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Venice Economic Summit Briefing Book

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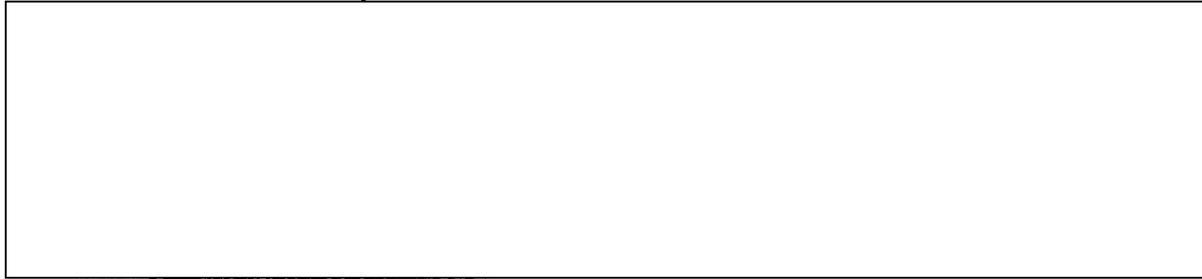
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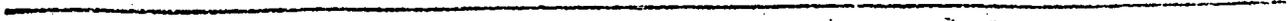
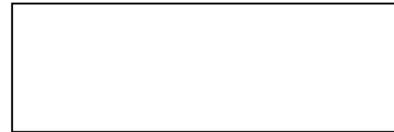
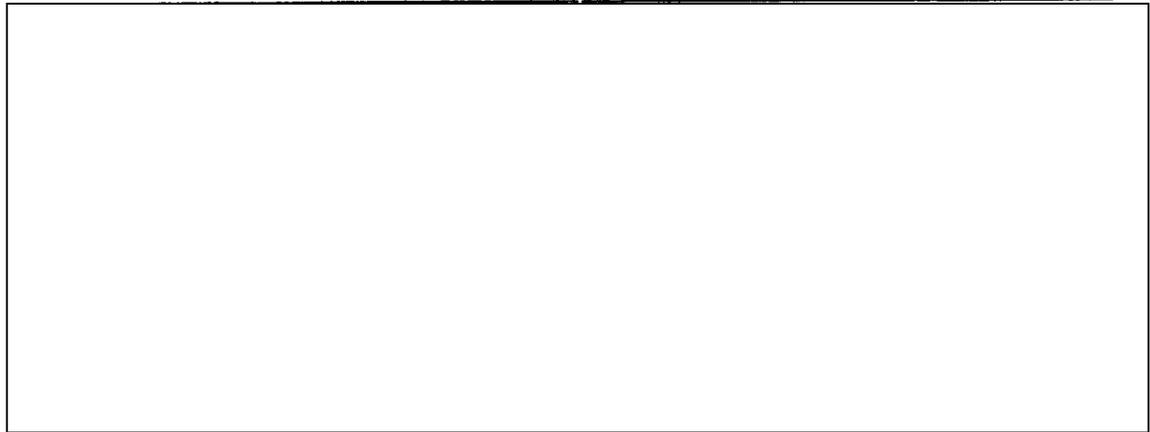
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Overview

Prime Minister Francesco Cossiga will host the Venice Summit just as Italian politicians are completing their preliminary assessments of nationwide regional and administrative elections to be held on 8 June.* Although these elections will have no immediate bearing on the status of Cossiga's Christian Democratic/Socialist/Republican government, they will serve indirectly as a referendum on his tenure in office. The mood of the electorate will guide party leaders as they look for answers to the "Communist question" and for ways to move beyond the short-term expedients that returned Cossiga to power in April following the collapse of his first government. By fall the political horse trading that will follow the election is likely to yield a different government—in tone and shading if not in name.

While unlikely to receive much attention from the government until late in the year, the economy should manage to grow 3 percent, carried by the momentum of a strong fourth quarter 1979 showing. Although doing better on the growth front than most of its Summit partners, Italy will do worse in the area of inflation. Spurred by sizable wage increases, higher energy costs and a large public sector deficit, inflation will average around 20 percent this year. With export competitiveness falling and import costs rising, the current account has returned to deficit, perhaps reaching \$3 billion for the year.

