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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
EXECUTIVE DIRECTORS
ON A
PROPOSED LOAN
TO
THE CASSA PER IL MEZZOGIORNO
FOR INDUSTRIAL FINANCING IN SOUTHERN ITALY

June 11, 1965

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON THE PROPOSED LOAN TO THE
CASSA PER IL MEZZOGIORNO FOR INDUSTRIAL FINANCING IN SOUTHERN ITALY

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$100 million to the Cassa per Opere Straordinarie di Pubblico Interesse nell'Italia Meridionale (Cassa per il Mezzogiorno) to assist in the financing of industrial projects in Southern Italy.

PART I - INTRODUCTION

2. In March 1964 Dr. Guido Carli, the Governor of the Banca d'Italia, visited the Bank to discuss the possibility of the Bank's resuming lending to Italy, to which the Bank had last made a loan in 1959. In reviewing Italy's economic problems Dr. Carli pointed out that while the measures already taken by the Government were expected to meet the immediate difficulties, an inflow of foreign long-term capital in excess of what could be raised through the private financial markets would be needed for some time to come to make possible investments on a scale required to maintain a satisfactory rate of economic growth. I told Dr. Carli that I could make no commitment at that stage. However, I agreed to send a mission to Italy to study the economy, establish the country's need for external capital, and examine where Bank assistance could be most useful.

3. Missions headed by Mr. Leonard Rist were in Italy from May to July and from November to December of last year. They concluded that, at least in the near future, Italy would require more long-term capital from external sources than could be raised in the private markets and that Bank lending would be most useful if channeled to industry in Southern Italy through the Cassa per il Mezzogiorno. The negotiations for the proposed loan were held in Washington in March 1965. However, the passage of new legislation for extending the life of the Cassa after the expiration of the present law on June 30, 1965 and for amending its constitution required more time than was expected and conclusion of the proposed loan had therefore to be postponed. The new law was passed by the Chamber of Deputies on May 21 and is expected to be passed by the Senate towards the end of this month.

Market Eligibility

4. In my memorandum on Market Eligible Loans dated January 25, 1965 (R65-9), Italy was included in the category of "market eligible" countries. The flow of private long-term capital into Italy, mainly in the form of portfolio and direct investments, has been of the order of U.S. \$250 to 400 million annually in the past few years.

Borrowing in the United States has recently been restricted by the interest equalization tax and other measures designed to improve the U.S. balance of payments. Italian bond flotations in the private European capital markets in 1964 was equivalent to about \$64 million.

5. In accordance with my statement at the Executive Directors' meeting of February 9, 1965 (Memorandum R65-23 of February 15, 1965), the proposed loan would carry interest at 6-1/4%. Although the proposed loan does not coincide with an Italian market issue, the rate of interest seems to be in line with recent market conditions. The \$20 million London issue of twenty-year bonds of the Cassa in February 1965 had a coupon of 6% and an issue price of 97.5, giving a yield to maturity of 6.22%. It was recently quoted in London at 95, giving a yield of 6.4%. Italian long-term bonds, issued in 1963 and 1964 in various European private capital markets, have been yielding between 5.4 and 6.7% to maturity.

6. The proposed loan would increase Bank lending in Italy to \$398 million. Of the previous seven loans totaling \$298 million, which have been fully disbursed, less than \$132 million is still held by the Bank. The status of these loans, which were all made to the Cassa per il Mezzogiorno, was as follows on May 31, 1965:

| Year of Loan | Loan No. | Purpose | Amount (in \$ million) (net of cancellation) |
|--------------------------|-------------|---------------------------------|--|
| 1951 | 50 IT | Equipment for development | 10.0 |
| 1953 | 88 IT | Equipment for development | 10.0 |
| 1955 | 117 IT | Power, agriculture and industry | 68.4 |
| 1956 | 150 IT | Power, agriculture and industry | 74.6 |
| 1958 | 189 IT | Power, agriculture and industry | 75.0 |
| 1959 | 224 IT | Power and industry | 20.0 |
| 1959 | 235 IT | Nuclear power | <u>40.0</u> |
| Total loans | | | 298.0 |
| of which has been repaid | | | <u>62.5</u> |
| Total now outstanding | | | 235.5 |
| Amount sold | | 164.0 | |
| of which has been repaid | | <u>60.1</u> | <u>103.9</u> |
| Net amount held by Bank | | | <u>131.6</u> |

PART II - DESCRIPTION OF THE PROPOSED LOAN

7. The main characteristics of the proposed loan are as follows:

- Borrower: - Cassa per il Mezzogiorno.
- Guarantor: - Republic of Italy.
- Amount: - \$100 million equivalent in various currencies.
- Purpose: - To assist in financing industrial development in Southern Italy.
- Amortization: - In 23 semi-annual instalments, beginning July 1, 1969 and ending July 1, 1980; each payment of principal and interest would be approximately equal.
- Interest Rate: - 6-1/4% per annum.
- Commitment Charge: - 3/8 of 1% per annum.
- Relending: - The Cassa would relend the proceeds of the proposed loan to three special credit institutes which, in turn, would make them available to industrial borrowers.

