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by

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The Italian Economic Crises of the 1970's

Raymond Lubitz*

The high rates of economic growth that Italy had enjoyed in the 1950's, and a slower but still healthy pace in the 1960's, have disappeared in this decade. The Italian economy has suffered low investment and growth, high rates of inflation and balance of payments' difficulties, and these difficulties have erupted into two severe crises -- in 1974 and 1976 -- that required exceptional policy measures, external financial assistance, and the acceptance of externally-imposed economic conditions which have limited the policy authorities' scope for economic management. The selected indicators below give the bare outlines of Italian economic performance in this decade.

Selected Economic Indicators

	<u>1970-72</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Consumer Prices <u>1/</u>	5.25	10.8	19.1	17.0	16.8	16.4
Real GDP <u>1/</u>	2.35	6.9	4.2	-3.5	5.7	1.7
Gross Fixed Investment/GDP <u>2/</u>	14.2	14.3	14.3	12.8	12.6	12.5
Current Account <u>3/</u>	1.7	-2.5	-7.8	-0.5	-2.9	2.4

1/ Average annual rates of change.

2/ Excluding residential construction, in 1970 lire -- per cent.

3/ Billions of dollars.

* Economist, Division of International Finance, Board of Governors of the Federal Reserve System. The views expressed herein are solely those of the author and do not necessarily represent the views of the Federal Reserve System. An earlier version of this paper was presented at the Joint Country Groups Panel at the American Political Science Association meeting September 1977. I would like to thank George Henry and David Howard for their helpful comments on that paper.

In this paper I shall focus on the 1974 and 1976 crises and their aftermaths, rather than on the earlier difficulties of the decade; in addition, the background to 1974 and 1976 will be discussed in some detail. This background helps explain why Italian performance was among the worst of the advanced industrial economies, although all suffered badly in the last few years. The background factors are a staple of Italian discussion, although the relative importance attributed to the different factors varies considerably among observers. Also, Italian economists differ on basic analytical issues and the nature of these disagreements has an important bearing on policy decisions.

The outline of the paper is as follows: Section I discusses some of the background issues; Section II takes up, in a non-technical fashion, the analytical debate; in the third Section the two crises are analyzed; in the fourth Section I attempt to draw some conclusions as well as return to the themes of the second Section.

I

There are four background areas discussed in this section: the public sector deficit, wages, labor rigidity, and the public corporation.

A. The Public Sector Deficit

It has often been noted in Italian discussion that the public sector deficit, however measured, has been growing rapidly, both absolutely and as a share of Gross Domestic Product (GDP). The deficit can

be viewed in two aspects -- as a diversion of resources from other uses and as the source of monetary expansion.^{1/} From the point of view of a diversion of resources, the current account (the budget excluding capital transactions) is the most useful concept, since it constitutes dis-saving, which offsets saving performed elsewhere in the economy and reduces resources available for investment.

The data below for the current-account deficit of the Public Administration (i.e., all levels of government) indicate that the current account, which had run surpluses (1970 and before) ran a deficit in this decade which in the last three years averaged over 5-1/2 per cent of GDP. The Public Administration is composed of three sectors -- central administration, local government, and social security agencies -- and in all three sectors current deficits expanded.

Current-Account Deficit of the Public Administration
(Billions of Lire)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
Central Administration	334	-776	-1306	-2770	-1612	-3010	-1925	-261
Local Governments	-272	-415	- 445	- 370	- 483	-2406	-2399	-414
Social Security Institutions	578	332	- 613	697	- 221	-2905	-2905	-162
Total	640	-869	-2364	-2443	-2316	-8429	-7229	-836
As Percentage of GDP	1.1	-1.4	-3.4	-3.0	-2.3	-7.3	-5.0	-4.8

Source: Relazione Generale Sulla Situazione Economica del Paese, various issues.

^{1/} Cotula and Lo Faso provide a detailed analysis of the deficit through 1975.

Total transfers in the social security category rose from 8.7 trillion lire in 1970 to 34 trillion in 1977 -- nearly a fourfold increase while nominal GDP increased about 3 times. This spending has accounted for 45 per cent of the growth of current expenditures since 1970, although, of course, all other items have grown as well. The sharp increase in social spending reflects mainly the greatly improved health and pension benefits that Italian labor won after 1969. The data also show that the local authorities, also responding to the demand for greater services, and with limited revenues, ran larger deficits through the period.

It is true that public spending has been growing in all the OECD countries, and the ratio of spending to GDP in Italy is at the average level for the OECD as a whole (roughly 40 per cent); however, taxation has not grown sufficiently to cover these expenditures, although the ratio of taxation to GDP has grown significantly in the last few years. The Italian deficit cannot be taken as lightly as a generation (or more) of Keynesian economics has taught us to regard deficits. These deficits are not the result of either fiscal policy deliberately chosen to achieve macro-economic goals, nor are they based on optimizing public finance calculations. Rather they reflect two pressures -- the pressure for increased benefits to which successive governments since the "hot autumn" of 1969 have yielded (as well as other pressures for increased government spending) and a tax system which did not respond elastically to income increases and which continues to be marked by widespread tax evasion. The easiest course for the government to follow has been to accept the demand for higher benefits and "pay" for them through deficit financing.

