public and private sectors, and GDP reached 19.9 % in that year, compared with 16.7 % in 1970 and around 14 % in each of the four preceding years. Long-term interest rates continued to decline slowly which facilitated the placement of large issues of securities, notably by the real-estate credit institutions, and made conditions easier for the financing of investment. In 1971 the ratio between the formation of financial assets and gross national domestic product was 20.4 % as against 16.4 % in the year 1970. The increase in credit flows in 1971 compared with the previous year was mainly due to the larger Treasury deficit. In 1972 the ratio of total financing to GDP reached 23.8 %, the increase from the previous year being mainly attributable to the private sector of the economy.

The liquidity position of the corporate sector, which had already shown some improvement during 1970 after the tight conditions which had prevailed until the middle of the year, improved further during 1971 and increased again appreciably during 1972. Given the persistent slackness of investment demand, the current position of the balance of payments remained strong; international organizations were calling for a revaluation of the lira. But there were again large outflows of capital; in 1972 the deficit stood at over 1,900 billion lire (compared with 500 billion in 1971): this negative balance increases if it is adjusted for compensatory loans amounting to about 250 billion. The negative movements began in the spring of 1972 when the agreement to keep the fluctuations between the European currencies within a band of 2.25 % — together with the obligation of using for the regulation of debts all the reserve assets, including gold — came into force (the so-called snake arrangement). They then became more marked from June on, partly in connection with speculation against the pound sterling (which had joined the agreement on 1st May and left in June); at the end of June Italy obtained the possibility of using only dollars for regulating movements of reserves, and almost 3.4 billion dollars were spent in the second semester for

interventions on the exchange market. The banks' foreign position improved by 180 billion lire in 1971 and again in 1972 in the form of an outflow of 440 billion of short-term funds through that channel.

2. The Economic Revival of End 1972 and Floating of the Lira

At the end of 1972 there was a substantial recovery in production in response to an increase in investment demand and more especially in exports. In addition to the stimulus provided by the domestic monetary expansion, the Italian economy was again influenced by the international cycle and production picked up in Italy two or three quarters after the improvement in economic activity in the main industrialized countries. In the OECD area as a whole industrial output, which had been stationary for two years, rose by over 10 % between the beginning and the close of 1972 in response to the expansionary policies introduced from the middle of 1970 on.

A contributory factor to the recovery in Italy was the corporate sector's improved earning capacity. Labour costs per unit of output in the industrial sector rose by 5.5 % in 1972 while wholesale prices increased by 4.1 % and consumer prices by 5.7 %. The surge in economic activity at the end of 1972 was brought to a halt at the beginning of 1973 by a new and violent wave of labour conflicts concentrated in the metal and engineering industry, which caused the general index of industrial production to fall by 3.3 % between the fourth quarter of 1972 and first quarter of 1973.

The large expansion of economic activity in the OECD as a whole prompted member countries to give monetary policy a restrictive turn again. Once more interest rates showed a tendency to rise in both Europe and on the Eurodollar market and at the beginning of 1973 there reappeared a negative spread between interest rates in Italy and interest rates on international markets. On the other hand, it was not yet obvious in Italy that the expansion under way was leading in the direction of a new vigorous cyclical upswing in investment and production; in fact there had been a further decline in employment during 1972 and unemployment had continued to increase.

The conflict between the internal and external objectives was solved by breaking the link between the current account and the capital account of the balance of payments. Following the example of other coun-

tries, Italy left on 23rd January — the EEC exchange rate agreement — creating the two-tier exchange market: under this system fixed exchange rates were maintained for current account transactions by means of the usual central bank intervention, while the exchange rate applied for capital account transactions was left to float freely in relation to demand and supply. A spread between the two exchange rates immediately appeared, with the floating rate falling by about 6% during the first days of application of the new system.

In March the devaluation of the dollar and the tendency of the European currencies to appreciate made it seem unlikely that the exchange rate vis-à-vis the EEC snake currencies could be kept stable even for current account transactions. On the other hand, since there were as yet no clear signs of an upturn in economic activity, the forecasts indicated a positive current account of the balance of payments for the whole of 1973. The adverse trend of the moment appeared to stem not only from the usual seasonal factors but also from the above-mentioned losses in output in industry and thus certain to be reabsorbed later.

The float of the lira against the other currencies led to a rapid devaluation, despite the massive intervention undertaken by the monetary authorities (around 400 million dollars in May, 300 in June, 800 in July). The depreciation of the exchange rate had an adverse effect on the rate of inflation, which increased rapidly particularly in the case of wholesale prices, but firms' profit and loss accounts were influenced for the better. Since the level of interest rates was still low there was increased accumulation of stocks of domestically produced and imported goods with favourable effects on production but harmful ones on the balance of payments, with further negative effects in the external value of the lira.

During the first half of the year the balance of payments recorded a deficit of 915 billion lire, but this figure reflected already 560 million dollars' worth of compensatory loans; in that period the deficit on current account was over 800 billion lire. The return to normal conditions in the productive sector made it possible to increase exports at a fast pace, but at the same time it was also evident that the rate of rise of domestic demand was accelerating and was bound to lead to a large external deficit for the year as a whole.

On the monetary front the balance-of-payments results led to a destruction of monetary base through the foreign channel; this caused

a considerable decline in the banks' excess reserves, with repercussions on short-term interest rates in particular. As regards banks' earning assets, the large deficit in the external accounts and the development of stockpiling led to a fast rise in lending and a decline in the demand for long-term securities, which reduced the resources available to the special credit institutions and hence the possibilities of financing fixed investment. The fiscal reform which came into force at the beginning of 1973 for indirect taxes, had an adverse effect on the volume of tax receipts and hence on the Treasury deficit, which tended to increase in relation to national income.

In June it was obvious that external equilibrium and an acceptable rate of inflation, on the one hand, and the level of domestic economic activity, on the other, were incompatible. A policy was adopted to increase the cost and reduce the availability of short-term finance, while guaranteeing the level of long-term interest rates and especially the availability of funds to finance fixed investment. In mid-June all banks, with the sole exception of the Farmers' and Artisans' Banks, were obliged to increase their portfolios of medium and long-term fixed-interest securities during the calendar year 1973 by the equivalent of 6% of their total deposits at the end of 1972. The figure set for the increase would make it possible to reduce the opportunities for expanding short-term credit to what was necessary to sustain production, would guarantee an adequate supply of funds to the medium and long-term credit institutions and would ensure the placement of public securities.

The expansion of bank credit, both medium and long-term, the formation of deposits and the public's demand for fixed-interest securities were consistent with the objective of an expansion in national income of 4.5% at constant prices and of 15% at current prices, with the balance of payments in slight surplus on current account and close to equilibrium overall. The Treasury deficit was forecast at 7,000 billion lire (5,750 billion in 1972) or 8.5% of GDP.

Immediately bank lending rates increased. By contrast a demand surplus developed on the securities market, causing yields to show a slight downward tendency; this was arrested by the central bank which offered for sale securities from its own portfolio. On the credit market a phenomenon which had already appeared during the previous restrictive phase between mid-1969 and mid-1970 showed a tendency to

re-emerge, that is to say an increase in the relative share of lending to large-sized firms compared with smaller ones.

In order to avoid phenomena of credit rationing to the detriment of small firms, at the end of July a measure was adopted to limit the growth rate of the loans granted by each individual bank to firms with outstanding debts of over 500 million lire. The rate of growth was fixed at 12 % for the period running from 31st March 1973 to 31st March 1974 and was calculated with reference to the desired total expansion of bank lending. This measure, together with the security investment requirement, brought about a slowdown in the growth rate of total bank lending, with favourable effects on short-term capital movements.