PART III - THE PROJECT

8. A report entitled "The Development of Southern Italy, the Cassa per il Mezzogiorno and the three Special Credit Institutes, ISVEIMER, IRFIS and CIS" (TO-467a) is attached.

The Industrial Development of Southern Italy

9. Since the close of the war, the Italian government has made substantial efforts, on the whole successful, to promote the economic development of Southern Italy. In the early years, per capita income continued to increase at a lower rate than in the North. Until the late fifties investment was largely in agriculture and transport. Industry which had been expected to develop as a result of the investment in other sectors expanded slowly. In 1957 the Government increased the incentives offered for investment in industry and, as a result, there has been a sharp rise in industrial investment in the South during the last few years. Continued full employment of labor and capital in Northern Italy had further stimulating effects on the South during this period. Unemployment in the

region declined from 6% in 1959 to 3% in 1963, and for the first time per capita income in real terms grew more rapidly than in the North, reaching a rate of nearly 8% per annum in recent years.

10. The principal instrument of the Government for developing Southern Italy is the Cassa per il Mezzogiorno which was established in 1950 and whose life is just being extended to the end of 1980. The Cassa was the borrower of the seven Bank loans totaling \$298 million made to Italy between 1951 and 1959. Initially, it concentrated mainly on agriculture, transport, water supply and sewage disposal but, in recent years, it has given increasing support to industry. The primary channels for medium and long-term lending to industry under the Cassa program are three special credit institutes which operate on a regional basis: ISVELMER on the Italian mainland, IRFIS in Sicily, and CIS in Sardinia. The Cassa holds 40% of the share capital of each Institute, and the remainder is held by regional banks and the Autonomous Regions of Sicily and Sardinia. The Institutes are, together with other institutions lending in the South, the channel through which the Cassa provides important incentives to industrial investors, including interest subsidies. From their establishment in their present form in 1953 until 1963, the three Institutes made more than 4,500 loans for a total of \$1.2 billion equivalent, mainly during the last few years. The Institutes were used as channels for industrial lending under four of the Bank loans, and reloaned a total of \$90.8 million to 21 enterprises.

11. Since about the middle of 1964 the Institutes have been finding it difficult to obtain funds to maintain their recent rate of lending. They rely principally on two sources: the bonds which they issue on the domestic market and the proceeds of the Cassa's foreign borrowings which, in recent years, have included funds provided by the European Investment Bank. These sources will not yield enough funds in the near future to permit the financing of the great number of sound projects submitted to the Institutes. The proposed loan would help to cover this financing gap and would thus make possible industrial investment at the relatively high level needed for the continued economic development of Southern Italy.

Use of the Proposed Loan

12. The proposed loan would be made to the Cassa for a period of 15 years, including four years of grace, with interest at 6-1/4%. The Cassa would relend the lira equivalent to the Institutes for the same duration and with the same grace period. The interest rate it would charge would be no higher than 3.55%, and the difference between this rate and the 6-1/4% it would pay to the Bank would be borne by the Treasury. The loans made by the Institutes would be for a maximum period of 15 years, including up to 5 years of grace, and would have an interest rate of 4%. This, together with their earnings from other sources including appraisal fees, would leave the Institutes a margin adequate to cover their administrative costs.

13. The responsibility for selection, appraisal and follow-up of the projects to be financed from the proceeds of the proposed loan would rest with the Institutes which would apply criteria and use procedures discussed during negotiations. The Institutes and the Cassa have presented to the Bank a list of projects selected on the basis of these criteria, to which the Bank has agreed. This list could be supplemented as required for the full utilization of the proposed loan. The Institutes would normally make loans only for projects with an investment cost falling between \$100,000 and \$8 million equivalent, but projects with a slightly higher investment cost would not be excluded if they seemed justified.

14. No special arrangements were called for with regard to procurement. The Institutes see to it that goods purchased with the proceeds of their loans are of satisfactory quality and are procured at the lowest price, regardless of the source. It is estimated that no more than 10-15% of the proceeds of the proposed loan would be utilized for foreign exchange expenditures, primarily for imports of special machinery. There are no restrictions on imports into Italy and machinery for use in the South is exempt from import tariffs.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

15. The draft Loan Agreement between the Bank and the Cassa per il Mezzogiorno and the draft Guarantee Agreement between the Republic of Italy and the Bank are being distributed to the Executive Directors separately.