In addition, the Italian deficit has, to a large extent, been financed by the central bank creating monetary base, leading to a large expansion of the money supply. This mechanism will be discussed in more detail later; it suffices to say now that the Italian authorities not only did not finance the growth of public spending through higher taxes, but, instead, by following the path of least resistance, monetizing Treasury debt. The public-sector-deficit concept that measures the overall borrowing needs of the Treasury, the Treasury cash deficit, grew as a percentage of GDP from 4.5 per cent in 1970 to an average of 12.4 per cent in 1975-77.^{1/}

B. Labor Costs

Real wages have grown substantially in Italy during the 1970's. Despite a 130 per cent increase in consumer prices between 1970 and 1977, money wage rates in industry increased sufficiently to allow real wages to rise about 53 per cent. At the same time, real GDP grew by about 21 per cent and industrial output only slightly faster. Most of the increase in real wages thus came about through a sizeable redistribution of income to wages; the wage share of net national income rose from 59.5 per cent in 1970 to 70.5 per cent in 1977. The national accounts data include in the non-wage share various types of income which obscure the true relationship between wages and profits. It is clear that the worsening of business profits has been substantial, although comprehensive historical data are lacking. Although some of the shift of income from profits to wages may have been cyclical, due to depressed conditions in the Italian

^{1/} This figure includes certain one-time debt-consolidation operations.

economy, the magnitude and consistency of the movement is probably indicative of an underlying trend. Bank of Italy data for the industrial sector illustrate the rise in labor costs. Income per worker rose faster than output per worker as a comparison of the first and second lines indicates, thereby forcing up unit labor costs shown in the third line (the quotient of the two lines -- labor costs per unit of output). For the entire period product prices did not rise as fast as unit labor costs, thus squeezing business profits. Data collected by Mediobanca (a large credit institute) for 795 companies indicate that for the period 1968-76 these companies collectively made net cumulative losses.

Productivity and Labor Costs in Italian Industry
(Percentage change from preceding year)

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>
Output per Employed Worker	3.8	1.4	5.4	8.4	3.0	-8.6	9.8
Labor Income per Employed Worker	18.6	11.6	11.2	22.9	23.5	22.5	22.4
Labor Cost per unit output	14.2	10.1	5.5	13.3	19.9	34.1	11.5

Source: Bank of Italy, Annual Report, various issues.

The rise in real wages and the dramatic shift in income shares reveals the power of labor to extract real income increases despite a stagnant economy. Increases in real labor compensation have been due to the contractual wage increases and also to a substantial increase in fringe

benefits financed by employees. In addition, the real value of the wages (and much of the fringe benefits) have been protected by the scala mobile -- the Italian system of wage indexation.

The sharp rise in unit labor costs poses a severe dilemma for policy makers. If the authorities accommodate the higher labor costs by expanding the nominal value of aggregate demand through fiscal and monetary policy, and therefore permit business to pass on these increased costs in the form of higher prices (if the authorities in other words "validate" the price pressures) then the overall price level will rise. On the other hand, if the pressures are resisted, output and employment will fall, business will suffer losses and, in the Italian context, the state, faced with the choice of subsidizing business losses or watching companies fail and unemployment rise, will choose to subsidize, thereby further burdening the public sector.

In an open economy the policy problems are compounded since higher prices at home will cause a loss of international competitiveness requiring corrective action. This will probably involve some combination of exchange rate depreciation and domestic demand restraint, which will in turn raise problems that will be further discussed below.

Before concluding this Section, some aspects of Italian labor costs will be briefly compared with developments in other countries, using for this purpose a table from the OECD's 1977 Economic Survey of Italy.^{1/}

^{1/} The table on page 18 of the Survey, is based on a study by the European Community Commission.

Comparative trends of wages and labour costs
Average annual percentage changes

	Earnings per wage-earner in national currency		Unit costs in national currency		Purchasing power of wage earners		Unit cost in dollar
	1963-1972	1972-1975	1963-1972	1972-1975	1963-1972	1972-1975	1972-
	Italy	9.9	21.7	4.8	21.7	5.4	5.3
Germany	9.1	10.5	3.6	7.6	5.7	3.7	17.4
France	10.0	16.2	4.1	15.7	5.4	3.2	22.6
United Kingdom	8.9	21.3	4.6	20.8	4.0	4.3	15.9
United States	5.7	7.6	2.8	6.6	2.4	- 0.8	6.6

In the first two sections of the table, changes in earnings and unit labor costs in local currencies are shown for two periods; the third section shows changes in purchasing power. It can be seen that Italy and the United Kingdom had the largest increases in rates of change of money earnings between the two periods. Also, in the second period real purchasing power increased much more slowly in Germany, France and the United States but rose at the same rate in Italy, despite the slowdown in economic growth and actually rose faster in the United Kingdom. In the second period Italian workers enjoyed the fastest real income growth of the countries shown. The final column gives unit labor costs converted into dollars from local currencies, and indicates that because of currency appreciation (relative to the dollar) in France and Germany and depreciations in Italy and the United Kingdom, the dispersion of unit labor costs measured in a common currency, under the pressure of international competition, was reduced.

As a final point, international comparisons also indicate that the ratio of fringe benefits to direct wages is higher in Italy than elsewhere further burning Italian businesses. ^{1/}

^{1/} See OECD Italy 1977, p. 18.

D. Public Corporations

Italy's large state corporations are a significant part of the Italian economy and hold commanding positions in certain sectors. The largest group is IRI (Istituto per la Ricostruzione Industriale) a holding company with subsidiaries inter alia in steel, engineering, shipbuilding, shipping, telecommunications and banking. The hydrocarbons sector is dominated by ENI (Ente Nazionale Idrocarburi) and there are also state companies in minerals, electricity generation and other areas.

The ideal of the state corporation -- publicly owned, acting in a market environment, but on the basis of social considerations and not commercial profitability alone -- was supposed to be a unique Italian institution and a driving force in Italian growth. For some time the corporations did perhaps play this role, but by general agreement they no longer do so, although parts of the state sector still turn in commendable performances.^{1/}

The difficulties of the state corporations arise from several sources. At first they were relatively free of political control, but beginning in the late 1950's it is alleged that they became a Christian Democratic power base with political appointees placed in top positions.

^{1/} The treatment by Allen and Stevenson, chapter 7 is an example of an earlier view of these corporations. For a good summary of the criticisms, see Paul Betts.

In addition to managerial inefficiency created by political control, the corporations, in my view, suffered from some confusion as to their objectives. They were enjoined to economicity (an untranslatable word) which does not appear to mean profit-maximizing, but does imply that economic efficiency should be respected, subject to taking account of non-economic objectives. Translating into economist's terminology, one could say that the firms were meant to maximize a "profits" variable with social objectives incorporated into "profits."