However, the measure which set the ceilings on the expansion of bank lending provided for exemptions in such cases as the prefinancing of fixed investment with bank loans. In practice, during the second half of the year, the criteria adopted for granting these exemptions were lenient and consequently bank lending could once more expand at a fast pace. No constraints to credit expansions came from the supply of monetary base since, after a slowdown in the first half of the year, monetary base creation had become abundant owing to the improvement in the external accounts during the summer months and to the introduction of the measures relating to securities and lending. In anticipation of the reform of the system of taxation of earnings from fixed-interest securities, which was to come into force on 1st January 1974, the special credit institutions stepped up their issues during the closing months of 1973. In the fourth quarter of the year issues exceeded the forecast amount by about 1,000 billion: most of these securities were placed with the banks, thus making it possible to extinguish prefinancing operations and hence to expand the volume of new loans. During the summer, for all those who bought foreign bonds, an obligation of depositing a sum, equal to 50 % of the capital and yielding no interest, was introduced.

Over the year as a whole the ratio of total financing to GDP reached 28.3 % thus greatly exceeding both the forecasts and the figure for 1972 (23.8 %). The balance-of-payments deficit destroyed part of newly created liquid assets with the result that the formation of total financial assets as a percentage of GDP was little above the figure for the previous year (26.2 % compared with 25.2 %). The balance on current account recorded a deficit of 2,000 billion lire for the year, compared with 290 billion in 1972 (and against a forecast, at the beginning of the year,

of a 500 billion lire surplus); in particular, in the fourth quarter the deficit was close to 1,000 billion lire. A major contributory factor to the current account deficit was the volume of illegal capital outflows, camouflaged behind movements in the service sector (after correction for this component the deficit was about 1,500 billion lire).

The two-tier exchange market caused a very marked slowdown in the rate of rise of gross capital movements; overall the recorded part of these movements showed in 1973 a surplus of 1,700 billion lire; the compensatory loans were 2,600 billion lire. In December the lira exchange rate applied to current account transactions recorded a 11 % depreciation compared with February; the exchange rate applied to capital account transactions was still 3 % lower. Between the beginning and the end of 1973 wholesale prices rose by 27.8 % and retail prices by 12.5 %.

3. The Results for 1973

Under the stimulus of the rise in demand of the improvement in profits and in the availability of medium and long-term credit, at the same interest rates as in previous years, there was an extremely fast acceleration of fixed investment, especially in the second half of the year, after the termination of the trade union negotiations.

Despite the decline in economic activity during the early months of the year, investment in plant and machinery rose by 22 % in real terms. Investment in construction also recorded a large increase (15 %) owing to the availability of sufficient finance and, generally, to the improvement in demand prospects. The gross national income rose by 5.9 % at constant prices and by 17 % at current prices, compared with forecasts of 4.5 and 15 % respectively. Between the end of 1972 and the end of 1973 industrial production increased by 15 %, while there was a slight improvement in the employment situation after the decline of the previous year and the rate of unemployment fell.

The balance of payments recorded a deficit on both current and capital account, partly as a result of the good liquidity position of the economy and the low level of interest rates. Between 1969 and 1973 GDP rose in Italy by 4.1 % per annum on the average, and prices (GDP deflator) by 7.8 %. In the OECD area the growth was 4.6 % per year, while prices increased 6.1 % per year. The industrial production index stood in December 1973 in Italy, as in the OECD, at 120 (1970=100), while in the

EEC area it stood at 116. From December 1969 to December 1973 bank deposits grew by 19 % per year and bank loans by 16 %. The growth of total financial assets was lower than that of deposits.

III. From 1974 to 1978: Reabsorbing the Oil Deficit

1. *The Oil Crisis*

The oil crisis caught the Italian economy in the midst of the delicate situation described above, when monetary policy was still sufficiently easy and a balance-of-payments deficit was accepted as the cost of an increase in productive investment, which appeared all the more necessary since it followed three years of stagnation. However, it was not yet appreciated, between the end of 1973 and the beginning of 1974, how very large that increase was (the largest since 1950) and in any case it was not immediately obvious that the course of monetary policy had to be altered drastically. In fact, it was still possible to borrow on world markets in the form of compensatory loans and although, looking ahead, it appeared that the demand for loans was bound to increase, it was believed that those markets would receive a larger inflow of funds from the countries benefitting from the rise in oil prices.

In the first quarter of 1974 the existing disequilibrium in the external accounts was compounded by the effect of the increased cost of oil imports; in addition there were further speculative capital movements. Despite recourse to compensatory loans (amounting to 590 billion lire in the first quarter) and to financing through the banks, intervention on the foreign exchange market totalled each month around one billion dollars. The already high rate of inflation increased again: in the space of three months, between December and March, wholesale prices rose by almost 20 % and retail prices by 6.5 %.

In Italy too the debate opened concerning the effects of the oil crisis on the international economy and the domestic and international policies best suited to cope with it⁵. However, the foreign exchange situation and inflationary conditions continued to worsen and the possibilities of taking out additional loans at not very heavy terms by resorting to the market faded; this was due not only to Italy's difficulties but also, to the inability of the Eurocurrency market to meet the increased

⁵ Cf. L. Izzo — L. Spaventa, "Alcuni effetti interni ed esterni dell'aumento del prezzo del petrolio", *Moneta e Credito*, March, 1974.

demand. (Actually there were failures of some banks and difficulties of some other in that market). It became increasingly obvious that there was an urgent need for a stabilization programme aimed at eliminating at least the demand surplus which existed prior to the oil crisis and at cushioning the inflationary effects of the crisis itself.

Against this background the decision was taken to resort to a stand-by arrangement with the IMF but it was only signed by Italy after a cabinet crisis and the formation of a new government. The aim of the agreement was the gradual adjustment of that part of the balance-of-payments deficit not caused by the rise in oil prices, to be achieved within the space of about eighteen months by curbing the Treasury deficit and the volume of credit to the economy.

The concept of total domestic credit (TDC) was formulated — and adopted in the letter of intent — as being the aggregate best able to control, within the time span considered, the acquisition by firms of both real assets (fixed investment and inventories) and financial assets including foreign assets, i. e. exports of capital) and hence the balance of payments. The concept of total domestic credit was obtained by excluding from total financing — which is an aggregate usually adopted, together with others, in monetary analysis in Italy⁶ — the amount represented by financing obtained from abroad and funds raised through share issues. The reference to the aggregate constituted by the money stock was considered particularly inappropriate because it is incomplete (financial assets in the form of securities are excluded) and because the ratio to the level of economic activity is unstable over the short run. Moreover, since, all other conditions being equal, the deficit in the external accounts reduces the money stock, the indicator may in that very event show an improvement when there is a large balance-of-payments deficit.

A ceiling was placed on the share of total domestic credit used to finance the Treasury. For the calendar year 1974 this limit was set at 9,200 billion lire, that is 9.0 % of GDP compared with a result of 7,500, that is 9.1 % of GDP the previous year. For total domestic credit a figure of 22,400 billion lire was set for the 12 months ending 31st March 1975. The amount of TDC was established on the basis of a forecast of a rise in GDP at constant prices of about 4 % and at current prices of about 15 % (the implicit price deflator of domestic consumption was

⁶ Cf. F. Cotula — M. Caron, "I conti finanziari della Banca d'Italia", op. cit.

3 % higher than that of GDP owing to the worsening of the terms of trade).