16. The draft Loan Agreement requires the Cassa to relend the proceeds of the loan to the Institutes in specified amounts which may be changed from time to time by agreement between the Bank and the Cassa (Section 3.01 (a)), under arrangements subject to the approval of the Bank (Section 4.01). The Institutes are to apply the proceeds of the loan thus made available to them to the financing of projects agreed to by the Bank, the Cassa and the Institutes (Section 3.01 (b) and Section 1.02 (8)). The arrangements between the Cassa and the Institutes will contain obligations on the part of the Institutes to cause these projects to be constructed and operated efficiently and in accordance with sound technical, financial and business standards (Section 4.02 (a)(iii)).

17. The draft Loan Agreement also contains certain provisions designed to facilitate sales of portions of the proposed loan by the Bank. Section 2.07 provides that the Bank and the Borrower may from time to time agree that any portion of the loan repayable in one currency may be made repayable in one or more other currencies. With the agreement of the Cassa under this provision, the Bank will be able to offer prospective purchasers portions of the loan repayable in any currency desired by them. Section 5.03 permits the Bank to request bonds representing two or more maturities of the loan but payable on the date of the latest maturity which they represent. These bonds would be subject to redemption for a sinking fund on dates and in amounts reflecting the amortization schedule for the loan. It is intended in appropriate cases to incorporate similar provisions in future loan agreements.

18. The effectiveness of the Loan Agreement is conditioned upon the enactment of legislation extending the life of the Cassa (Article VIII). Since the proposed Agreement was negotiated in March, it does not incorporate the new procedure whereby loan agreements are terminated if they are not made effective by a specified date unless the Bank establishes a later date.

19. The draft Guarantee Agreement is substantially similar to those in previous loans to the Cassa.

PART V - THE ECONOMY

20. The report entitled "The Situation and Prospects of the Italian Economy" (EA-150a) dated December 23, 1964 was distributed to the Executive Directors on December 29, 1964. The report discussed the most important structural changes which took place in the Italian economy during the postwar years up to 1963, in particular the rapid economic growth during the fifties and early sixties, the gradual disappearance of unemployment and its effects on wages and income distribution and on consumption and saving. As a result of these developments the balance of payments started to deteriorate gradually in 1962 and this trend was accentuated in 1963 and early 1964 by mounting inflationary pressures and a dwindling confidence in the stability of the currency, accompanied by massive capital flight.

21. Severe monetary and, to some extent, fiscal measures adopted by the Government to cope with this situation produced quick results. With the slackening of domestic demand the increase in prices was brought under control around the middle of 1964. The expansion of exports was resumed, resulting in an increase of 15% in 1964 while imports declined by 3%. Since at the same time the capital flight came to an end, the balance of payments was reversed and showed a surplus of \$780 million compared to a deficit of \$1,250 million in the previous year. The favorable trend continued in 1965. By the end of March 1965 foreign exchange reserves had increased to \$3,860 million from \$2,942 million a year earlier.

22. However, the price for checking inflation and stabilizing the balance of payments was the interruption of economic growth. For the first time in many years, industrial production stagnated in 1964 and despite good harvests GNP increased by only 2.7%, compared to an average of about 7% in the previous five years. As a result of weakening demand and declining profits, investments in real terms were almost 10% lower in 1964 than in 1963. Employment declined in several industries and underemployment and underutilized capacities became widespread.

23. The restrictive monetary and fiscal measures were gradually lifted in the second half of 1964, and early in 1965 the Government introduced

positive measures to stimulate the economy. Of particular importance are guarantees for bonds issued by special credit institutes to finance public works of municipalities and of the central government, fiscal exemptions for the building industry, and the reduction of social security contributions of private employers.

24. The conclusions of the economic report are not changed by the recent developments. Large investments are needed in various sectors of the economy; a considerable part should take place in the South to insure its long-term growth. The report also concluded that the inflow of capital from abroad will be limited and is likely to be small in relation to the funds needed. The picture of creditworthiness has also not changed and Italy has ample capacity to service additional foreign debt.

PART VI - COMPLIANCE WITH THE ARTICLES OF AGREEMENT

25. I am satisfied that the proposed loan complies with the requirements of the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

26. I recommend that the Executive Directors adopt the following Resolution:

RESOLVED:

THAT the Bank shall grant a loan to the Cassa per il Mezzogiorno, to be guaranteed by the Republic of Italy, in an amount in various currencies equivalent to one hundred million United States dollars (U.S. \$100,000,000), to mature on and prior to July 1, 1980, to bear interest at the rate of six and one-quarter per cent (6-1/4%) per annum, and to be upon such other terms and conditions as shall be substantially in accordance with the terms and conditions set forth in the form of Loan Agreement (Southern Italy Industrial Projects -- 1965) between the Bank and Cassa per il Mezzogiorno and the form of Guarantee Agreement (Southern Italy Industrial Projects -- 1965) between the Republic of Italy and the Bank, which have been presented to this meeting.

George D. Woods
President

Attachment

By J. Burke Knapp

Washington D.C.
June 11, 1965