Of course, even the best managed firms would only approximate such a counsel of perfection, but in the Italian case, many investments, particularly in the Mezzogiorno, were not justifiable by even the most generous interpretation of a socially-modified profitability criterion; rather, they were clearly wasteful of resources. Investment also tended to be more capital-intensive than for the rest of the economy, which is in part a reflection of the technical characteristics of the sectors involved, but also is probably due to the fact that equity is provided by the state and borrowing often is subsidized. Another source of waste is the use of state endowment funds (intended for capital formation) to cover operating losses. Finally, state corporations have been increasingly used to take over failing companies in the private sector, increasing the holding companies losses and weakening market discipline in the private sector.

The problems of the state corporations explain in part why few Italian economists argue for greater nationalization as a remedy for the country's ills. The call instead is for either subjecting the corporations to strict market criteria, letting losing firms go under ^{1/} or (and these are not exclusive alternatives) better management and state co-ordination of the activities of the corporations.

Before concluding this section, I would like to draw together some of its themes and show their applicability to the economic crises to be discussed later. The Italian public sector ran large and growing deficits due in significant measure to the expansion of social benefits, the growing deficits of the local authorities and the financing of inefficient enterprises, while at the same time the state was unable to raise taxes sufficiently to pay for these expenditures. The strength of Italian labor was shown in its ability to receive growing benefits from government and business. At the same time, the social infrastructure -- housing, hospitals, urban transportation, schools -- were in disarray so that the returns to public spending were low in part due to a large and inefficient bureaucracy. The flexibility and productivity of the economy was harmed by labor practices and the state enterprises were a source of growing weakness.

The point of repeating this sad litany is to show that the traditional tools of economic policy are not adequate in such a situation and that, as happened, the country was prone to move from crisis to crisis with economic recoveries running up against the barriers of inflation

^{1/} Most economists would, I think, agree that to the extent state firms undertake activities which are socially desirable, but that deviate from private profit maximization, some subsidization might be legitimate.

and external disequilibrium. Finally, although I point to union pushfulness as a major element in the economic dilemma facing the government, labor's behavior may legitimately be seen as a reaction to the inequities and inefficiencies of the political and economic system and the backward state of public services.

II

As might be expected, Italian economists have been vigorously debating the causes of their country's economic problems. There is widespread recognition of the importance of the factors discussed in Section I,^{1/} however, a more technical debate over causation is also taking place.

The two main views stress the role of either excess aggregate demand or wage pressure stemming from trade union activity. Within this very broad division, many theories are clearly possible. For the purposes of this paper I shall concentrate on two specific analytical viewpoints.

The first view, that of Modigliani and Padoa-Schioppa argues that the trade unions have imposed a real wage on the economy inconsistent with achieving the goals of full employment, price stability, and external equilibrium (what I shall sometimes call internal and external balance). The second view holds that excessive aggregate

^{1/} A useful presentation of the eclectic approach stressing structural factors can be found in Schmitt.

demand, rather than union wage pressure is responsible for Italian inflation. In Frattianni's version of this argument, monetary expansion has been the major cause of this excessive demand.^{1/}

The second view, which I shall, loosely, call monetarist, argues that Italian inflation can be explained almost entirely by increases in the monetary aggregates greater than necessary to finance increases in real output, and the foreign rate of inflation.^{2/} Money wages of course have risen sharply, but it is asserted that these wage increases are explained by workers responding to past and expected price increases. Because the Italian authorities have responded to the inflation caused in large part by excessive monetary growth with restrictive policies, the Italian economy has undergone a cycle of stop-go policies which has led to the stagnation it has experienced.

The rapid expansion of the monetary aggregates is in turn due to the increase in the monetary base and the major source of monetary base creation has been the central bank's financing of

1/ At the time of writing, I did not have available to me a full exposition of Frattianni's general position. Modigliani-Tarantelli provide econometric support for the role of trade union activity in explaining inflation, while Spinelli's work fails to find such evidence, but rather argues for the role of excess demand as does Frattianni's. Robert Gordon provides evidence that wage push accounts for wage-inflation, but that the latter fails to explain price increases.

2/ Frattianni does not rule out on theoretical grounds that non-monetary sources of aggregate demand could have produced the Italian inflation, but argues that, empirically, monetary impulses have predominated.

of the Treasury's deficit.^{1/} The Bank of Italy has itself maintained that it has been required to finance the Treasury deficit and therefore has lost control of the monetary base and money supply.

One fact is not in dispute: central bank financing of the Treasury has been throughout the 1970's the major component of monetary base creation and in 1974-76 contributed more than 100 per cent to creation of monetary base (other components, essentially the foreign sector, because of external deficits, being negative). However, the interpretation of this fact, as well as the monetarist position in general, is disputed.

The Modigliani-Padoa-Schioppa position is presented in a tightly argued paper and the following account highlights only some of the essential points. The unions have imposed a real wage on the economy because 100 per cent indexation under the scala mobile fixes the real wage implied by any nominal contractual wage. The specified real wage will, for a given capital stock and technology, determine a level of output and employment which varies inversely with the real wage.^{2/} Since a basic price in the system is fixed, there is no reason

^{1/} For present purposes monetary base can be defined as the liabilities of the central bank (currency in circulation and bank reserves held at the central bank). Since base is either bank reserves or currency which, if deposited at a commercial bank, is convertible into bank reserves, the amount of monetary base in existence will roughly determine the amount of bank deposits and the stock of money. The process the text describes can in essentials be reduced to the following: the Treasury deficit is financed by issuing debt against itself, much of which is bought by the central bank. The Treasury receives a deposit at the central bank in return for the debt obligation, spends the deposit, thereby placing in the hands of the public liabilities of the central bank (monetary base). When deposited at a commercial bank these reserves support a multiple deposit creation and therefore money supply expansion.