The hypothesis adopted for gross fixed investment was a 4 % increase in real terms and a 22 % increase at current prices, in which event the figure of 22,400 billion set for TDC would leave scope for firms to accumulate a sufficient volume of financial assets to meet normal requirements for transaction purposes⁷.

As regards the balance of payments, after the 1,500 billion lire deficit (on current account) of 1973 the forecasts at the time the agreement with the IMF was signed set the deficit at 5,300 billion for 1974, 3,600 billion of which was attributable to the rise in the price of oil, and the rest to the gap between domestic demand and supply which had arisen independently of the oil crisis. The objective of the stabilization policy was to reduce this second component of the deficit gradually during 1974 and to eliminate it before the end of 1975. In addition to curbing credit and the Treasury deficit it was intended to pass onto regulated domestic prices for refined oil products the increased financial burden caused by the rise in the prices of crude oil.

The level of the exchange rate, which was 16 % below that of February 1973, was judged sufficient for the purposes of maintaining Italy's competitive position and achieving the objectives set for the balance of payments and for the stabilization of the economy. It was believed that in order to hinder capital outflows and encourage inflows from abroad interest rates, at least short-term ones, had to be aligned with those prevailing on foreign markets and, in practice, raised considerably (in fact, the movements in interest rates were already implicitly determined, by the increases in the real aggregates).

The guidelines adopted for total domestic credit were put into effect as regards the most dynamic component, that is bank lending, by the imposition of a ceiling. This ceiling, which had been introduced for the first time in July of the previous year for loans to large-sized firms, in 1974 covered all lending, with the sole exception of loans of very limited amounts or those granted to productive sectors (production of energy, rail transport, etc.) which deserved special treatment. Within the frame-

⁷ For the scheme of the financial accounts used, see: A. Fazio — F. Cotula — S. Lo Faso, "A Revised Version of the Model of the Financial Sector of the Italian Economy (M2BI)", *Econometric Research in European Central Banks*, edited by F. Maserà, A. Fazio e T. Padoa Schioppa, Banca d'Italia, 1975.

work of the ceiling on the expansion of lending, which was set at 15 % between March 1974 and March 1975, a lower limit was applied to financial firms, commercial activities and households (12 %). It was further established that for each bank total lending to clients whose initial outstanding loans equalled or exceeded 500 million lire could not increase by more than 15 %. A similar restriction was placed on total lending by each bank to local authorities. In this way it was sought to ensure that these categories (large-sized firms and local authorities) did not increase their borrowing more than the average and so use up the credit available to the banks' remaining clients.

By introducing a ceiling on the expansion of lending by each individual bank it was hoped to avoid falling seriously short of the objectives. Theoretically the same degree of control could be obtained by regulating the volume of monetary base, given the compulsory reserve coefficient and the share of monetary base demanded by the public. However, as econometric analyses have shown, changes in the monetary base are only completely reflected on credit after considerable delay, more than a year, and furthermore it is uncertain how the effects will be distributed within that period. Finally, the interest rate elasticity of the credit supply is extremely high and therefore it is only possible to achieve a drastic slowdown in the growth rate of lending by reducing the monetary base if the level of interest rates rises by more than the desired extent (with adverse effects on security prices which, at least initially, had to be minimized⁸).

Consequently, since it was necessary to obtain sufficiently well-defined results in terms of credit expansion within a set period and in fixed intermediate stages, it appeared advisable to set each bank limits on the expansion of its lending for each period. The ceilings were consistent with the total domestic credit expansion established for each quarter in the letter of intent. However, it was intended to regulate the monetary base within limits which were consistent with the expected expansion of bank lending and of other bank assets. In fact, it was believed that if the amount of monetary base greatly exceeded that required by the expected expansion of bank assets it might jeopardize the desired results for the expansion of lending, despite the ceiling.

Already at the start of the year, prior to the agreements with the *International Monetary Fund* and independently of them, the banks'

⁸ Cf. G. Caligiuri — A. Fazio — T. Padoa Schioppa, "Demand and Supply of Bank Credit in Italy", *Journal of Money, Credit and Banking*, 1974.

security investment requirement was renewed for the first half of 1974 and again set as a percentage of total deposits at the end of 1972. As regards financing granted by the special credit institutions, reference was made not only to bank purchases of their security issues, which had been made compulsory by the security investment requirement, but also to the probable amount which would be placed with the public.

The cyclical situation deteriorated in April with interventions on the exchange market remaining at a particularly high level. Early in May a measure was adopted requiring six-month non-interest-bearing deposits to be made with the Banca d'Italia equal to 50 % of the value of imports, except for raw materials, energy resources and investment goods. The regulation was originally intended to absorb about 2,000 billion lire of monetary base and liquid funds of enterprises and other financial operators, but, as a result of a series of exemptions and reductions in the rate for foodstuffs and agricultural products (initially subject to the full 50 % deposit), it actually absorbed about 1,400 billion (in the six months to November when the system reached a steady state with the start of reimbursements). In view of the limits imposed on the expansion of credit importers were forced to accept a reduction in their liquidity though they were able to offset this to a certain extent by obtaining short-term credits from their foreign suppliers.

The credit squeeze immediately led to a general rise in interest rates: in June, short-term rates reached 18 %, compared with values around 8 % on the beginning of the year; long-term rates rose rapidly — by 2 percentage points in May — and this caused private demand for bonds to dry up leaving only that imposed upon the banks by the security investment requirement. The increase in the price of oil products led to an acceleration in the rate of inflation, but equally it tended to depress demand in real terms, though, at first, this effect was partly offset by an increase in the propensity to consume. The credit squeeze slowed down stockbuilding, while the expansionary stimulus of productive investment tended to peter out as a result of the uncertainty caused by the crisis and, to a lesser extent, because of financial difficulties. Economic activity reached its maximum level in the spring, but the foreign exchange situation — as already mentioned — remained difficult during the whole of the month of May. Furthermore, the turning point was only recognized to be such some months later.

In order to limit the negative effect on fixed investment by shifting the burden of adjustment on to consumption and, therefore, on to fiscal

policy, in May the Annual Report of the *Banca d'Italia* proposed a programme of tax increases, most of which were supposed to be in direct taxes, amounting *ex ante* to 3.5 % of gross domestic product⁹. The program was approved during the summer, though on a reduced scale and exclusively in the form of increases in indirect taxes and public utility charges. This had a negative effect on the rate of inflation. The intention was to bring about a gradual expansion of lending to the private sector in parallel with the reduction in the public sector deficit. The course of the Treasury deficit during the year was in line with the limit agreed with the IMF, but the fiscal measures introduced caused the outturn for the year to be 8,650 billion instead of the 9,200 billion forecast.

During the summer, the credit squeeze, together with the non-interest-bearing deposit on imports, began to produce its effects on the flow of short-term credit into and out of Italy through the reduction in firms' liquidity. Partly in connexion with the Washington agreement of June within members countries of the group of Ten, which allowed the official gold reserves to be revalued and, made it easier to mobilize them, there was a sharp turnaround in foreign currency flows. The improved situation continued for the whole of the summer (thanks in part to the seasonal contribution of tourism) only to suffer a temporary setback in the autumn in conjunction with yet another government crisis.