As a Summit host hoping to bolster his domestic political image, Cossiga will seek to downplay disagreements among the Seven. He is unlikely to sponsor any major initiatives or to lodge any broad substantive objection trying to reinforce Italy's image as a quiet but constructive member of the club. Rome's sensitivity to being included in discussions among the major Allies underlies Italy's desire to discuss political issues at the Summit.

* The Italian political situation is currently unsettled because of the scandal surrounding the family of former Christian Democratic Party Deputy Secretary Donat-Cattin. Donat-Cattin's son is currently being sought by authorities for membership in the Front Line terrorist organization. The opposition has begun to press for Prime Minister Cossiga's resignation, arguing that he learned of the younger Donat-Cattin's involvement while serving as Interior Minister two years ago and told his colleague that his son was about to be arrested, thus allowing him to escape.

According to a reliable Christian Democratic source, the Prime Minister believes he has an agreement with the Communists to drag out any full parliamentary investigation until after the Venice Summit and President Carter's visit. The same source reports, however, that Cossiga's aides are pessimistic about his government's chances of surviving beyond early July.

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Cossiga hopes that the Seven can arrive at common positions on Iran and Afghanistan featuring limited economic measures but a strong diplomatic stance. Cossiga does not expect any major breakthroughs on the traditional agenda items for the Summit. The Italians probably will go along with likely joint initiatives or statements on inflation, energy development, expanding North-South relations, and trade liberalization; they remain reluctant to commit Italy to specific energy targets. [redacted]

**The Political Situation:
Cossiga Redux**

Cossiga's present coalition is the fruit of a political truce that ended a two-week-long government crisis in March, which was precipitated by the Socialists' withdrawal of parliamentary support from his first government. Each of the parties to the deal wanted to avoid a second general election in less than a year and the embarrassment of having a caretaker government in office as Italy completed its term as EC president and prepared to host President Carter's state visit and the Economic Summit in June. [redacted]

This arrangement became possible when Socialist chief Bettino Craxi and the center-right leaders of the Christian Democratic Party agreed unexpectedly—in hopes of bringing along their respective left wings—to exclude the strongly anti-Communist Social Democrats and Liberals from the government. The Christian Democratic and Socialist interlocutors reportedly hoped that a government alliance between their two parties—even if not an ideal formula—would help their chances in the June election, weaken their respective internal opponents, and facilitate the creation of a five-party government after the vote. Cossiga, however, apparently insisted on including the Republicans—who share the desire of leftwing Christian Democrats and Socialists to cooperate with the opposition Communists—probably hoping to create a bridge government the Communists might later support. [redacted]

None of the parties has given evidence of a strong commitment to this government. A programmatic accord was reached in two weeks. Negotiations would probably have taken much longer if the parties saw the present government as anything more than a stopgap. The government has refused to commit itself to a significant legislative program, and it is unlikely to do so. Nonetheless, even limited progress on the many problems facing the government and the country will influence the electoral test in June and the negotiations on a successor government. The recent, highly publicized string of terrorist arrests comes to mind in this regard (even though it is uncertain whether they really amount to the breakthrough that some have suggested). [redacted]

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Election Calculus

The Italian political elite has fastened its attention on the 8 June elections not only because they will amount to the first nationwide electoral test since last June but also because people recall the extraordinary Communist Party gains in the same elections five years ago which originally brought the question of Communist participation in the national government to prominence. Communist losses in last June's parliamentary elections provided the first indication that the party's progress toward a governing role including cabinet ministries might not be as inexorable as had seemed. All the parties will scrutinize the election results for hints about what the Communists' year in opposition has done to the electorate's expectations about Communist involvement in decisionmaking at the national level.

With so much at stake, the Christian Democrats have, strangely enough, campaigned with less unity and with poorer preparation than ever before. In fact, they seem to be running two separate campaigns. The right wing, led by party chief Piccoli and former Foreign Minister Forlani, has focused on traditional anti-Communist themes, apparently believing that public support is turning in its direction. It will be tempted to seek new parliamentary elections come fall if the voters deal the left a further setback. The party's left, on the other hand, long identified with the late Aldo Moro and currently led by former party Secretary Zaccagnini has taken a softer approach, stressing the need for cooperation between Christian Democrats and Communists to solve the country's ills. Leftwing Christian Democrats worry that an all-out campaign against the Communists could force the party to retreat to a less cooperative form of opposition that would make the country impossible to govern.