^{2/} Modigliani-Padoa-Schioppa derive this relationship from an oligopoly model and not from marginal productivity theory which would also produce the inverse relationship.

to expect internal and external balance to be simultaneously achieved. If the authorities respond to the unemployment created by an overly-high real wage by monetary expansion, a higher level of output might be achieved but at the cost of continuous inflation. In an open economy under a fixed exchange rate, full employment and price stability might be achieved, but only at the cost of a balance of payments deficit. This deficit can persist for only as long as it is financed, and the same inconsistency between full employment and price stability will reappear when the deficit is corrected. A devaluation can improve the external position only temporarily, since, given that real wages are fixed, higher import prices resulting from the devaluation will re-ignite the inflationary process and the external disequilibrium will be recreated at the new higher price level. In the end the economy will be at a higher price level, depreciated exchange rate and external imbalance.

In this analysis it is accepted that the inflationary process must be validated by the monetary authorities. The alternative to doing so is a fall in output and employment. But Modigliani-Padoa-Schioppa argue that increases in the money supply are a response to price and cost increases rather than their cause. Moreover, they assert that it is fallacious to say that central bank financing of the Treasury deficit causes the increase in the money supply. That increase could have been equally brought about by the central bank's purchase of any debt -- public or private; also, the Treasury always has the option of selling its debt on the market, which would drive up interest rates but would not increase monetary base.

I do not propose to resolve the controversy between the two views in this paper. The simple facts do not resolve the issues as the following table may suggest:^{1/}

Money Supply, Gross Domestic Product and wages (Percentage Changes from Preceding Year)							
	M ₂	GDP			Contractual wage	Real wage ^{1/}	
		Nominal	Real	Deflator			
1970	11.8	12.1	5.0	6.7	20.7	15.1	
1971	15.0	8.8	1.6	7.2	11.9	6.8	
1972	18.3	9.6	3.1	6.2	9.2	3.3	
1973	20.3	19.4	6.9	11.7	23.0	11.0	
1974	20.4	23.3	4.2	18.3	20.1	0.8	
1975	18.8	13.1	-3.5	17.2	23.0	9.4	
1976	22.8	25.0	5.7	8.3	20.9	3.5	
1977	20.7	20.3	1.7	18.3	27.4	8.9	

^{1/} Contractual wage deflated by consumer price index.

Source: Bank of Italy, Bollettino; ISTAT, Bollettino Mensile de statistica; Relazione Generale Sulla Situazione Economica del Paese.

The money supply (defined as M2 -- the broad definition), wage rates, prices and nominal income all rose sharply. For the period 1973-77 (except for 1975), M2 and nominal GDP rose at roughly the same rate, and a simple table gives no indication of causation. It does seem that in 1971-72, M2 rose far faster than nominal GDP and the need to validate inflationary pressures; one might argue that in this period the inflationary process was ignited by monetary factors. The wage push view could reply that the authorities were indeed pursuing a consciously expansionary policy, but in response to the recession

^{1/} As the footnote on p. 14 suggests, econometric analysis has not resolved the issues either.

brought on by the wage-explosion of 1969; that is, in order to offset the depressing effects on output of the wage increase, nominal demand had to expand. It does appear, however, that for 1971-72 monetary expansion was overdone, and that this expansion might have helped prepare the way for the subsequent inflation. In this period the central bank's hand was probably not forced by the need to finance the Treasury; rather there was general agreement among policymakers on the need to pursue expansionary policies.

The simple data for 1973-77 differentiate even less between the two views. On the wage-push side, one can note that money wages were rising faster than that justified by inflation plus productivity -- i.e., real wages were rising faster than productivity.^{1/} This lends support to the view that workers were not only responding to past and anticipated inflation; since real wages were rising faster than productivity, the wage level may have become incompatible with internal and external balance.

On the other hand, the wage claims made by labor are not necessarily insensitive to the willingness of the authorities to expand the money supply. Moreover, the expansion of the moneysupply may not simply have been a matter of the authorities validating wage pressures. I think that one must give a great deal of weight to the repeated statements by the Bank of Italy that it had lost control of the monetary

^{1/} To see that real wages were rising faster than productivity compare real wages in the table above with productivity in the table on p. 6.

base because it was constrained to finance the Treasury deficit and did not have the option, contrary to the Modigliani-Padoa-Schioppa view, of letting the Treasury sell securities on the market forcing up interest rates. Thus, one can agree with Modigliani-Padoa-Schioppa that the real wage is too high for internal and external balance, but still believe that an exogenous expansion of the money supply (not simply a validation of wage claims) occurred, which may in part have been responsible for the sizeable wage claims Italian workers made.

However, it appears that the unemployment rate associated with price stability did rise because of a rise in the real wage unjustified by productivity increases. This wage behavior lies outside the monetarist framework. In my view, the explanatory power of the monetarist hypothesis is greater if the starting point is a position of labor-market equilibrium associated with a given real wage. Monetary expansion can then lead to changes in nominal values -- prices, wages and exchange rates -- leaving real variables, including the unemployment level, unchanged.^{1/}

The ability of Italian labor to raise substantially its real wages must also be explained. One possible explanation is the formation of the CCU, a confederation of the three large Union confederations, in 1969, which permitted a common front in wage negotiations and perhaps increased union bargaining power. Another (not preclusive)

^{1/} Indeed, according to the natural rate hypothesis (accepted by many monetarists) the equilibrium unemployment rate is determined in part by labor market imperfections. The level of the real wage is given at a point of time; it seems to me, in the Italian context, that a monetarist could accept the view that the natural rate of unemployment rose after 1969 due to real wage increases outstripping productivity.

explanation is the disappearance of the labor surplus in the 1960's which had characterized the Italian post-war economy.^{1/} I think this is an important part of the explanation for the faster rise of wages, but not probably a sufficient one. A greater degree of labor scarcity can explain a higher real wage, but can less easily explain (for a given degree of scarcity) its higher rate of growth except in the transition period of adjustment to the new scarcity.