Autonomous capital movements (i. e. excluding compensatory loans) in the second half of the year showed a surplus of approximately 2 billion dollars, as against an almost identical deficit in the first half. The trade balance improved continuously during the second half of the year, so that the current account balance also showed an improvement which, even when seasonal factors are taken into account, was considerable. In fact, the total deficit in the first semester, excluding compensatory loans, was 4,300 billion lire compared with a deficit of 4,900 billion lire for the whole year. If the effect of the increase in the price of oil is excluded, there was approximately a 1,000 billion lire deficit on current account in the first half of the year but an equivalent surplus in the second. The weighted average exchange rate of the lira, which at the end of June had declined by 7.7 % compared with December 1973, declined by a further 4.2 % in the second half of the year and rose by 1.3 % in the first half of 1975. This greater stability of the exchange rate had a

⁹ Cf. F. Cotula — P. Gnes, "L'aggiustamento della bilancia dei pagamenti nel breve periodo, *Moneta e Credito*, September, 1974.

positive effect on the rate of inflation: wholesale prices, which had risen at an annual rate of 56 % in the first six months, rose at an annual rate of 15 % in the second six months and remained stable in the first semester of 1975; consumer prices, increased at annual rates around 25 % both in the first and second half of 1974 and slowed down at a rate of 12 % in the first six months of 1975. The current account of the balance of payments reflected the slowdown in imports caused by the weakening of economic activity and demand, and especially of investment demand.

Credit expansion during the year was exactly in line with the undertakings entered into with the IMF (the divergences can be considered negligible in view of the size and volatility of the aggregates involved). The credit squeeze — apart from the effects of the fiscal package — was none the less sharper than had been foreseen — as result of the higher rate of inflation (linked to the unexpected depreciation of the exchange rate and the recourse to increases in indirect taxes) — and was reinforced by the restrictive effect of the compulsory deposit on imports. At constant prices gross fixed investment increased in line with expectations (about 4 %), but at current prices the increase was 33 % instead of the forecast 22 %. Both the GDP implicit price deflator and the cost of labour rose by 6 percentage points more than had been expected, thus increasing the need for working capital. Wages in the private sector rose by 24 % and the cost of labor by unit of production by 20 %.

In view of the amount of credit granted, these developments produced financial tensions which made necessary an increase in the velocity of circulation of firms' liquid balances and thus altered the normal flows of trade credit. The tightness of credit and the corresponding increase in interest rates, and especially in short-term rates (in the fourth quarter of 1974 banks' lending rates were 8 percentage points higher than in the fourth quarter of 1973) explain the inflow of funds from abroad, but also the halt in stockbuilding and the size of the fall in investment activity. Industrial output in December was 10 % down compared with December 1973 and 12 % down compared with June.

The ratio of the flow of total credit to gross domestic product fell to 20.9 % in 1974 compared with 28.3 % the year before. The slowdown was most marked for the formation of financial assets, which was depressed by the large external deficit: as a proportion of gross domestic product, they amounted to 14.9 % compared with 26.2 % in 1973. In the twelve months ending on 31st March 1975, total domestic credit expan-

sion amounted to 21,500 billion lire compared with an initial target of 22,400 billion. The exchange rate fell by 7.3 % compared with a year earlier, whereas it had originally been expected to remain essentially stable. The current account deficit over the twelve months to end-March was equal to 3,905 billion lire compared with the original forecast of 4,700 billion. If the effect of the increase in oil prices is excluded, there was a surplus of 400 billion.

2. *The 1975 Recession and Reflation*

At the beginning of 1975 the rapidity of the balance-of-payments adjustment and the fall in economic activity became clear. This immediately gave rise to calls for an expansionary policy. In its Annual Report, published at the end of May, the *Banca d'Italia* opposed reflation based on monetary expansion, since this was liable to upset the external accounts again before having any appreciable impact on production.

The fall in production only had a limited and delayed effect on employment. At the beginning of the year (in January) the employers' organizations and the trade unions reached an agreement which, besides guaranteeing straight increases in wages of about 7 %, modified the system of inflation cover by linking the value of the sliding wage scale point to the average level of industrial wages in 1975 in such a way that the price elasticity of wages came close to unity. The change from the previous system of indexation, which provided about 50 % cover, was made gradually (with the new system only coming fully into force in the fourth quarter of 1977). At the same time the concept of equality was introduced into the system by making the compensation for loss of purchasing power through inflation the same for all categories of employee labour. In view of the wide dispersion of wages, these features of the new system led to the price elasticity of wages being well above unity for below average wages and well below for above average wages. Under conditions of rapid inflation, the mechanism therefore tended to equalize wages and reduce the differentials between sectors, skills and grades¹⁰. The agreement described above led to an increase in earnings in 1975 of 25 % compared with 1974. When account is taken of the fall in the average level of output, unit labour costs in the industrial sector rose by around 35 % compared with the previous year. Calls by politi-

¹⁰ For an analysis of the effects cf. G. Caligiuri, "Evoluzione dei redditi da lavoro dipendente e da pensione nel quinquennio 1973—77", *Bollettino del Servizio Studi della Banca d'Italia*, n. 2—3, 1978.

cians and the public for a policy of reflation and expansion grew stronger during the course of the summer as the figures for industrial output, the balance of payments and inflation became available. During 1975 the production continued to decrease slowly but steadily up to the third quarter. At the beginning of 1975 the Italian authorities, in exchange for medium-term support, had entered into an undertaking with the EEC to limit total domestic credit expansion to 24,700 billion lire, of which 8,000 billion were to cover the Treasury deficit. At the same time, Italy also agreed to maintain short-term interest rates at a level compatible with a balance-of-payments situation which was still insufficiently consolidated. In the summer, the Treasury Minister, as part of the conditions agreed to with the IMF for access to the oil facility, indicated for the Treasury deficit a limit for calendar year 1975 to 10,000 billion lire.

The need to reflate was recognized by the Government and a programme to revive economic activity was formulated which, at least as far as the authorities' intentions were concerned, was extremely large. The program included the introduction of a system of subsidized short-term export credit, which permitted 50 % of the credit granted for this purpose to be automatically discounted with the *Banca d'Italia*. The public sector deficit tended to expand excessively during the last quarter, and at the end of the year amounted to more than 13,000 billion lire. The stance of monetary policy remained expansionary, and the creation of monetary base received a strong boost from the refinancing of export credits. In September, money market rates were around 9 % as against 15 % at the beginning of the year. The public sector deficit was negatively influenced by the regulations which reduced personal income tax rates so as to offset the effects of inflation and exempted large revaluations of firms' real estate, and assets in general, from company taxation. Since the latter measure also applied to banks, it resulted in a reduction in the effective compulsory reserve coefficient, which is applied to increases in bank deposits less increases in their capital and reserves. Instead of a theoretical value of 15 %, required by a reform of the system of compulsory reserves introduced in January, the effective coefficient declined to approximately 8 % during the year 1975.

The ratio of total credit to gross domestic product rose to 29.6 %.

GDP contracted in real terms for the first time in 1975 since the end of the Second World War, recording a fall of 3.7 % compared with 1974. The recovery in the latter part of the year only produced a limited

improvement in the outturn for the whole year. The size of the fall was influenced not only by the sharp downturn in investment but also by a reduction in the average propensity to consume. The phenomenon was similar to what had already been observed in the early 70's when there was an acceleration in the rate of inflation and a deterioration of employment expectations¹¹. In 1975 the phenomenon was more acute and also in line with developments in other major industrial countries. Inventories declined sharply during the first half of 1975, and this was reflected in the performance of imports which, for the whole year, fell by 11 % in real terms compared with 1974. Whereas world demand fell by about 5 %, Italian exports, despite the increase recorded in unit labour costs, rose by 4 % in real terms as a reaction to the weakness of domestic demand.

