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APPROVED FOR RELEASE
DATE: MAR 2004

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Italy: Economic Outlook Fair Despite Political Turmoil

An Intelligence Assessment

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PA 80-10118
EP 80-10161
March 1980

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An Intelligence Assessment

Research for this report was completed on 7 March 1980.

This assessment is one in a series of seven being issued to assist in preparations for the Venice Summit. [redacted]

This paper was prepared by [redacted] the Office of Political Analysis and [redacted] the Office of Economic Research. It was coordinated with the National Intelligence Officer for Western Europe. Comments and queries are welcome [redacted]

Confidential
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Italy: Economic Outlook Fair Despite Political Turmoil

Overview

When the Venice Summit convenes in late June the present Italian Government probably will have fallen, the victim of deep differences among the political parties over Communist participation in a future government. Prime Minister Cossiga may still be in office, but only as a caretaker. The Socialists effectively have withdrawn their support for Cossiga because the Christian Democrats have refused to sanction a coalition including both leftist parties.

Cossiga will remain in office as long as he can avoid a vote of confidence. Even if Cossiga's government collapses, none of the parties would likely be willing to make the concessions necessary to create a more viable successor prior to the nationwide local elections scheduled for May or June. Cossiga probably will be in office until the elections are over and the parties can begin serious negotiations on what to do next. If Italy's previous record holds, the elections themselves will be inconclusive and the negotiations to form a new government protracted.

Since his government was installed last August, Cossiga has been unable to obtain the parliamentary support to deal effectively with Italy's persistent economic, institutional, and public order problems. He has enacted some emergency measures, but only one—a special antiterrorism measure—has yet received parliamentary ratification. It is unlikely that any policies of note will emerge from Parliament between now and the Summit, particularly if Cossiga is reduced to caretaker status.

There was no slowdown in the Italian economy in 1979, despite wide predictions to the contrary. Rapid economic growth took place without substantial worsening in the foreign accounts; but inflation did reach worrisome levels, with consumer prices rising at an annual rate exceeding 20 percent by yearend.

The Cossiga government originally premised its fiscal policy for 1980 on forecasts of a slump in real growth and a slowdown in inflation. Seeking to forestall recession, the government designed a package of measures to have a net stimulative effect on real gross domestic product in 1980 of about 1 percent. But the measures are stalled in Parliament and may have to be reevaluated in light of new economic conditions.

The strength of economic activity toward the end of last year has caused government forecasters to raise their growth projection for 1980 to 2.5

percent, a rate we believe will be exceeded. If the government's economic measures are implemented at all, they will be carried out piecemeal and probably will have a limited impact on the economy [redacted]

Preoccupation with political affairs has also caused Rome to procrastinate on energy questions. Except for some switching from oil to natural gas, Italy's energy balance has remained essentially unchanged since 1973. Further fuel substitution will not be feasible for several years. In recent months, government officials have been concentrating on securing an adequate short-term supply of oil. Rising world prices combined with government retail price ceilings had created some supply problems, but a change in the ceilings along with mild weather have made the situation manageable. [redacted]

Italy: Economic Outlook Fair Despite Political Turmoil [redacted]

The Political Setting

In Italy, domestic politics are overshadowing all other events. By late June the present minority government will probably have fallen, although to postpone an almost inevitable political crisis, the political parties may have decided to keep Prime Minister Cossiga in office in a caretaker capacity. [redacted]

The current stalemate on the Communist question stems from the incompatibility of the Communist and Socialist positions with that of the Christian Democrats:

- The Communists refuse to support a government from which they are excluded.
- The Socialists will not back a government opposed by the Communists.
- The Christian Democrats will not grant the Communists Cabinet ministries, although they might be willing to consider some very limited cooperation with them. [redacted]