Before concluding this section, I should briefly discuss another viewpoint on the underlying causes of the Italian crisis. Socialist economists such as L. Spaventa argue that union militancy was a response to years of neglect of social investment. He also says that economic mismanagement, particularly in the fields of agriculture, energy and technological development, left Italy vulnerable to the international shocks of the 1970's. Spaventa's argument is related to what I suspect is a more general view among Italian economists on the proper role of government. In this view, unless the state takes the lead in certain fields, such as agriculture and technology, or provides a general economic stimulus,^{2/} sustained growth is not likely and the Italian crisis is rooted in general failures of government.

It is true that government inefficiency has been endemic in Italy, and those functions government does perform should be performed effectively; but one might argue that a reduction in the role of

^{1/} See Schmitt, pp. 62-3

^{2/} See Ciocca, et. al., passim.

government would be a more desirable path for the country to follow. Thus, government involvement in the Italian economy is probably as great as in any western industrial country, viz. the public corporations, government control of the capital market, the widespread use of subsidized credit and other features of Italian economic life, for example bailing out failing firms; these have reduced the role of the market, and in the process of favoring certain sectors (e.g., in access to capital), have penalized the non-favored sectors.^{1/} It is difficult to conclude that greater government intervention is a desirable direction for Italy to follow. Nor is it clear why sustained growth requires continuous government stimulus.

III

The Crisis of 1974

The fourfold increase in the price of oil in late 1973 and 1974 proved more damaging to Italy than the other major industrial countries. Before the oil-price increase, Italy was already experiencing inflationary and balance of payments problems. The Italian economy, after stagnating in 1970-72, in part because of the sharp increase in wages and disruptive strikes in 1969 and again in early 1973, was recovering rapidly in mid-1973.^{2/} This recovery was out of phase with the cycle in the rest of the industrial world, and was in full swing when activity was flattening out elsewhere. This was one reason for the widening of the trade deficit. In addition, the world-wide

^{1/} There appears to be a widespread failure to recognize that a subsidy to one sector is equivalent to a tax on the non-subsidized sectors, and that, to some extent, the stagnation of Italian agriculture may have been induced by a policy of encouraging industrialization.

^{2/} Recovery actually started in late 1972.

upsurge in commodity prices struck Italy particularly hard because of the country's heavy dependence on raw material imports.

In terms of growth and investment, 1973 was the best year since 1969, and the government, anxious for a sustained recovery, did not try to brake the boom; there were some steps taken in 1973 to tighten monetary policy primarily because of capital outflows, and price controls were imposed to try to control inflation. By the end of 1973, inflation, measured by the consumer price index, was running at a 12 per cent annual rate; the current account swung into deficit and was \$2.5 billion for the year.

The rise in oil prices turned a worrying deficit into an unprecedented one, since Italy imports nearly all its oil and about 80 per cent of its total energy consumption. The 1974 current account deficit reached nearly \$8 billion. The rise in oil prices greatly accelerated the inflation rate: wholesale prices rose by 17 per cent in the first three months of 1974 over the previous quarter (not annualized) and the average for 1974 was 40 per cent above 1973. Consumer prices in December 1974 were 25 per cent higher than a year earlier.

The external deficit forced the authorities to act. Italy had formally abandoned a fixed exchange rate in January and February 1973, but the central bank still intervened in the exchange market to support the lira. In the first five months of 1974, although the lira was allowed to float downward, the Bank of Italy also engaged in heavy support intervention, losing about \$1 billion per month for January-May. Since

Italy only had about \$2 billion in foreign exchange available at the start of the year, and was unwilling to draw down its gold reserves, intervention on the scale performed required external assistance.

In the past, the Italian authorities, when they wanted to improve the reserve position, would request the state corporations and credit institutions to borrow on the Euro-currency markets and turn the foreign exchange proceeds over to the central bank. The borrowing would be repaid when the external situation warranted. This so-called compensatory borrowing had reached \$7 billion by early 1974 and further use of the Euro-currency market would have forced Italy to pay unacceptably high interest rates. Consequently, the Italians turned to official lenders and in the course of 1974 borrowed from the IMF (both a stand-by credit and the oil facility), the European Community (EC) and the Bundesbank for a total of about \$5.9 billion. The IMF imposed conditions (seconded by the EC) on Italy to limit domestic credit expansion, and the size and central bank financing of the Treasury deficit.

The negotiations with the IMF provoked a political crisis and the fall of the (fourth) Rumor government which had been formed the previous summer, marking a return to the center-left formula. The center-left coalition (Christian Democrats, Republicans, Socialists and Social Democrats) had dominated Italian governments since the early 1960's. Although the crisis ended with the (fifth) Rumor government, and the acceptance of the IMF conditions, the political situation was unstable throughout the year^{1/}; the Socialists in particular were unhappy about

^{1/} Rumor tried to resign again in June, but his resignation was not accepted and he stayed, until December, to put through further restrictive measures.

supporting restrictive policies. The need for parliamentary support on the left, and the unsettled labor situation, limited the degree of deflation the government could carry out.

In fact a strong stabilization program using both monetary and fiscal policy, was carried out. The main tools of monetary policy were a limit on bank lending and the import deposit scheme,^{1/} whose effect, in addition to adding to the cost of imports, was to absorb monetary base. The effect of the monetary squeeze was to send interest rates soaring (short-term rates were over 20 per cent in June) and to slow down the growth of monetary base in the second half of the year. In July a wide range of direct and indirect taxes increases were imposed which absorbed about 2-1/2 per cent of GDP.

The restrictive policy produced dramatic effects; indeed some economists have charged that it was overdone. The rate of inflation decelerated: the wholesale price index was nearly flat between October 1974 and June 1975 and consumer price inflation was cut nearly in half by the middle of 1975. The external situation also responded strongly; the lira strengthened on the exchange market and the current account deficit fell from \$8 billion in 1974 to \$500 million in 1975. The main reason for this sharp improvement in trade and current account was the fall in

^{1/} This required importers to deposit at the Bank of Italy for a fixed period a given proportion of the value of their imports in a non-interest bearing account. The foregone interest on the deposits adds to the cost of imports, acting like a tariff, and the deposit itself, since it is held at the central bank, reduces the monetary base.

imports (volume fell over 11 per cent between 1974 and 1975) while at the same time export volume managed to rise slightly despite the recession in world trade. As in 1963-64, the Italian economy had responded quickly to restrictive policy.