3. *The Recovery of End 1975*

Economic activity recovered in September 1975, and even more markedly during the fourth quarter. This resulted in industrial production growing in the three quarters to the middle of 1976 at an annual rate of 19 %. The recovery was common to all the OECD countries, and was led by stockbuilding after the sharp fall recorded in 1975, though it was also the result of the reflationary measures taken by all the countries concerned. In Italy, the acceleration of production and the build-up of stocks, including imported goods, caused the reappearance of the trade deficit which had been masked during the first part of 1975 by the sharp fall in economic activity. In the fourth quarter the current account once more showed a large deficit, which made inroads into the reserves. These had been at a low level, (i. e. excluding gold 4.3 weeks' imports) since the end of 1974 and had declined during the summer as the result of large repayments of foreign currency loans to the banks by Italian businessmen, prompted by the rapid appreciation of the dollar and expectations of further increases in its value. At the end of 1975 they were equivalent to less than 2 weeks of imports.

During the first few days of 1976 the political crisis, the market's critical view of the low level of the country's foreign currency reserves and rumours of negative assessments of the Italian economy's solvency in international banking circles set off a wave of speculation which led the authorities to abandon intervention on the foreign exchange market.

¹¹ Cf. F. Frasca — E. Tarantelli — C. Tresoldi — I. Visco, "La funzione del consumo, analisi in serie trimestrali e su cross sections", forthcoming.

It was hoped that the lira would return to equilibrium vis-à-vis the dollar and the other major currencies with only a limited depreciation.

As a first reaction, monetary measures were taken (the official discount rate was raised from 6 to 7 and then to 8 %; a call was made for additional compulsory reserves equal to 0.75 % of deposits, but to be paid in two instalments for a total of 800 billion lire; and the marginal compulsory reserve coefficient was raised from 15 to 15.75 %). However, these measures soon proved to be insufficient and the lira continued to depreciate steadily. In February, the depreciation compared with the average for January (which already reflected the low values recorded in the last ten days of that month) was 8.7 %.

4. Developments in 1976

In March, with the formation of a new Government, the decision was taken to reopen the exchange markets. Nonetheless, the Government's programme seemed to give precedence to the objectives of increasing production and absorbing unemployment rather than to that of stabilizing prices. At the end of the same month, the automatic export credit rediscounting facility was abolished and the official discount rate raised by 4 percentage points. Fiscal measures were introduced, designed to reduce the public sector deficit by an amount equal to approximately 1 % of GDP on an annual basis. However these restrictions turned out to be insufficient to keep the increase in domestic demand within limits compatible with an improvement in the balance of payments.

Besides being reflected in higher levels of inventories and consumption, the increase in domestic and foreign demand, together with the improvement in firms' profits (due in part to the depreciation of the lira), boosted fixed investment which for the year rose 8 % compared with 1975. The depreciation of the lira against the dollar and the other major currencies continued in March, with a 5.8 % fall compared with February, and in April with a further fall of 5.7 %. The limited foreign currency reserves available, even though they had been increased in the meantime by the drawing down of a 1 billion dollar EEC loan, obliged the authorities to conduct an elastic defence of the exchange rate. Several restrictive measures affecting the availability of foreign currency to tourists, the terms of payments for imports and exports, the availability of currency for importers and exporters were adopted. A legislation which provided for criminal proceedings those who ex-

ported capital illegally was passed, thus reversing the more liberal attitude adopted in the past. Expectations of a political nature also influenced the exchange rate and, as had happened thirty years earlier, in May 1976 the dollar rose above 900 lire.

The figures regarding export prices clearly show that Italian businessmen were automatically adjusting their lira prices for the depreciation of the currency. In fact, between December 1975 and May 1976 export prices rose by 17.8 %, exactly in line with the weighted average depreciation of the lira, which was equal to 18.6 %. The rise in Italy's export prices nonetheless lagged behind that recorded on international markets so that there was an improvement in Italy's competitive position, but also a worsening of the terms of trade.

The rapid depreciation was reflected in domestic wholesale prices which rose during the first and second quarters at annual rates of respectively 44 % and 42 %. The rate of increase of consumer prices also accelerated sharply compared with 1975, and rose at an annual rate of 23 % during the first six months of the year. In these circumstances it was decided to impose new controls on purchases of foreign currency with the introduction of a three-month, non-interest-bearing deposit in lire equal to 50 % of the amount of such purchases. The measure similar to that taken two years before but more reserve, immediately reduced the demand for foreign exchange so that during May intervention sales and purchases on the foreign exchange market almost balanced after net sales of 700 and 300 million dollars in March and April. The lira showed strong signs of recovery with the dollar falling back to around 820 lire by the middle of May. Further appreciation of the lira was held in check by central bank purchases of reserves.

In June, a new political crisis led to the dissolution of Parliament and early general elections, which once more gave the Christian Democratic Party a relative majority vis-à-vis the Communist Party. This result seemed to be mirrored on the exchange market by a large inflow of foreign currency during the last ten days of June and in July. Between the end of May and the end of July the official reserves increased by 1,700 million dollars. Economic activity slackened in the summer as a result of the restrictive monetary and fiscal measures introduced, but also in parallel with similar weakness in all the other main industrial countries. In the fourth quarter there was an unexpected spurt which, at least in part, was again due to stockbuilding. In December 1976 industrial output was 20 % higher than in December 1975.

For the whole of 1976 industrial output was 12 % up compared with 1975. This strong upturn improved labour productivity so that unit labour costs only rose 15 %, compared with an increase of 21 % in earnings. The depreciation of the lira between December 1975 and December 1976 amounted to 20 %, and on a year-on-year basis to 17 %. This resulted in a considerable improvement in Italy's international competitiveness since labour costs expressed in dollar terms declined by 13.5 % (whereas they increased by 1.0 % in the United States and declined by 5.0 % in Western Germany and by 1.6 % in the OECD area as a whole). The good performance of exports, due mainly to the recovery in world demand and the improvement in their competitiveness, together with increases in all the components of domestic demand (except for construction), resulted in gross domestic product growing in volume by 5.6 %.

5. The Stabilization Program of End 1976 and for 1977

The recovery in demand and output during the last quarter once more revealed the precariousness of Italy's balance of payments. The pressure was countered through monetary measures: the official discount rate was raised from 12 % to 15 % (which meant that it could reach 18 % with the imposition of penalties); in addition to the non-interest-bearing deposit on purchases of foreign currency a special tax was also imposed (at the rate of 10 % for the first fortnight of October and then, after it had been abolished for a week, at 7 %). The result of these measures was to increase the cost of the dollar to importers from the quoted price of around 860 lire to about 920 lire. Other exchange controls were also introduced to reduce the period exporters were allowed to hold their foreign currency receipts and the volume of lire held abroad. Ceilings were imposed on the expansion of lira-denominated bank lending in relation to the situation in June 1976. These limits were set at 7 % for November, 11 % for December and 11 % for March 1977. The acceleration of output and prices and the various restrictive measures taken during the year led to a ratio of total credit to domestic product in 1976 of 23.4 % as against 29.6 % in the previous year. The setting of a ceiling applying exclusively to growth in lending in lire was explicitly intended to encourage the inflow of foreign currency through the intermediation of the banks.

The balance-of-payments situation at the end of 1976 showed that the deficit due to the increase in the price of oil had not yet been absorbed.

As a result it remained impossible to pursue, at one and the same time, the internal objective of high employment (of both plant and labour) and external balance. Awareness of this fact led to the adoption (as from September) of a stabilization programme based on the curbing of the public sector deficit. The policy beyond a counter cyclical aim, was designed to produce its effect over the medium term, in which it was considered that a reduction in the current deficit of the public sector — on the assumption of a total derivative of national saving vis-à-vis this deficit of less than unity — had to make way for an increase in investment.