The Christian Democrats are sharply divided on party policy: some favor the reinvolvement of the Communists in the governing process, others prefer a coalition including the Socialists and some of the smaller parties. Many observers expected the Christian Democratic Party congress in February to soften the party's attitude toward the Communists, but a majority of the congress rejected a proposal to acknowledge even the possibility of a future government including the Communists—even if the Communists change their policies on key political, economic, and international issues. [redacted]

Instead, Christian Democrats endorsed the concept of an alliance with the Socialists and smaller parties, leaving the door ajar to some role for the Communists—perhaps agreement on a program the party could support in Parliament. The Christian Democrats probably are hoping that this position will induce the Socialists to participate in negotiations that might extend Cossiga's tenure until after the spring elections. [redacted]

Despite loss of Socialist support, Cossiga will continue in office as long as he can avoid a confidence vote. The Socialists are reluctant to put any more pressure on him for the time being in large part because of the deep split in the Socialist Party about what to do next. The left wing apparently intends to coordinate its moves with the Communists, while the right wing probably would participate in a government without the Communists if a Socialist were granted the prime ministry. This latter group also might be willing to participate in proposed interparty talks that would keep Cossiga in place, hoping that a program agreement might lead to an acceptable government formula. [redacted]

The Communists have refused to participate in the proposed interparty consultations unless the Christian Democrats concede that a program agreement could lead to a government including the Communists—very unlikely in view of the party congress vote. Communist leaders seem convinced that their party's losses in last year's general election were a result of supporting a government and program over which it had little or no influence. Therefore, they are reluctant to become involved in a similar situation prior to the spring vote and may be hoping to improve their own chances with the voters by going into the election opposing a sitting government. [redacted]

If Cossiga does maintain a tenuous hold on power, it will be because the impasse over direct Communist participation in a future government that has prevented the parties from agreeing to a more stable governing formula also restrains them from plunging into a "crisis in the dark." Nonetheless, Cossiga's tenure will probably be near an end by midyear. The parties will be sorting out the results of nationwide local elections scheduled for either May or June and reevaluating their respective positions on the "Communist question" prior to what almost certainly will be protracted negotiations on the makeup and program of a new government. [redacted]

Electoral Prospects

In the spring vote, the advantages and disadvantages of the three major parties on key local, national, and international issues seem likely to cancel each other out. This being so, the election results may prove to be inconclusive to the talks to form a new government—talks that already promise to be prolonged. [redacted]

On the local level, these elections probably will serve as referendums on the Communists' poor performance in governing their most recent conquests—such as Turin, Rome, and Naples. Since, in most cases, the Socialists have backed these Communist-led governments, the Socialists can be expected only to suffer from this association. The Christian Democrats undoubtedly will try to capitalize on Communist and Socialist shortcomings in this regard. But they will be equally vulnerable to attacks from the two leftist parties in localities where Christian Democratic refusal to allow the Communists into the ruling administrations has immobilized these governments [redacted]

On the question of Communist participation in the national government, the Communists' prospects could improve significantly if the party can capitalize on its arguments that Cossiga's tenure has proven that effective government in Rome is impossible without the Communists. At the same time, the continuation of a do-nothing Cossiga government, dominated by the Christian Democrats, can hardly fail to dampen that party's hopes of success. It is not clear how the Socialists will fare on this issue. Their abrupt shift from an apparent willingness to join a five-party non-Communist majority to a refusal to back a government without the Communists is likely to alienate voters on both sides of the question [redacted]

The Soviet invasion of Afghanistan has once again raised the issue of the Italian Communist Party's relationship with Moscow. In the course of the election campaign, the Christian Democrats can be expected to argue that the Communists have not cut their ties to Moscow, berating the Communists for coupling their condemnation of the Soviet action with criticism of US countermeasures and for their calls for independent European initiatives to mediate between the two superpowers. However, this issue could cut both ways if the Communists attempt to exploit the Italian public's fears about the future of detente by linking the Christian Democrats and the government to an uncritical adherence to US policy [redacted]