These successes were brought at a high price. GDP fell 3.5 per cent in 1975 and industrial production over 9 per cent. Unemployment rates did not show much variation because of the policy limiting layoffs; but the number of lost hours due to short-time work compensated by the state, more than doubled. Finally, total fixed investment fell by about 13 per cent.

Because the correction of the inflation and balance of payments problems depended on deflation, it was feared by many economists that economic recovery would bring a renewal of these problems. The breathing spell enjoyed by the Italian economy in 1975 was not used to effect basic changes, i.e., a redirection of resources towards investment and exports. Indeed, the rigidity of the economic system was increased significantly in January 1975 by the agreement between Confindustria (the employers association) and the unions, which increased the degree of indexation, so that when the system was fully in place in February 1977, the degree of indexation was roughly 100 per cent.^{1/}

^{1/} Faustini gives a very detailed account of the scala mobile; the system is also described in OECD Italy 1977, pp. 15-18.

The Crisis of 1976 and the Aftermath

Economic policy became expansionary over the course of 1975; monetary policies loosened (the import deposit scheme and the bank credit ceilings were ended in March), and in August a large fiscal reflation package was adopted. The monetary aggregates grew rapidly, particularly in the second half of the year, and M2 increased in the 12 months ending December 1975, by 24 per cent. Interest rates fell steadily till the end of 1975, the short-term rate reaching about 8 per cent in December.

Recovery began in the fourth quarter of 1975, and, at the same time, the trade and current account deficits widened. The central bank supported the lira in the exchange market keeping the effective exchange rate (an average exchange-rate which weights bilateral rates by trade shares) nearly fixed. However, foreign exchange reserves were meager, and on January 20, 1976 the crisis exploded with the announcement of the "closing" of the foreign exchange market -- in actuality the suspension of official quotations and central bank support. It is not necessary to give a detailed account of the vicissitudes of the lira during 1976; it declined, with a few intermissions, steadily between January and May, at one point trading at more than 900 lire per dollar (on January 20 the rate was 688). By the end of the year the effective depreciation was about 20 per cent from a year earlier.

The immediate causes of the sharp fall in the lira were, I believe the overly rapid expansion of the money supply in late 1975^{1/} and

^{1/} At least one observer, Monti, on the eve of the crisis, on the basis of an examination of the monetary aggregates, warned of impending trouble.

and the deteriorating political situation. Other economists have stressed the role of recovery and the sharp rise in imports at the end of 1975. Since the political situation throughout the period was of such great importance, it would be useful to summarize briefly the key political developments before returning to our discussion of the economic situation.

A Moro government was in office since December 1974, and was based on a truncated version of the center-left coalition: only the Republicans joined the Christian Democrats in the cabinet but the Socialists provided parliamentary support. In June 1975 the Communists has scored substantial gains in the regional elections. The shaky governing coalition fell apart in January, prior to the exchange crisis, because of disagreements over economic policy and, more immediately, the abortion question. This government was replaced with a minority Christian Democrat government, which in turn fell April 30 because of lack of Socialist support, leading to early elections in June. The Communists greatly improved their showing over the 1972 election (but only marginally over 1975), but the results were something of a victory for the Christian Democrats as well, since they rebounded from June 1975; they held the same percentage of seats as in 1972 and remained the largest party. The poor showing of the smaller parties, including the Socialists and the strength of the Communists, made a return to the old formulas politically impossible (although, arithmetically, a slim center-left majority was possible) and brought the Communists openly into the political discussion.

The Andreotti government that was formed in July was again a minority Christian Democrat government with the agreement of the Communists and other parties of the so-called constitutional arc to abstain. In exchange for their support via "non no-confidence" the Communists received important Parliamentary positions and their agreement is necessary for the passage of legislation. The Andreotti government was reformed in March 1978 after a crisis in January 1978 provoked by the Communist demand for greater participation. The new government included the PCI in the parliamentary majority (as well as the other parties of the constitutional arc except for the Liberals) but the cabinet again was composed only of Christian Democrats. The economic performance of the Andreotti government must be viewed in the light of the delicate political balance throughout this period.

The immediate effect of the lira depreciation in early 1976 was on the rate of inflation, particularly at first on wholesale prices, which jumped 16 per cent in the first four months and rose 30 per cent over the year. Consumer prices increased more than 20 per cent during the year. Although it is often stated that the depreciation caused the price rise, I would argue that the immediate cause of the inflation was the monetary expansion which increased prices through the route of the exchange rate depreciation.

In response to the repeated exchange crises throughout 1976, the authorities used a broad range of policies. To control capital outflows they imposed a panoply of exchange controls or tightened existing ones. Monetary policy swung into restraint as the discount rate was raised,

reserve requirements increased and ceilings were again placed on bank lending. Fiscal policy also became restrictive, particularly after the formation of the Andreotti government; a large package of tax and public utility tariff increases was assembled. Renewed exchange market pressure in May and again in October led to the adoption of extreme measures -- an import deposit scheme in May and a tax on foreign exchange purchases in October.

The effect of the exchange controls, import measures, and the sharp rise in interest rates in the summer, as well as the June election, despite its ambiguous outcome, was to stabilize the lire. The improvement in the exchange market did not come via the trade account which showed little response to the lira depreciation or deflationary measures in 1976. In 1976 real activity was vigorous and the inflation rate stayed high.