In the absence of action to reduce the public sector deficit, macro-economic forecasts indicated a probable balance-of-payments deficit on current account of around 2,000 billion lire, with a 18 % inflation rate and a 3 % increase in gross domestic product (at constant prices).

The amount of Italy's foreign indebtedness and preliminary contacts with IMF officials for a new stand-by agreement suggested that a balance-of-payments current account surplus in calendar year 1977 of around 1,000 billion lire would be desirable. The analyses made indicated that compared with the current trend the additional tax yield needed to achieve the desired 3,000 billion improvement in the current account balance amounted to 4,000 billion. This estimate assumed a decrease in the propensity to consume similar to that which had occurred after the introduction of restrictive measures in 1974 and during the 1975 recession (without such a shift in the propensity to consume, the additional yield would have had to have been 6,000 billion).

This objective was incorporated in the Government Forecasting and Planning Report for 1977 which was presented to Parliament on 30th September 1976. Compared with the current trend the Report stated that an additional tax yield equal to 2.5 % of GDP (expected to amount to 160,000 billion lire) was necessary. The same document postulated an increase in expenditure for industrial restructuring and other interventions of various kinds by the public sector which were to boost investment in 1977. Against additional revenue of around 4,000 billion lire, the Report thus foresaw an increase in public expenditure, between 1,000 and 1,500 billion. This stabilization program was expected to result in zero growth in GDP compared with 1976, with a marked slowdown in economic activity during the year. It was decided to eliminate gradually the 7 % tax on the purchase of foreign currency and the 50 % three month deposit.

The level of output in the last quarter of 1976 turned out to be 2 % higher than had been forecast in September. The balance-of-payments current account deficit was correspondingly larger. On the assumption that demand and output would show the same pattern as had previously been expected, the increase in GDP in 1977 was now expected to be 2 % (as against the earlier zero growth forecast), which would cause a larger balance-of-payments current account deficit in the first part of the year and a 500 billion deficit for the whole of 1977. For the twelve months ending in March 1978 a return to current account surplus was expected, with a 500 billion positive balance.

During the last few months of 1976 in view of the rapid recovery mentioned above, the Italian Government introduced legislation to produce 5,000 billion lire of additional revenue instead of the 4,000 billion originally foreseen. It was also decided that there should be no increase in expenditure above the trend. Furthermore, the IMF officials, obedient to the statutes of their organization, asked that the tax on purchases of foreign currency and the non-interest-bearing deposit should be immediately eliminated. They also considered that if Italy's external position was to be adjusted without causing an excessive contraction in economic activity, the lira would have to considerably devalued and a check put on the wage-indexation mechanism.

The fiscal measures and public utility charge increases were approved in the autumn and gradually introduced during the last few months of 1976 and the first few months of 1977. Together with the measures designed to reduce the public sector deficit, a whole series of regulated prices were raised so as to produce a 3,000 billion shift in the distribution of income away from the households to the benefit of the corporate sector.

Negotiations between the employers' organizations and the trade unions regarding a programme to raise productivity led to an agreement to suppress five mid-week holidays and eliminate the indexation of a number of supplementary wage items as well as severance and retirement bonuses. The basket of goods used to calculate the trade union cost-of-living index was also modified, thereby restoring the possibility of increasing a number of regulated prices and public service charges without this immediately affecting the wage-scale index.

In the letter of intent to the IMF signed by the Italian government in April, no explicit mention was made of the need to lower the exchange rate in order to adjust Italy's external position. In order to dampen the

increase in the costs of the industrial sector, a part of employers' social security contributions was charged to the budget with the result that labour costs in manufacturing industry were reduced by about 4%. The cost of this measure was only partially covered by an increase in Government receipts obtained, in part, through higher indirect taxes. It proved impossible to persuade the unions to accept that the resulting increase in prices should be excluded from the calculation of the wage-scale index.

As for the public sector deficit, the Government undertook to hold it down to 16,500 billion lire. This total, besides covering general government, also included ENEL and the autonomous agencies (the enlarged public sector). The Government also agreed with the IMF to keep total domestic credit expansion (TDC) within a limit of 30,000 billion lire in the twelve months ending on 31st March 1978. The Government was required to take action, if necessary, to limit the rise in the wage-scale index — after the nine point rise in February (caused by the acceleration of inflation at the end of 1976 and in the early months of 1977 which in turn was due, at least in part, to the increases in indirect taxes included in the stabilization programme) — to not more than 7 points in May, 6 in August, 5 in November, 4 in February 1978 and 4 in May 1978, for a total of 26 points. As part of its recommendations for economic policy linked to the granting of medium-term support and Community loans, the EEC Council of Finance Ministers considered that total DCE should be kept within a limit of 30,600 billion in 1977.

The performance of the economy in 1977 was marked by a fall in output which was larger than had been expected. This was due to the extreme sluggishness of the international economy and, more specifically, to the slowdown in economic activity in Europe — the result of the stabilization measures applied in France and the United Kingdom as well as of the uncertainty surrounding the course of industrial output in Western Germany.

The renewal of the ceiling on the expansion of lira-denominated bank lending from March 1977 to March 1978 caused credit to become particularly tight up to September and this affected stockbuilding. The downward trend of international raw material prices improved the terms of trade of industrial products and this further reduced the tendency to build up stocks of imported commodities.

TDC in the first quarter of 1977 amounted to 7,400 billion lire compared with a forecast of 6,300 billion. The excess expansion can be seen as

the result of Italian importers repaying — following the progressive elimination of the deposit on the purchase of foreign currency — of the short-term credits they had obtained from their suppliers after the introduction of the same deposit. In the second quarter, which was the first covered by the terms of the IMF agreement, TDC amounted to 8,194 billion lire compared with a target of 8,200 billion. The figure for the third quarter was 6,400 billion as against a target of 6,200 billion. Up until September the public sector deficit, and in particular that of the Treasury, remained within the limits set.

The abundance of international liquidity stemming from the U. S. balance-of-payments deficit, together with the rigid control of domestic bank lending in lire, encouraged recourse to the banks for foreign currency loans. These compensated for the limited availability of credit in lire, at least in the productive sectors with close links with international markets, and lowered the average cost of funds (more than 18 % for lira-denominated loans and about 9 % for those denominated in other currencies). Thus a virtuous circle was created with larger foreign currency loans, the prospect of a stable exchange rate and hence encouragement to contract further foreign loans. At the end of March 1977, these operations had increased the banks' net foreign indebtedness by 1,348 million dollars compared with December 1976, and at the end of June by further 2,864 million dollars. These amounts easily covered the deficit of the balance-of-payments on a cash basis, which amounted to 1,942 million dollars in the first half of the year. One of the factors contributing to this deficit (987 million dollars in the month of March alone) was the repayment of the short term loans connected with the deposit on purchases of foreign currency. The phasing out of the 7 % tax did not upset the official quotations of foreign currencies thus considerably reducing the effective cost for importers. Economic activity sank to its lowest level for the year in June and July. In the third quarter, the index of industrial output (1970 = 100) stood at 116 after standing at 120 in the second quarter and at 130 in the first (129 in the fourth quarter of 1976).

In September there were signs of recovery, but they were not confirmed in the months that followed. This led to the fourth quarter level of economic activity being lower than the average for the whole year. The public sector deficit unexpectedly shot up compared with the forecast in the fourth quarter, partly as an automatic consequence of the slowdown in economic activity, but also as a result of the cuts in receipts

which this prompted and of the shortfall in tax revenues compared with the forecast. At the end of the year, the enlarged public sector deficit amounted to 21,000 billion and total DCE to 35,500 billion. The overshooting of the target of 30,600 billion for 1977, although partly due to the over-expansion of the first quarter was mainly caused by the size of the public sector deficit in the last quarter. In spite of this and of the slowdown in economic activity the ratio of total credit to GDP fell again with respect to the previous year to 21.0 %. Approximately 60 % of the credit flow was extended to the public sector.