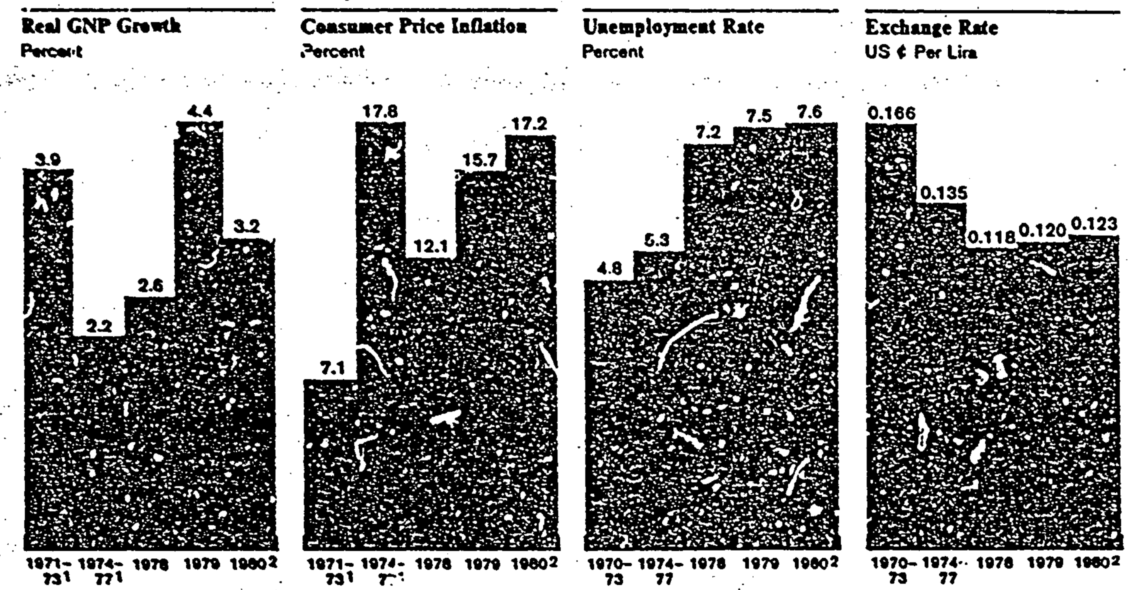
Domestic Priorities and Plans

Since his government was installed last August, Prime Minister Cossiga has been unable to obtain the parliamentary support required to deal effectively with Italy's persistent economic, institutional, and public order problems. Theoretically, the government has commanded a parliamentary majority as a result of the Socialist pledge to abstain on key votes. But, in practice, disagreements among the Christian Democrats and the other members and supporters of the government—the Social Democrats, Liberals, Republicans, and Socialists—have stymied the legislative process. Hence, Cossiga seems to have abandoned the emphasis of his immediate predecessors on correcting such basic economic problems as high public sector deficits, low productivity growth, and rising labor costs. [redacted]

Cossiga has enacted some emergency energy conservation policies, raising the price of petroleum and electric power, increasing the oil stock requirement, imposing residential heating limitations, and altering school schedules to allow for longer winter vacations. But none of these measures have thus far received parliamentary approval, and some, established by decree law, will expire soon unless ratified by Parliament. The government recently obtained parliamentary support for its decree laws on extraordinary antiterrorist measures but only by making the test a vote of confidence. Cossiga was certain that this particular issue enjoyed widespread popular support and that Communists and Socialists would vote in favor to avoid appearing soft on terrorism. [redacted]

In the unsettled political atmosphere that is almost certain to prevail between now and this summer, economic considerations will take a back seat to virtually everything else in the minds of policymakers. No new policy initiatives seem likely. Nor does the government have any reason to believe that a parliamentary consensus will develop in support of any of its already stated goals. Consequently, it is unlikely that any policies of note will emerge from Parliament, particularly if the Cossiga government is reduced to caretaker status. [redacted]

Italy: Selected Economic Indicators



[1] Average annual.
[2] Projected.