On past occasions when the Christian Democrats have found themselves badly divided and unable to compromise, they have finally come together to protect their hold on power and its perquisites. Since Moro's death, however, the party has lacked an arbiter capable of reconciling the views of the various factions. Party leaders are concerned about presenting an image of disarray and are working to tone down party infighting until after the campaign. Failing this, the party may face serious questions about its future viability.

Socialist Party leader Craxi remains optimistic that the June elections will support the present government formula. He recently expressed the opinion that the Cossiga government could last as long as a year. He believes the left as a whole will lose votes but that most of those losses will fall to the Communists. The Craxi forces are hoping that the party's recent agreement to support some of the small Radical Party's upcoming referendum efforts.

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[redacted]

exchange for a pledge not to run candidates in the June elections will free up a large enough chunk of the overall votes to allow them to minimize their losses and perhaps even register some gains [redacted]

Craxi probably has more at stake personally than either his Christian Democratic or Communist counterparts. This election has become, in effect, a referendum on his decision to lead the party back into partnership with the Christian Democrats. (The left wing of the Socialist Party [redacted] will take steps both to replace Craxi with Claudio Signorile and to bring down the Cossiga government if the Socialists lose one-half percent at the polls. The leftwing Socialists hope to replace the present government with a "government of national solidarity," including the Italian Communist Party in a majority. [redacted])

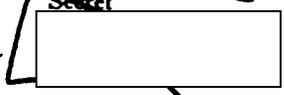
Communist Party leader Enrico Berlinguer emerged from the party's 1979 electoral debacle with his reputation and policies basically intact; nevertheless, he had to consolidate his position in the face of several months of harsh criticism from within the party hierarchy and loud grumbling from the party base which forced him to remove critics from power and elevate loyal followers to their vacant posts. Although the party remains committed to the "Historic Compromise" strategy, a broad spectrum of party members has become increasingly uneasy with this approach in view of party electoral defeats. [redacted]

(Fully aware of this history, the party's leaders have commissioned an outside polling organization to survey voters in an attempt to gain a better understanding of the party's actual strengths and weaknesses and put themselves in a better position to plan campaign tactics. The leaders are quite aware that a decline of one to two percent would likely set off another wave of unrest and criticism within the party which could weaken their hold on power over the long run. For the time being, however, a decline of this magnitude could probably be absorbed without too much difficulty.)

[redacted]

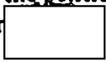
A larger loss—3 percent or more—would put the party below its 1972 benchmark and would pose a more formidable challenge to Berlinguer's leadership. The process would take several months to play out, and its chances of success would depend upon Berlinguer's ability to read party sentiment and adjust his policies accordingly. If Berlinguer ultimately falters, his successors would probably realign the party toward a more aggressive opposition stance; even so, Communist opposition tactics probably would not revert completely to the hard line of the past. [redacted]

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Polls and Prospects

Independent surveys show the Christian Democrats, Socialists, and socialist parties marginally improving their overall standings compared with performance in 1979, while the Italian Communists continue to decline. Dramatic shifts in percentages are not in the cards; the 8 June election probably will not provide the clarity the politicians are seeking about what the electorate wants or will stand for.



Even though the Cossiga government will face increasing strain following the Summit regardless of the outcome of the election, the parties are unlikely to initiate a crisis during the summer. The early fall is likely to bring a change in government and, if the Christian Democrats have done well, a possible dissolution of parliament and early parliamentary elections. Regardless of the results of the 8 June balloting, the present government probably will collapse within a few months of the election under the weight of its own immobilism.



Current Economic Situation and Short-Term Prospects

Italy turned in one of the OECD's most impressive economic performances last year and is likely to do better on the growth front this year than in other developed countries. Real GNP was up 5 percent in 1979, buoyed by consumer spending and exports, while the current account surplus topped \$5.2 billion, thanks to a robust surplus on invisibles. This strong showing was marred by 16-percent inflation and growing concern over Italy's long-term trade and energy positions. While momentum from last year ensures a 3-percent rise in 1980 GNP, inflation is accelerating and the current account will end this year in a sizable deficit.