Imports declined in 1977 by 2 % in real terms, as against a forecast increase of 3.5 %. Compared with a forecast of 9 %, exports increased by 6 % as a result of the slackening in the rate of growth of world demand from 8 to 4 %. The fall in raw material prices and in the dollar itself led to Italy's terms of trade improving by about 2 percentage points, whereas originally an improvement of 1 percentage point had been expected. The growth in tourism throughout Europe helped to raise the surplus on invisibles, while the illegal outflows of capital characteristic of earlier years also petered out. For the whole of 1977, the balance-of-payments surplus on current amounted to 2,000 billion lire compared with a forecast of a deficit of 500 billion. GDP at constant prices grew by 1.7 % compared with a forecast of 2 %. The divergence between the results actually achieved and the forecast widened during the last part of the year. The year-on-year increase in consumer prices was 19 %, which was slightly less than had been forecast. The increase between December 1976 and December 1977 was 14.5 % compared with a forecast of 16 %. The sliding wage-scale index rose 6 percentage points in May, 5 in August and 4 in November compared with forecasts of respectively 7, 6 and 5 points.

6. Developments in the Year 1978

During 1978 the Italian economy will show a growth of more than 2 % in real terms, and an increase in prices around 13 %. The growth of exports will be around 7 % in real term, greater than the development of international demand, consumption will rise in line with GDP, investments will show a decline in real terms with respect to the previous year, owing to the rapid fall in the course of that year and to the sluggishness during this year. The weakness of internal demand is reflected in a limited growth of imports which will rise only 3 or 4 % in real terms. Given also a further improvement in the terms of trade the balance of payments will show a current surplus of approximately

5,000 billion lire. TDC will be around 48,000 billion lire with a ratio of 24 % to GDP, but growth is due, in a greater extent than in the previous years, to the expansion of the public sector deficit. The tendency which appeared at the end of 1977 has actually continued during 1978, so that the public sector deficit will absorb two thirds of TDC. The possibility of returning to a normal term structure of interest rates has made it possible to substantially eliminate the portfolio requirement for the banking system. It has seemed necessary instead to maintain the ceiling on bank credit expansion in order to avoid an overexpansion of TDC and a return to a situation of excess liquidity, given the tendency in the public sector deficit.

At the end of 1978 the Italian economy is in a very different situation with regard to the conditions affecting its development possibilities compared with four years earlier in the period immediately following the outbreak of the oil crisis. In 1974 the balance-of-payments deficit on current account exceeded 5,000 billion lire or, in other words, 5 % of gross domestic product. In 1978 the balance on current account will show a surplus of more 2.5 % of GDP. The absorption of the deficit has been achieved mainly through a reduction in the growth rate of the economy, and to a lesser — but significant — extent through a shift in relative prices in conditions of rapid inflation.

In the four year-period from 1974 to 1978 the Italian economy will have grown by 7 % in real terms. The slowdown in domestic consumption (up 7 % over the four years), and especially — though regrettably — the decline in investment (down 11 %) have made it possible to slow down the increase in imports. Valued at 1970 prices, these will have risen by the end of 1978 by only 14 % since 1974. Over the same period the volume of exports will have increased by 34 %, with the terms of trade also rising 2 percentage points. The potential growth of the Italian economy in these four years, on the basis of the results achieved since the war and assuming a sufficient supply of labour, was between 15 and 20 %. The difference between this potential growth and the actual 7 % recorded gives an idea of the cost — in terms of GDP — of adjusting the economy to the deterioration in the terms of trade which occurred between 1972 and 1974. It is not surprising, in view of the shortfall in the rate of growth compared with earlier periods, that we should now be faced with today's problems of unemployment, disequilibria in firms' finances and the worsening of inflation.

Table 1
Money, Credit and Financial Assets

		percentage rates of growth (yearly averages)				
		1952 - 57	1958 - 63	1964 - 68	1969 - 73	1974 - 77
Bank loans		16.7	17.0	10.1	15.9	17.7
Total financing of which: ...		—	—	9.3	14.6	17.3
— Private sector		—	—	7.9	12.7	14.2
— Public sector		—	—	15.1	22.5	24.1
Bank deposits		15.8	16.2	13.7	15.1	25.0
Stock of money (M 2)		12.5	15.1	12.5	15.9	20.8
Total financial assets		15.7	15.3	9.8	14.1	14.4
<i>Changes in:</i>		<i>ratios to GDP (yearly averages)</i>				
Total domestic credit		—	—	—	—	22.4
Total financing of which		9.2	13.1	13.0	21.5	23.8
— Private sector		6.7	11.2	9.0	13.9	13.2
— Public sector		2.5	1.9	4.0	7.6	10.6
Total financial assets		8.5	13.8	15.2	21.7	21.4
		<i>(ratios to GDP)</i>				
	1951	1957	1963	1968	1973	1977
Bank deposits	25.2	37.0	51.6	65.6	75.5	87.9
Stock of money (M 2)	44.1	54.5	72.0	85.9	102.4	104.1
Financial assets	77.7	113.8	176.2	160.1	176.1	143.6

Table 2
Credit and Financial Assets

Years	ratios to GDP		
	Total financial assets (flows)	Total financing	Total domestic credit
1958	10.0	7.6	—
1959	12.7	9.9	—
1960	13.7	13.6	—
1961	15.1	13.3	—
1962	16.5	16.5	—
1963	13.4	15.2	—
1964	10.3	9.3	—
1965	15.3	12.2	—
1966	17.2	14.6	—
1967	15.0	13.8	—
1968	17.0	14.4	—
1969	17.0	14.6	—
1970	16.4	16.7	—
1971	20.4	19.9	—
1972	25.2	23.8	—
1973	26.2	28.3	—
1974	16.0	21.9	19.1
1975	24.4	28.3	26.8
1976	21.6	24.2	23.2
1977	22.5	21.5	20.7
1978*	28.0	25.5	24.0

* Estimates.

Zusammenfassung

Die Geldpolitik in Italien zwischen 1970 und 1978

Heute können einige Schlußfolgerungen über die Bedeutung der italienischen Geldpolitik gezogen werden. Seit dem Ende des Zweiten Weltkrieges hat die Geldpolitik in der Steuerung des italienischen Konjunkturverlaufs und der Auslandsguthaben eine entscheidende Rolle gespielt. Die Stabilisierung von 1947 legte den Grundstock für ein rasches und langandauerndes Wirtschaftswachstum in Italien, während die von 1963 eine Rückkehr zu Wachstum von Produktion und Investition bei stabilen Preisen ermöglichte. Sie führte jedoch nicht zu einem erhöhten Beschäftigungsniveau. Die Wäh-

runbspolitik setzte seit 1969 ihre Korrektur des außenwirtschaftlichen Ungleichgewichts fort; jedoch blieb besonders im Zusammenhang mit den veränderten Arbeitsmarktbedingungen die Inflationsrate hoch und die Produktion erholte sich nur langsam.

Insbesondere verlangte die Ölkrise den Einsatz der Geldpolitik, um die Inlandsnachfrage zu beschränken und dem Ungleichgewicht bei den Auslandsguthaben entgegenzuwirken. Hinsichtlich des Kostenniveaus und dem ständig wachsenden Gewicht des öffentlichen Defizits beeinflusste der Konjunkturrückgang hauptsächlich das Investitionsniveau und nur teilweise die Inflationsrate.