As in 1974, the Italian authorities turned to the IMF in 1976 and began discussions which at first proved inconclusive. After the elections, negotiations were concluded in April 1977 with the granting of a SDR 450 million standby credit to Italy. The stand-by negotiations depended in turn on protracted negotiations between the government, the unions, and Confindustria over the issue of labor costs and productivity. At the heart of these negotiations was the issue of the scala mobile, which the government and employers wanted to modify but which the unions proclaimed to be untouchable. The Confindustria-union negotiations, concluded in January, produced only some minor changes in the scala mobile.

There were other agreements -- on holidays, vacations, absenteeism, overtime, multiple shifts and labor mobility -- which may prove of more significance in the long-run.

In addition, the government acted to "fiscalize" a part of the social insurance charges paid by business in order to reduce labor costs, and concurrently enacted increases in indirect taxes to pay for this measure. Since an increase in indirect taxes feeds into the scala mobile and raises wages, negating the measure's beneficial effects (this is an illustration of how the scala mobile frustrates economic policy) the government wanted to offset this effect by "sterilizing" the impact of the taxes on the scala mobile. The government was forced to retreat under a storm of criticism from the unions and the left and instead, as a compromise, the unions agreed to reduce the weight of certain items in the scala mobile basket. While the agreements on labor costs and productivity were limited, and 100 per cent indexation is still in effect, the willingness of the unions to negotiate on these issues is itself significant and an implicit recognition that they were on the defensive on these questions.

The Letter of Intent to the IMF in connection with the new 1976 standby (as well as undertakings given to the EC in connection with a new loan from the Community) as in 1974, contain conditions on the expansion of domestic credit and the size of the public sector deficit.

The public sector deficit conditions are more stringent than in 1974 since they limit not only Treasury borrowing but the deficit of the "enlarged" public sector, which includes not only the central government, but also the social security agencies and the local authorities.

The 1976 conditions are extensions of the 1974 ones insofar as they try to limit credit growth and public sector deficits. In addition, there are some new elements, notably an inflation target; thus the IMF has set conditions not only on the size of policy instruments but also on achieving specified outcomes.

The impact of the stabilization program was felt over the course of 1977 as GDP fell after the first quarter, and for the year as a whole rose by only 1.7 per cent. At the same time, the inflation rate, especially wholesale prices, fell sharply, and the IMF's inflation target, measured by a cost-of-living index, was more than achieved. The IMF had set goals for reducing the current account deficit; in fact, there was a \$5 billion swing in 1977, which was much larger than required, and a large surplus of \$2.3 billion was achieved. This improvement was due in part to the effects of weak economic activity on import and export volumes, as well as to the effect of the Lira depreciation which also strongly benefitted tourism. Once again, the Italian economy had responded quickly and dramatically to a deflationary policy. The strengthened external position has allowed Italy to repay some of its official borrowing, although official debt, when combined with external borrowing done by the commercial banks is still considerable. The 1976

emergency measures of the import deposit scheme and the foreign currency tax came off during 1977. If Italy adheres to its stabilization program over the next few years, a period of slow growth can be expected. The 1976-77 experience has again illustrated Italy's inability to achieve the goals of economic growth, price stability and external balance.

IV

Italian economic performance over the past few years has been disheartening. Since 1973 GDP has grown 8.2 per cent, an annual average of about 2 per cent. Consumer prices have risen at an annual average rate of over 17 per cent and the cumulative current account deficit for (1974-76) was \$11.4 billion before turning positive in 1977. External borrowing rose about \$9 billion until end-1976. Of course, all the industrial economies turned in unimpressive records over the past few years, but, except for GDP growth, the Italian performance^{1/} is among the worst.

An important part of the reason for this relatively poor performance is the heavy reliance on imported oil by the Italian economy. In response to the deficit created by the oil price increase, Italy

1/ The OECD Economic Outlook: July 1977 in a special section on "the Adjustment Process since the Oil Crisis" presents comparative statistics for the OECD countries for a number of important variables for the period 1973-76.

followed a combination of external financing, domestic deflation and depreciation.^{1/} Total domestic demand grew for 1973-76 by less than 1 per cent, considerably lower than the OECD average. Largely because of this deflationary policy, the foreign balance as a share of GDP rose by 6 per cent, over 1973-77.

The depreciation of the lira was also substantial. On the basis of Bank of Italy calculations, the effective exchange rate fell nearly 34 per cent from 1973 to end 1977; yet the improvement in Italy's competitive position has been relatively slight, because the inflation differential between Italy and its trading partners was only a few percentage points lower.

The seeming inability of depreciation to cause more than a temporary change in competitive position has led nearly all Italian economists to rule out the use of depreciation in present conditions. A depreciation, it is argued, cannot improve the trade balance because import prices and consumer prices will rise and, given the scala mobile, nominal wages and prices will follow. In order for a depreciation to improve the trade balance, real incomes must be reduced -- the economy must reduce its total absorption of goods -- and given limits to the possible compression of profits, real wages must fall, which is prevented by 100 per cent indexation. Monetarists, and others, respond that the increase in costs and prices after a depreciation must be accommodated by

^{1/} Given the OPEC surplus on current account, it is generally agreed that the non-OPEC countries should not try to eliminate their deficits entirely. However, the Italian authorities did have to eliminate that part of the current account deficit that could not be financed. Also there was a substantial deficit prior to the oil crisis.

monetary expansion. But, a refusal to accommodate the price increase imposes losses of output and employment just as under an explicit deflationary policy. As it turned out, because of the ineffectiveness of depreciation, and limits on obtainable external financing, Italy did rely heavily on domestic deflation (relative to abroad and to what is needed for full-employment growth).