The first Cossiga government failed to implement an economic program to deal with the commonly identified problems of inflation, sector deficits, wage reform, and energy diversification. Cossiga attempted to solve problems piecemeal through a series of decree laws, most of which expired because of subsequent parliamentary inaction. His second government finally made some legislative headway in late April of this year when the 1980 budget and financial law were approved by parliament, both of which had been on the table since last September. A comprehensive economic program cannot be expected from the new government, at the very least until after the June elections, when the public's political preferences may be more discernible.



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Inflation

Inflation remains high and in April was running at an annual rate of 21 percent. Primary catalysts have been oil price increases, the wage indexation system, and a jump in private consumption. In its plan to fight rising prices, the government would like to:

- Modify the wage escalator to exclude the impact of higher oil prices; any change certainly will be opposed vehemently by labor unions in the absence of costly government concessions.
- Revive efforts to diversify energy sources; previous attempts to move away from oil have, with the exception of the natural gas pipeline from Algeria, been rendered ineffective by parliamentary inaction and public opposition to nuclear and coal conversions.
- Reduce the public sector deficit; this is a traditional but elusive goal because of continued bureaucratic inertia and the need to satisfy diverse and growing claims from too many constituent groups, including financially strapped state industries

The 1980 budget is not expected to help in the fight against inflation. Consumer tax breaks and higher public spending this year imply an even larger total public sector deficit (including local governments, transfers, and state enterprises), which may reach as much as \$50 billion. Rome estimates it reduced the public sector deficit on a cash basis to 13.3 percent of GDP last year from 15.6 percent in 1978. Its success, however, arose from deferring capital expenditures to later years and from unexpected increases in tax receipts. The government hopes to decrease further the cash deficit as a percentage of GDP this year; however, inflation, payment of deferred expenditures, and financial infusions needed by state firms will make it difficult to hold the line.

The Bank of Italy (which provided the only real defense against inflation last year) remains the major bulwark against inflation. In 1979, the prime rate rose to a record 19.5 percent from 15 percent, while the growth of the money supply was held at 19.6 percent compared with 22.8 percent a year earlier. Money will be relatively tight again this year with the private sector feeling the biggest pinch. Two-thirds of total new domestic credit will probably be absorbed by the government's borrowing needs; last year the government soaked up 60 percent of total domestic credit expansion.

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Current Account

The 1979 current account surplus of \$5.2 billion disguised some less favorable trends. The trade balance deteriorated sharply in the second of the year, bringing the total merchandise deficit to just over \$1 billion compared with a \$2.9 billion surplus in 1978. The deterioration was due in part to declining Italian competitiveness, which curtailed export momentum. In addition, import growth, which had slowed, returned to the traditional pattern of more rapid rises than domestic demand. A large invisible surplus, particularly tourism, was the key to the current account surplus.



This year we expect the current account to swing to a deficit of near \$3 billion as world trade falls off and the oil import bill rises. Prospects for the current account may dim even further as export competitiveness continues to be undermined by rising labor costs. The lira depreciated against the dollar since the beginning of the year will boost imports since 40 percent of Italy's imports (mostly oil) are denominated in dollars. On the export side, keeping the lira within its European Monetary System (EMS) bands rules out lira depreciation to gain a competitive edge in exports to the EC. Italy's major exports—clothing, textiles, and footwear—are facing increasing competition from newly industrialized countries. Some exporters are beginning to complain that in the absence of currency devaluation, the price differential will soon be too great to compensate for higher Italian quality. Government officials, however, are intent on maintaining a strong lira as an anti-inflationary tool.



