Dear Vice President, dear Commissioner,

In response to your letter dated 29 May 2019, I enclose the Report on Debt Developments ex art. 126(3) TFEU written by our Treasury Department. I also take the opportunity to illustrate the position of the Italian government with respect to deficit and debt developments in 2018, our expectations for this year and our plans for the 2020-2022 Budget.

As a preliminary observation, I wish to recall the spirit of cooperation that allowed us to reach an agreement last December. I believe it is appropriate, today as it was back then, to assess comprehensively the budget plan for this year and the next three rather than solely focusing on the 2018 outturn. As for last year, while macroeconomic conditions did not allow Italy to fulfil the demanding requirements of the debt-reduction rule, I believe that the new government followed a responsible and prudent approach.

Indeed, since we took office there was no decision implying a relaxation of the fiscal stance for 2018. Even though economic growth surprised on the downside – due primarily to external factors – we closed the year with a significant decline in the general government deficit, to 2.1 percent of GDP from 2.4 percent in 2017. The primary balance improved to 1.6 percent of GDP, from 1.4 percent in the previous year; interest payments as a share of GDP declined by one tenth of a percentage point, to 3.7 percent.

According to the Commission’s estimates, Italy’s structural balance in 2018 worsened to -2.2 percent of GDP, from -2.1 percent in 2017. However, this assessment is based on the Commission’s estimate of potential growth. Despite minor changes to the country-specific methodology, the quantification of Italy’s output gap remains at odds with macroeconomic evidence (still high unemployment rate, a virtual absence of inflationary pressures and a large output loss compared to pre-crisis levels). With output gap levels that, though based on the commonly-agreed methodology are more consistent with Italy’s macroeconomic conditions, such as the ones we published in the latest Stability Program, the structural deficit in 2018 would have been smaller and would have not worsened.

Turning to the debt-to-GDP ratio, the rise recorded in 2018 was partly due to a year-end increase in treasury balances in anticipation of sizable bond redemptions in early 2019. Other
stock-flow adjustments also contributed to raising the debt ratio, notably the fact that we issued a higher share of government securities below par.

Away from these technical considerations, we recognise that in principle a higher primary surplus would be necessary in order to put the debt ratio on a clear downward path. The question, however, is the timing and extent of the adjustment. The drop in global trade and manufacturing activity in the second half of 2018 was abrupt and deeper than expected, raising the difficulty of promptly introducing offsetting measures. At any rate, given continuing high unemployment and near-deflationary conditions, the introduction of restrictive fiscal measures would have been counter-productive.

Turning to the outlook for this year, in the Spring Forecast the Commission projects a real GDP growth rate of only 0.1 percent and a budget deficit of 2.5 percent of GDP. These forecasts are only a touch more pessimistic than the ones featured in Italy’s Stability Program (0.2 and 2.4 percent, respectively). However, the Commission projects a worsening of 0.2 percentage points in the structural balance. In view of the 0.18 percentage points of flexibility that were granted for extraordinary expenditures due to unusually bad weather conditions, infrastructure repair and hydrogeological risk mitigation, and in view of the 0.6 pp correction recommended by the Council, strict compliance would require a 0.42 pp improvement in the structural balance. The Commission’s estimate would thus point to a risk of noncompliance.

However, the assessment presented in our Stability Program differs from the Commission’s. We estimate that the output gap in 2019 will be -1.6 percent and the growth rate of the economy will be below potential. The economy is thus in ‘bad times’ according to the grid of the preventive arm of the Stability and Growth Pact (SGP). Consequently, the required fiscal adjustment would be of 0.25 pp (and 0.07 pp net of the flexibility margin). Given that our official estimate indicates a worsening of the structural balance of only 0.1 pp, Italy would not be in a significant deviation.

In addition, I would strongly underline that the up-to-date information summarised in the attached Report on Debt Developments indicates that this year’s deficit will come in below the latest official forecast. The year-to-date performance of the economy and of tax revenues has so far exceeded the projections of the Stability Program. Furthermore, other recurrent revenues look set to outperform expectations and the take-up for the new welfare policies is so far lower than the estimates underlying the 2019 Budget. As a result, the deficit would be significantly lower than the Commission’s forecast and the change in the structural balance would be SGP-compliant also on the basis of the Commission’s output gap estimate.

As concerns the budgetary plan for the next three years outlined in the Stability Program, we intend to reduce gradually the nominal deficit to 1.5 percent of GDP by 2022, the final year of the program, with a cumulative improvement in the structural balance of close to 0.8 pp. The primary surplus would reach 3.1 percent on a structural basis in 2022.
For 2020, we aim to achieve an improvement of 0.2 pp in the structural budget balance. Given the latest official macroeconomic forecast, the headline deficit will decline to 2.1 percent of GDP.

The Italian parliament formally endorsed the budgetary projections of the Stability Program, and I wish to reiterate that the 2020 Budget will be SGP-compliant. Consistent with existing legislation, the Stability Program includes a hike in indirect taxes worth close to 1.3 percent of GDP, which would go into effect in January 2020.

Parliament has called on the government to reform the personal income tax without prejudice to the deficit-reduction targets for 2020-2022 presented in the Stability Program. In addition, Parliament urged the Government not to raise indirect taxes in 2020 and to identify offsetting fiscal measures in order to achieve the stated improvement in the structural balance.

Consequently, in preparation for the Draft Budgetary Plan 2020 and in light of updated macroeconomic projections, the Government is working on a comprehensive plan of spending review and revenue enhancement.

I trust these clarifications will be helpful to the Commission as it assesses Italy’s compliance with fiscal rules and finalises the new Country Specific Recommendations. My team at the Economy and Finance Ministry and I remain at your disposal should you wish to discuss further the content of this letter and the government’s budget plans.

Kind regards,

Giovanni Tria

------------------------------
Mr Valdis Dombrovskis
Vice-President
European Commission
Brussels

Mr Pierre Moscovici
Commissioner
European Commission
Brussels