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Economic Environment and Outlook

Despite the lack of attention to it, the economy's outlook for 1980 is not bad, in part because 1979 was much better than expected. In fact, economic activity picked up remarkably in the fourth quarter, with exports, consumption, and investment all scoring large gains. We estimate that real GDP grew 4.4 percent last year, a strong advance from the 2.0 and 2.6 percent growth rates of 1977 and 1978, respectively [redacted]

The novelty of 1979 was the strength of internal demand. Private consumption, buoyed by higher real wage rates, rose 6.0 percent. With productivity increases helping firms generate cash, investment recovered from a four-year slump; plant and equipment expenditures jumped 5.4 percent. [redacted]

Although economic growth was rapid, the foreign accounts remained in good shape. Last year's current account surplus of $5.4 billion was down only about $800 million from the record level of 1978. Tourism—which earned $6 billion in 1979—and an improved government transfers balance were responsible for the strong current account showing. The trade balance was slightly in deficit last year, in contrast to a $2.8 billion surplus in 1978. [redacted]

The sour note in Italy's recent economic performance has been inflation. Consumer price increases accelerated almost continuously in 1979, ending the year at an annual rate in excess of 20 percent. While special factors such as the relaxation of rent controls and hikes in excise taxes undoubtedly contributed to inflation,

Table 1			Billion US $
Italy: Current Account			
	1978	1979	1980
Trade balance	2.8	−0.5	−7.5
Exports	55.0	68.9	81.9
Imports	52.2	69.4	89.4
Services balance	3.8	4.1	4.4
Transfers balance	−0.4	1.8	1.8
Current account balance	6.2	5.4	−1.3

[redacted]

underlying pressures remained strong. Growth of the money supply is approaching annual rates of 25 percent. Increased government transfer expenditures have pushed up consumer demand. Some industries are now working close to capacity; bottlenecks, especially for skilled labor and semifinished goods, are developing [redacted]

The Cossiga government originally based its fiscal policy for 1980 on forecasts of weak aggregate demand and an easing in inflation. The Cossiga fiscal program is detailed in the 1980 budget and an omnibus finance law, which were submitted to Parliament last fall for passage before the yearend budget deadline. But debate over economic policy proved so acrimonious that both documents stalled in parliamentary committee and the various provisions are being dealt with piecemeal. Government operations are being financed under continuance legislation [redacted]

In order to forestall recession, the government proposed a combination of fiscal measures designed to have a net stimulative effect on real GDP of about 1 percentage point. Proposed legislation calls for cutting tax burdens on low income groups by raising personal exemptions, and on firms by reducing social security charges. Special public works and housebuilding programs are planned. At the same time, ceilings would be placed on spending by local and regional governments and on treasury borrowing [redacted]

Budget Minister Andreatta contends that a $50 billion limit on public sector borrowing in 1980 is still valid. Other economists are more skeptical, noting that political pressure is rising for costly welfare projects and more spending by local authorities. Large capital infusions will be required for loss-ridden state corporations. Meanwhile, the unions are pressing for greater tax reductions. [redacted]

The premises of Cossiga's fiscal program may have to be rethought in view of new economic conditions. If it is implemented at all, it will be issue by issue and will have only a small net impact, and this concentrated in the second half of this year. The tax reductions would give the main lift to aggregate demand; proposals to increase public works spending are likely to become bogged down in the perennial mires of underfunding and bureaucratic red tape. Expansionary fiscal policy probably would be counteracted to a considerable degree by the actions of the Bank of Italy [redacted] he Bank has raised its discount rate to 15 percent, a historical maximum, and is reportedly considering other adjustments. [redacted]

With the lira above its parity in the European Monetary System, the government's exchange rate policy has come under fire. Andreatta in particular, however, values a strong lira as a useful anti-inflation tool. Calls for devaluation are coming from firms that find their competitiveness eroded by rising costs. Inflation differentials already have worsened enough to wipe out the advantage gained by previous lira depreciation, and exporters are insisting that some sort of devaluation be carried out this spring [redacted]

