Il Ministro
dell'Economia e delle Finanze

P.774 IR

Rome, 1st February 2017

Dear Valdis, dear Pierre

I refer to your letter dated 17 January about the proceedings relating to the fiscal surveillance executed by the European Commission for Member States.

The report hereby attached, in accordance with provision of art. 2(3) of Council Regulation n. 1467/97, contains an in-depth analysis of relevant factors influencing recent debt developments in Italy. It explains why, although prima facie the debt criterion appears not to be fulfilled, it should be considered as currently complied with once such relevant factors are duly taken into account.

In line with the objective of securing long term control over deficit and debt, the implementation for several years of a sound fiscal policy characterized by sizable primary surpluses, has resulted in the virtual stabilization of the debt-to-GDP ratio in 2016. This is a significant accomplishment given the persistence of deflationary pressures and the high volatility experienced by financial markets. Italy's budget deficit has been on a downward path since 2014, declining by 0.3 percentage points of GDP per year, while at the same time providing support to the economy and employment growth. The Government has pursued its privatization programme. However, while the Enav ipo has been successfully launched right after the Brexit referendum, other operations had to be postponed due to volatile market conditions.

The Government intends to continue along the path of growth friendly consolidation and structural reform. An excessively accelerated pace of adjustment would hurt the economy at a time of heightened global economic and geopolitical uncertainty while bearing the risk of self-defeating consolidation.

Mr Valdis DOMBROVSKIS
Vice-President
European Commission
Brussels

Mr Pierre MOSCOVICI
Commissioner
European Commission
Brussels

Against this backdrop, it is of the utmost importance, especially for countries still experiencing negative output gaps like Italy, to find the right balance between supporting the ongoing recovery and safeguarding debt sustainability, which stronger growth contributes to reinforce. European fiscal rules rely critically on output gap estimates that are hugely penalizing for Italy. Despite a sharp output loss compared to 2008, an unemployment rate of 11.6 percent and virtual stability in wages and prices, the Commission estimates that Italy's gap in 2017 is equivalent to only 0.8 percentage points of GDP and will shrink to zero in 2018. Based on more realistic and wider negative output gap estimates provided in the attached report, Italy's fiscal policy in 2017 and the plan for 2018-2019 are shown to be fully compliant with the Stability and Growth Pact.

The attached report also stresses the exceptional circumstances, notably the inflow of migrants and the recurrent severe seismic events that are entailing significant unexpected budgetary pressures. Further strain is imposed by the most recent events where a dramatic sequence of severe earthquakes combined with exceptionally hard weather conditions, is making the effort of securing the needs of the affected population extremely challenging. The Government and local administrations are producing their best efforts to face the emergency and will ensure the most rapid and efficient reconstruction. At the current early stage we cannot fully assess the impact of the recent seismic events on the public finances but they are likely to be well beyond one billion euro already in 2017. To mobilize resources to this effect a dedicated Fund will be established.

Thanks to a comprehensive reform effort, which is consistent with the country specific recommendations to Italy and was recently enhanced by the measures adopted under the 2017 budget law, the growth performance of the Italian economy is improving. The real GDP growth rate in 2016 probably exceeded the Government forecast of 0.8.

The Government remains fully committed to the implementation of ambitious structural reforms and to supporting growth, efficiency and equity, facilitating investment and strengthening the business environment. Reforms of the civil justice system are beginning to bear fruits. Additional measures are currently under consideration in Parliament as well as further improvements of the insolvency framework and a comprehensive law on competition. Secondary legislation to improve the efficiency and quality of services provided by Public Administration is under approval. The reform of the labour market, "Jobs Act", is being completed by a reorganization of employment services and active labour market policies. Further measures are included in the budget law supporting students, enforcing the right to education and further implementing the education system reform. The recently approved budget reform will be applied this year for the first time, making the spending review a fundamental feature of the budgetary process. The privatization program continues, further contributing to debt reduction: preparatory work undergone in 2016 will be finalized in 2017.

As highlighted in your letter, the resumption of the adjustment path towards the MTO in 2017 represents a further key relevant factor to be taken into account to assess compliance with the debt rule. Following a continuing path of multiannual reform effort, the government is planning to adopt the necessary measures as part of a more comprehensive strategy to be detailed within the forthcoming Economic and Financial Document (which includes both the Stability Programme and the National Reform Programme).

The overall amount of the structural effort to resume the path towards the MTO will be composed for approximately one fourth of expenditures cuts and for the rest of revenue increases. Expenditure savings will come roughly ninety per cent from intermediate consumption and the rest from tax benefits. Measures on the expenditure side follow the significant achievements in expenditure control of the recent years and will be further framed in a more comprehensive spending review strategy in the forthcoming budget cycle, thanks to the recently approved budgetary reform. On the revenue side, the adjustment effort will include measures such as indirect taxation, excise duties and further enhancements of the policies recently adopted, with satisfactory results, to improve revenues collection.

These measures are part of a more comprehensive multiannual strategy to be detailed in the 2017 Stability Program and will be taken within the timeframe of the Economic and Financial Document approval. The composition of the adjustment is growth friendly and takes into account distributional concerns. As mentioned above, this structural effort will come together with additional outlays to cope with the impact of the most recent earthquake.

I am confident that Your assessment will duly take into account all the above elements.

Yours sincerely

Pier Carlo Padoan

Attachment:

Note on relevant factors influencing recent debt developments in Italy.