The argument that has just been made is not an endorsement of the "vicious circle hypothesis" which in some statements of this hypothesis seems to view depreciation as an exogenous cause of inflation, that in turn leads to further depreciation. The Hypothesis, stated in so bald a fashion, ignores monetary factors and the initial cause of the depreciation. In my view, neither the 1974 nor the 1976 Italian inflations were caused by depreciations. It is true that in 1976 the sharp rise in prices paralleled the fall in the lira; but there had been a rapid monetary expansion in 1975 (as well as a sharp recovery in activity and imports in the latter part of the year) while the effective exchange rate was virtually pegged. I think it is more convincing to view the subsequent depreciation and inflation as adjustments to this monetary expansion, (as well as a reflection of the recovery in activity.) However, I do think it is reasonable to argue that -- for a given external disequilibrium and fixed real wage -- changes in exchange rates will to a large extent be offset by nominal wage and price changes, so that the external imbalance will not be corrected, provided the monetary authorities validate the process.

If labor costs are controlled, the policy dilemmas that have faced successive Italian governments could be more readily resolved; by the use of demand management and exchange rate policy, full employment, price stability and external balance would be more achievable. This view is close to that of Modigliani-Padoa-Schioppa. However, I would like to register a dissent to some extent from the policy implications they draw. Accepting the real wage as given, the authors argue that labor costs must be reduced in other ways, primarily by raising productivity. The desirability of increasing productivity is obvious and there seems to be ample room in Italian industry to get productivity improvements -- at least of a once-over kind. However, I think it is mistaken to accept 100 per cent indexation, because it perpetuates a rigidity in the system, which can repeatedly reproduce the conditions in which the contractual real wage is inconsistent with the policy goals of internal and external balance.^{1/}

Suppose, for a given contractual real wage, labor costs have been reduced by some combination of productivity increases and reduction of social insurance charges, and that wages are consistent with internal and external balance. If contractual nominal wages now rise faster than productivity, real wages will again be inconsistent, and are made rigid.

^{1/} In Modigliani-Tarantelli the authors do call for a reform of the *scala mobile*.

by 100 per cent indexation. It is unlikely that the economy will repeatedly have reserves of unused once-over productivity gains available (and there is a limit to the extent social insurance charges can be assumed) to allow a return to consistency between the contractual real wage and policy objectives. It would be trusting to luck to expect nominal contractual wages and productivity to keep growing in step, once consistency has been achieved. Moreover, the system could be destabilized by other events, e.g., a decline in the terms of trade. In my opinion, it follows from the compelling logic of the Modigliani-Padoa-Schioppa argument, that 100 per cent indexation, by fastening an unchanging relative price on an economic system, will repeatedly render the system unstable, once the other remedies proposed are exhausted.

There is a line of argument, proposed by Spaventa, which maintains that the Italian economy will only achieve sustainable growth if the external constraint is broken by greater government involvement in certain areas, and I think it is useful to discuss what is a fairly influential position. The existence of the external constraint on growth is derived as follows. For a given income-elasticity of import demand, the rate of growth of Italian GDP will be limited by the economy's ability to increase its exports in line with its import requirements. The rate of growth of exports is in turn dependent on the rate of growth of foreign markets and import-elasticities abroad. Foreign growth

therefore limits potential Italian growth, and indeed, because Italian import elasticities are alleged to be higher than those abroad (because of Italy's heavy dependence on food, energy and other raw material imports) foreign income must grow faster than Italian for external balance to be maintained. Since foreign growth is likely to be slower in the future than in the past, while Italy's need for fast growth is still pressing, a conscious policy of import-substitution, particularly in the fields of energy and agriculture, must be pursued to loosen the external constraint on growth.

This argument puts Italy in the position of a less-developed country facing, what the development literature calls, a foreign exchange constraint. In that literature it is recognized that for the constraint to hold fairly restrictive assumptions must be made about the inability to reduce imports, expand exports, or substitute factors of production, assumptions that many economists feel are unjustified for even an underdeveloped country, let alone an industrialized economy like Italy.

All the ramifications of this question cannot be pursued here, but I shall consider two lines of argument. First, the exchange constraint position, resting as it does on a given import-elasticity, seems to say that domestic supplies are fixed at each income level, and there is a fixed relationship between GDP on the one hand and food or energy consumption on the other. This assertion ignores the ability of relative price increases to reduce consumption and expand production for a given level of income and thereby lower the import-

elasticity. Second, the exchange constraint argument assumes either fixed exchange rates or the inability of a depreciation to improve the trade balance for any given income level. The difficulties involved in a depreciation with a given fixed real wage have been discussed at length, but it is an interesting question whether the advocates of the exchange-constraint position agree that allowing the real wage to vary would, by rendering exchange rate flexibility a usable policy instrument, loosen the exchange constraint and raise potential Italian growth.

The exchange-constraint position might at this point be restated -- deliberate policies of import-substitution are an administrative alternative to the market solution of depreciation when real wages cannot be lowered. The state must allocate resources into certain sectors because the market response is inadequate, since relative prices in those sectors are kept too low by an overvalued exchange rate. However, if the state transfers resources into these sectors, it must reduce resources available to the rest of the economy, including, it is almost certain, workers' income. The reduction in real income the workers would not accept via a depreciation would come about by other means -- presumably taxation. ^{1/} In my view, if real consumption is going to be lowered in any case, it would

^{1/} One could use the tax system to reduce workers' incomes by less than a depreciation (without indexation), but given the high wage share the difference in impact would probably be small.

seem preferable to do so by a depreciation with a flexible real wage, which would have general effects on the balance of payments by acting on all imports and exports and letting the market choose in which industries Italian comparative advantage lies.^{1/} Therefore, I do not think that Spaventa's analysis weakens the case for real wage flexibility.

There is a wide acceptance of the view in Italy today that sustainable growth depends on bringing aspirations into line with resources, which means reducing consumption and raising investment. The failure to act more decisively on labor costs, an essential component of such a strategy, did not stem from intellectual failure on the part of the government, but from the unwillingness of the authorities to impose such a solution because of the economic costs and political risks of an all-out deflationary program. Whether sustainable growth will be achieved after the present sacrifices remains to be seen.

^{1/} I do not wish to imply that there are not other grounds for state intervention in certain fields such as energy. But deliberate import-substitution in itself is inefficient if the goal is simply to reduce the import-elasticity. Optimal intervention depends upon the extent of market imperfections.

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