The strength of economic activity toward the end of last year has caused government forecasters to raise their growth projections for 1980. When the budget was submitted in October, real growth of 1.5 percent was expected this year. Government spokesmen now foresee growth of 2.5 percent, a figure which is 0.7 percentage point shy of our estimate. Italy, the only major European country to be stimulating its economy, will continue to be a leader in economic growth [redacted]

One unpleasant concomitant of stronger than previously expected demand will be worsening inflation. We expect a yearly increase in consumer prices of 17.2 percent in 1980—close to the postwar record of 19.1 percent in 1974. Price increases will be particularly pronounced in the early part of the year due to hikes in the government-controlled prices of electricity, telephone services, and petroleum products. [redacted]

More rapid inflation and economic growth in Italy than in the economies of its trading partners are likely to drop the current account $1.3 billion into deficit this year. A deficit this large should be of minor concern to policymakers; Italy has had three consecutive years of big surpluses. With ample reserves available, this current account showing should permit Rome to hold the line on the lira if desired. [redacted]

In 1981, real GDP growth is likely to slow—to perhaps 1.5 percent. Consumption growth should weaken as the stimulus provided by this year's tax cuts wears off. No major basic wage increases are in prospect for private sector employees, although larger cost-of-living adjustments for civil servants probably will drive up public consumption. Despite the slowdown, the current account could slip deeper into the red as the competitiveness of Italian exporters declines further [redacted]

Energy

As with economic policy issues, Rome continues to procrastinate on energy questions. Except for some switching from oil to natural gas, Italy's energy balance has not changed much since 1973. Further fuel substitution will not be feasible for several years, until sizable quantities of Algerian gas start arriving via pipeline and until plans for coal-fueled electricity generation are realized. The National Energy Plan still projects that nuclear power will play a central role, although siting problems remain unsolved and political opposition is growing [redacted]

Government energy officials have been preoccupied in past months with securing an adequate short-term supply of oil. Caught between rising world crude prices and retail price ceilings, Italy's independent oil companies, which traditionally supply one-third of the domestic market, threatened large cutbacks. At one time, Rome was publicly predicting a 25-percent oil shortfall in 1980. Fearing a shortage-induced recession, the government granted the companies price relief at yearend and has promised to keep retail petroleum prices more closely in line with world crude prices. This together with mild weather, has made the supply situation far less critical: any shortfalls that may develop can probably be covered in the spot market. The oil import ceiling adopted for 1980 implies no actual restraint on domestic consumption. [redacted]

Petroleum consumption rose by 3.2 percent in 1979, with oil used by thermal plants and industry rising less than real output. Gasoline usage shot up almost 8 percent but seems to be leveling off. Increased excise taxes, coupled with a raised price ceiling, have resulted in a jump in retail gasoline prices of about 30 percent since the start of last year. The excise tax structure is encouraging a switch from gasoline to diesel fuel; auto diesel consumption jumped 18.4 percent in 1979 [redacted]

ENEL, the national electric utility, recently published a 10-year investment program aimed at averting threatened blackouts. The program, involving the construction of a series of nuclear, hydroelectric, thermal, and geothermal plants, is designed to raise by about 70 percent ENEL's present capacity of 40,000 megawatts (MW) and to reduce dependence on oil in electricity generation from roughly 60 to 40 percent over the decade. Despite reservations about the transport sector's ability to import and deliver coal, the government has approved the immediate construction of three new coal-fired plants. Coal-burning thermal plants are to supply 13,500 MW of the 27,000 MW of planned new capacity. Coal consumption is expected to rise from 1-2 million tons annually to 25-30 million tons by 1990 [redacted]