Growth

The carryover from strong 1979 fourth-quarter demand should bring economic growth to about 3 percent in 1980. Consumer demand will continue upward at a fairly good pace throughout the year as the wage escalator ensures real wage growth and tax breaks increase consumer liquidity. Nevertheless, the economy should slow in the second half of the year as the world economic slowdown gains momentum and the import-curtailed Italian export growth ripples through the economy. Investment strong last year and in the first half of 1980, will falter later this year as business optimism declines and tight money squeezes private credit. A slower economic pace should help curb inflation but will still leave inflation at an average for the year of 20 percent. The demand slowdown will hit in 1981. Real GDP growth should fall to about 1.2 percent as the consumer spending spree wears off, investment remains sluggish, and Italian competitiveness suffers from two years of rapid inflation.



Summit Positions

(Prime Minister Cossiga [redacted] believes that the Venice Summit will be only marginally important as an economic conference. Cossiga contends that the problems facing the participants are overwhelmingly political, and he hopes that the conferees will turn their attention to questions of Western cohesion on Iran, Afghanistan, and the Middle East. The Italians believe France will oppose such discussion during formal Summit sessions, but they hope that some procedural arrangement can be found that will allow the seven heads of government to consider these questions outside the normal Summit framework.) [redacted]

Cossiga's concern that the Summit address the larger political issues derives in part from dismay that Italy continues to be excluded from important Allied councils, such as at Guadeloupe; it also reflects Italian worries that East-West relations may continue their downward slide, worries that are underscored in the Prime Minister's mind by his belief that increased international tension serves to make the domestic political situation he faces more difficult. Given the opportunity, Cossiga will lend his support to a soft West European approach consistent with his perception of high economic vulnerability on sanctions against either the Soviet Union or Iran. [redacted]

Italy perceives *inflation* and *energy* as the foremost economic problems facing the Big Seven. Cossiga has had little success in his domestic anti-inflation fight and puts much of the blame on imported inflation. He is likely to be receptive to any joint initiative taken by the participants on controlling inflation, particularly if it addresses the medium term and not just short-run aspects of the problem [redacted]

While paying lip service to lower energy/GDP ratios and greater nuclear and coal use, Cossiga will be reluctant to commit Italy to specific targets. Short-term prospects for keeping within IEA 1980 oil import targets are good. In the long run, however, Italy's dependence on imported oil will likely increase substantially before leveling off. Even the most optimistic assessments indicate that Italy will be able to generate only 50 percent of its electricity from nuclear power and coal by 1990. If criticized about Italy's lack of a strong conservation program or failure to achieve a 5-percent reduction in oil demand last year, Cossiga can still boast that Italy has the lowest per capita energy consumption among the Summit participants [redacted]

Rome believes a combination of conservation and development of new energy sources would be appropriate areas for energy policy agreement by the Summit nations. Italy also is interested in lowering barriers to full exploitation of traditional and renewable energy resources—particularly if Italy, in addition to LDCs, can obtain financial or technological help for energy development [redacted]

[redacted]

Italy has a vital stake in maintaining an open *trading* system, as it upon exports to pay its energy bill and to undergird growth. In spite of internal pressure for protectionism, particularly by large ailing industries, Cossiga will support initiatives favoring trade liberalization. Italy probably will like to have some sort of clarification on Allied export credits with respect to the Soviet Union; Cossiga will ensure that Italy does not lose any competitive ground in this area. The Italian construction, chemical, automotive, and nuclear industries all see great potential for Italian deals, and progress on most Italian sales proposals has practically stalled since export credits were frozen in January. Rome has noted its difficulty in holding the credit line if other Allies—particularly France—are similarly restrained [redacted]

Rome has a special interest in the *North-South* issue because of its perception of Italy as a bridge between developed and less developed countries. In his EC Presidency role, Cossiga had as a prime objective the widening of cooperation and communication with LDCs. Italy can be expected to support and encourage the strengthening of the North-South dialogue and expansion of trade and aid relationships—without, however, making any specific aid commitments. To relieve the burden of high oil prices, particularly for LDCs, Cossiga favors broad cooperation or arrangements for recycling of oil payments. The Italians see the IMF as the key to recycling and also push for a statement suggesting that OPEC nations play a major role by increasing foreign investment, particularly in LDCs. They also have expressed some concern that they may be cut out of a proposed French recycling initiative tied to West European exports of good technology. Beyond recycling, Italy has little interest in specific international monetary issues. Rome would strongly back a positive statement on the substitution account, although realizing concrete decisions at this time around [redacted]