Dank der gegenwärtigen hohen Auslandsguthaben befindet sich Italien Ende 1978 in der Lage, zu einer Politik eines merklich schnelleren Wachstums als in den letzten Jahren zurückzukehren, mit einem Zahlungsbilanzüberschuß, der es ermöglicht, die ausländische Schuldenlast, die sich seit 1973 aufgebaut hatte, kontinuierlich zu reduzieren.

Die Geldpolitik und insbesondere die Kontrolle der Gesamtliquidität (insbesondere die der Unternehmen) sowie der Zinsstruktur bleibt weiterhin wichtiger Bestandteil, um die Gesamtnachfrage innerhalb der Grenzen des potentiellen Angebots zu halten und die Zahlungsbilanzsituation zu verbessern.

Wenn die Wirtschaft eine Wachstumsrate erreichen kann, die genügend Ersparnisse und Arbeit ermöglicht, ist es dennoch notwendig, daß in den nächsten Jahren eine Reihe von Bedingungen erfüllt wird, die weitestgehend außerhalb der geldpolitischen Steuerung liegen. Diese Bedingungen können wie folgt umrissen werden: a) adäquates Wachstum der internationalen Nachfrage; b) Umschwung der gegenwärtigen Tendenz zu einem erhöhten Arbeitnehmerinkommen im Verhältnis zum Volkseinkommen. Dies ist erforderlich, um die Exporte genügend wettbewerbsfähig zu machen und Raum für einen Anstieg der Investition zu schaffen. Um die Inflation einzudämmen, muß ein Rückgang in der Anstiegsrate der nominalen und realen Lohnneinkommen Platz greifen; c) ein Rückgang des Anteils der privaten Ersparnisse, die zur Deckung des allgemeinen Staatsdefizits in laufender Rechnung benötigt werden sowie auch um ein größeres Investitionsangebot zu schaffen und d) eine Erholung der öffentlichen und privaten Investitionsnachfrage.

Summary

Monetary Policy in Italy from 1970 to 1978

Some conclusions may now be drawn about the role of monetary policy in Italy. Throughout the whole period since the end of the Second World War, monetary policy has played a decisive role in the control of Italy's economic cycle and external accounts. The country's inflation and balance-of-payments crisis have been preceded — both during the 70's, which is the period considered here in greater detail, and earlier — by rises in the ratio of public and private sector financing to GDP. Monetary restriction has always been quite effective in controlling such crises. There has been

clear evidence since 1973 of a mechanism whereby an increase in firms' liquidity leads to the exportation of foreign exchange, speculative stock-building, depreciation of the lira and inflation. The control of monetary policy on the level of prices passes through the external value of the currency. The possibility of manoeuvring credit aggregates has been progressively reduced by the increase in the share of total credit absorbed by the public sector. Such a share was just below 30 % in the 50's, went down to less than 15 % in the period 1959—63, to rise again to 30 in the period 1964—69. In the 70's, up to 1976, the share of total credit going to the public sector rose on the average to 40 %; in 1977 and 1978 it was respectively around 60 and 65 %. (It is to be remarked however that a growing proportion of the financing to the public sector goes finally to cover financial needs of the private productive sector, and a growing proportion is transferred to agents with a high propensity to save.) The 1947 stabilization laid the foundation for rapid and long-lasting economic growth in Italy, while that of 1963 made possible a return to growth in output and investment with stable prices, though not in employment. Since 1969 monetary policy has continued to correct the country's external disequilibria but especially in connexion with the changed conditions of the labour market, the rate of inflation has remained high, and the recovery in production has been slow. In particular the oil crisis required recourse to monetary policy in order to curb domestic demand and check the imbalance in the external accounts. In view of the trend of costs and the increasing weight of the public sector deficit, the slowdown has mainly affected the level of investment, and only in part the rate of inflation.

Thanks to its present strong external situation accounts, Italy finds itself at the end of 1978 in a position to return to a policy of markedly faster growth than in the last few years, with a surplus on the balance of payments which is enabling the burden of foreign debt accumulated since 1973 to be steadily reduced. Monetary policy and, in particular, the control of total financing of liquidity (especially that of firms), and of the structure of interest rates continue to be essential in order to keep overall demand within the limits of potential supply and maintain the improved balance-of-payments situation. If the economy is to be able to achieve the growth rate which the availability of savings and labour would allow, it is nonetheless necessary that over the next few years a number of conditions — to a large extent outside the control of monetary policy — should be satisfied. These conditions can be summarized as: a) adequate growth in world demand; b) a reversal of the present tendency for the share of employee incomes to increase as a proportion of national income. This is necessary in order to keep exports sufficiently competitive and to make room for an increase in investment. To curb inflation, there will have to be a slowdown in the rate of increase of wage earnings in nominal as well as real terms; c) a reduction in the share of private savings used to cover the general government deficit on current account — again so as to provide greater scope for investment; d) a recovery in both public and private investment demand.

Résumé

La politique monétaire en Italie entre 1970 et 1978

L'on peut aujourd'hui tirer certaines conclusions relatives à la valeur de la politique monétaire italienne. Depuis la fin de la deuxième guerre mondiale, la politique monétaire a joué un rôle déterminant en Italie dans la maîtrise du développement conjoncturel et des avoirs à l'étranger. La stabilisation de 1947 constitua la base d'une croissance économique rapide et durable en Italie, tandis que celle de 1963 permit le rétablissement de l'expansion à prix stables de la production et des investissements; mais celle-ci ne haussa cependant pas le niveau de l'emploi. La politique monétaire a poursuivi depuis 1969 ses efforts de correction du déséquilibre de l'économie extérieure; néanmoins le taux d'inflation est, en particulier en raison des changements des conditions du marché du travail, demeuré élevé et la production n'a repris que lentement.

La crise pétrolière surtout a requis l'intervention de la politique monétaire en vue de réduire la demande intérieure et de s'opposer au déséquilibre des avoirs à l'étranger. Quant au niveau des coûts et au poids sans cesse croissant du déficit public, le fléchissement conjoncturel a influencé principalement le niveau des investissements et beaucoup moins le taux d'inflation.

Grâce à des avoirs à l'étranger aujourd'hui importants, l'Italie se trouve depuis la fin de 1978 en situation de revenir à une politique de croissance notablement plus rapide qu'au cours des dernières années, avec un excédent de la balance des paiements l'autorisant à réduire continuellement la charge des emprunts à l'étranger qui n'avait fait que s'alourdir depuis 1973.

La politique monétaire — et en particulier le contrôle de la liquidité globale (celle des entreprises au premier chef) et la structure des taux d'intérêt — demeure un élément essentiel de maintien de la demande globale dans les limites de l'offre potentielle et d'amélioration de la situation de la balance des paiement.

Même si l'économie parvient à atteindre un taux de croissance apte à assurer épargne et emploi suffisants, il n'en demeure pas moins indispensable de remplir au cours des années suivantes une série de conditions qui sont largement hors de portée de la politique monétaire. Ces conditions peuvent se résumer comme suit: a) Croissance adéquate de la demande internationale; b) Revirement de la tendance actuelle à la hausse des revenus salariaux supérieure à celle du revenu national; c'est indispensable en vue de rendre les exportations suffisamment compétitives et de se donner les moyens d'accroître les investissements; l'endiguement de l'inflation passe par un ralentissement des taux d'augmentation des revenus salariaux nominaux et réels; c) Fléchissement de la part de l'épargne de ménages en vue de couvrir le déficit général de l'État en compte courant et d'accroître l'offre d'investissements; d) Reprise de la demande publique et privée d'investissements.