In line with the National Energy Plan, the ENEL program calls for the construction of 10 nuclear reactors of 1,000-MW capacity—in addition to the two already sited and under development. The government has recently cleared one obstacle to nuclear power by resolving competition among contractors in favor of a single type of reactor, the Westinghouse light water design. [redacted]

Table 2

Italy:
Selected Energy Indicators

	1970	1973	1976	1977	1978	1979 [1]	1980
Energy consumption per capita [2] (barrels oil equivalent per year)	16.9	18.6	18.5	18.6	19.1	19.4	NA
Energy consumption [2] (thousand b/d oil equivalent)	2,479	2,796	2,840	2,875	2,951	3,020	NA
Net oil imports (thousand b/d)	1,770	2,090	1,963	1,936	1,908	2,040	2,070 [1]
Net oil imports (billion US $)	1.2	2.4	8.0	8.4	9.9	13.4	NA
Net oil imports as share of energy consumption (percent)	71	75	69	67	65	68	NA

[1] Preliminary.
[2] OECD data, including bunkers planned.
NA indicates Not Available.

[redacted]

But ENEL's plans for nuclear power may clash with political realities. Two years ago, the government overrode Socialist opposition to parliamentary endorsement of nuclear power by soliciting support from the Communists. The Communists have since returned to the opposition and are becoming increasingly leery of the nuclear issue. The tiny Radical Party is trying to force a national referendum on nuclear power. Local governments, until they are bought off by promises of reduced power rates or special public works investment, staunchly oppose nuclear plant siting in their regions. Italy will probably reach 1990 with no more than 3 percent of its electricity coming from nuclear plants. [redacted]

Foreign Policy Attitudes and Objectives

During his tenure in office, Cossiga has shaped his government's foreign policy to improve Italy's international standing, as well as to enhance his own domestic image as a statesman. The Prime Minister apparently is convinced that these twin objectives can be achieved by demonstrating Italy's solidarity with the United States in the context of the Atlantic Alliance and by using the Italian EC Presidency—which expires in June—to influence a European consensus supportive of Washington on a variety of international issues. [redacted]

Traditionally, Italy has been sensitive to the creation of a "European directorate"—from which it would be excluded—that would consult with the United States on a preferred basis. Cossiga has tried to forestall this development and to demonstrate Italy's reliability as an ally by associating Rome very closely with the United States on theater nuclear force modernization, Iran, and Afghanistan. [redacted]

Domestically, these moves have contributed to Cossiga's prestige by creating for him the public image of a trusted interlocutor in both Washington and major European capitals. Cossiga may also be hoping to obtain tactical Communist support for his policies. His determination to tie Italy more closely to the United States and the EC may be calculated to dispel Western fears and to remove external vetoes on Communist participation in any future Italian government, thereby persuading the Communists to be more cooperative on current foreign policy issues. [redacted]

Cossiga's ability to transform his country's symbolic support of US policies into more substantive backing is contingent, however, on domestic political and economic conditions. On the theater nuclear forces question, for example, the government was able to opt for participation largely because the Communists did not fully attempt to exploit nascent opposition to the program. Parliamentary approval turned out to be closer than expected, apparently because of the defection of some Socialists and members of Cossiga's own Christian Democratic Party. [redacted]

In the cases of Iran and Afghanistan, Cossiga has been reluctant to impose economic sanctions against either Tehran or Moscow because of the importance of Rome's commercial ties with these countries. The government also is vulnerable to charges from the Communists and some Socialists that by adopting these countermeasures Rome would be contributing to mounting international tensions and blindly following US policies. For these reasons, Italy has tried to develop its positions on these issues in conjunction with its Community colleagues. [redacted]

If Cossiga survives in a caretaker capacity, it is almost certain he will become more cautious on foreign policy issues. He is likely to be particularly circumspect in his support of US policies. For example, Rome probably will avoid making a final decision on the choice of sites for ground launched cruise missiles scheduled to be based in Italy as part of the theater nuclear forces program. [redacted]