Il Ministro
dell'Economia e delle Finanze
Prot. 851/RIS.

Rome, 30th May 2017

Dear Valdis, ~~Dear Pierre,~~ Dear Valdis

I welcome the thrust of the 2017 European Semester package issued on May 22nd, notably the key objectives to deliver more jobs and faster growth, while taking into account of social fairness consideration.

Furthermore, the Commission underlines the importance for the Eurozone to have a fiscal stance which strikes an appropriate balance between reinforcing the ongoing recovery and ensuring fiscal sustainability. I fully share this approach. As stated in Regulation 1466/97, the assessment of fiscal policy of each Member State should take into consideration cyclical conditions and, indeed, these are still peculiar. The prolonged phase of recession and low growth had an impact on potential output which is extremely difficult to gauge. Many economies have labour markets clearly out of their long-run equilibrium. For example, the Italian unemployment rate is still above eleven per cent, almost doubled of the pre-crisis level and, in spite of that, the Commission forecasts the output gap at zero in 2018. Investment, both public and private, has not recovered its pre-crisis level in several Member States. The structural position of public finances is, therefore, not easy to be assessed and current measures of potential output used for fiscal surveillance are uncertain and unreliable. Furthermore, low nominal growth in spite of extraordinary monetary policy suggests sustainable and self-sustained growth is not achieved yet.

I am fully convinced that, especially at the current juncture, the choice of the right policy mix of monetary and fiscal policy to be achieved at euro area level is crucial to deal with the legacy of the economic and financial crisis and to ensure to the Economic and Monetary Union a prosperous future.

As far as Italy is concerned, the package includes recommendations on structural policies which are by and large consistent with the agenda of the Government and it recognizes the action put in place to revert the dramatic decline of public investment during the crisis. I am also pleased that the Commission acknowledges the exceptional sequence of seismic events which hit Italy as well the exceptional effort to deal with migration inflows due to the specific geographic position of our country.

Mr Valdis DOMBROVSKIS
Vice-President
European Commission
Brussels

Mr Pierre MOSCOVICI
Commissioner
European Commission
Brussels

The implementation of the wide-ranging structural reform agenda while restoring the capacity of the public administration to deliver investment in an environment of sound public finances is of the essence to put the Italian economy on a sustainable path. Since February 2014, the Italian Government has been committed to the effort of keeping debt/GDP ratio under control. The ratio has indeed de facto stabilized thanks to a long-lasting fiscal effort which has virtually no comparison in the Eurozone since the outset of the financial and economic crisis especially with regard to the extent of the primary surplus achieved, (see the annex to this letter).

The Italian Government intends to continue along this path, i.e. striking the appropriate balance between reinforcing the ongoing recovery and fostering fiscal sustainability. It is a narrow path given the current macroeconomic conditions. A tighter fiscal consolidation would jeopardize the recovery and put at risk social cohesion. With this strategy in mind, let me inform you that the Government intends to adjust the structural balance by 0.3 of GDP in 2018. It is a substantial fiscal effort which will allow to further reduce the headline deficit and to ensure a decline in debt to GDP ratio. The ongoing recovery will benefit from such a balanced fiscal stance as well as from a structural strategy largely in line with the package the Commission released few days ago.

I am looking forward to discuss these issues with you in the coming months.

Yours sincerely

Pier Carlo Padoan

Fiscal consolidation while promoting growth

A comparison between Eurozone countries (2009-2016)

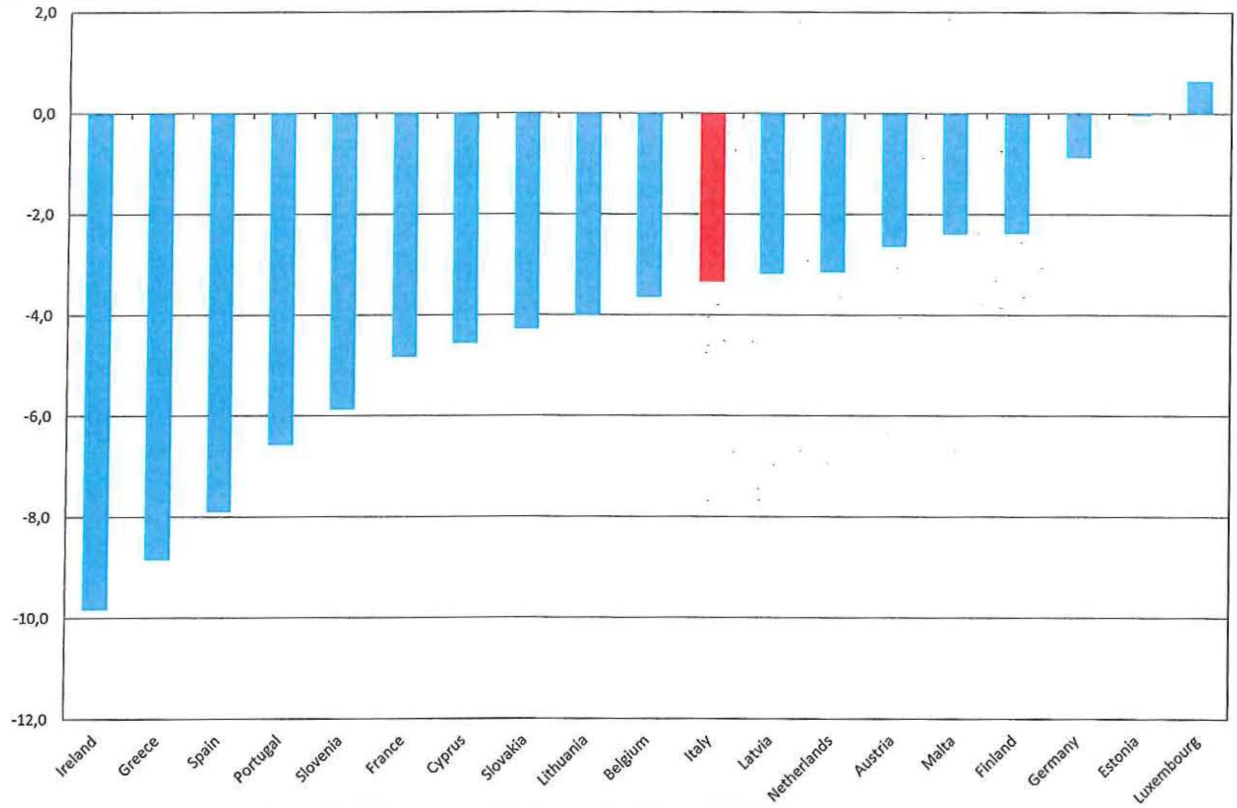
Some clarification is needed regarding certain analyses reported on the media concerning the size of fiscal adjustment measures implemented by Italy in recent years. This can be done by recreating what has actually been Italy's fiscal effort during the financial crisis. According to some observers, the consolidation of public finances undertaken by our country, over the past six years, could place us at the bottom of Euro area countries. Nothing could be more false.

Between 2009 – the first year to register a contraction in Euro area GDP – and 2016, Italy's average deficit was 3.3 percent (fig. 1); only six Eurozone countries' deficit was below the 3 percent threshold. If we match this result with the significant fall in GDP registered in the same time period, it is clear the extraordinary degree of fiscal effort put in place in Italy.

Fig. 1

NET LENDING AS A PERCENTAGE OF GDP

(2009-16 AVERAGE; PERCENT)



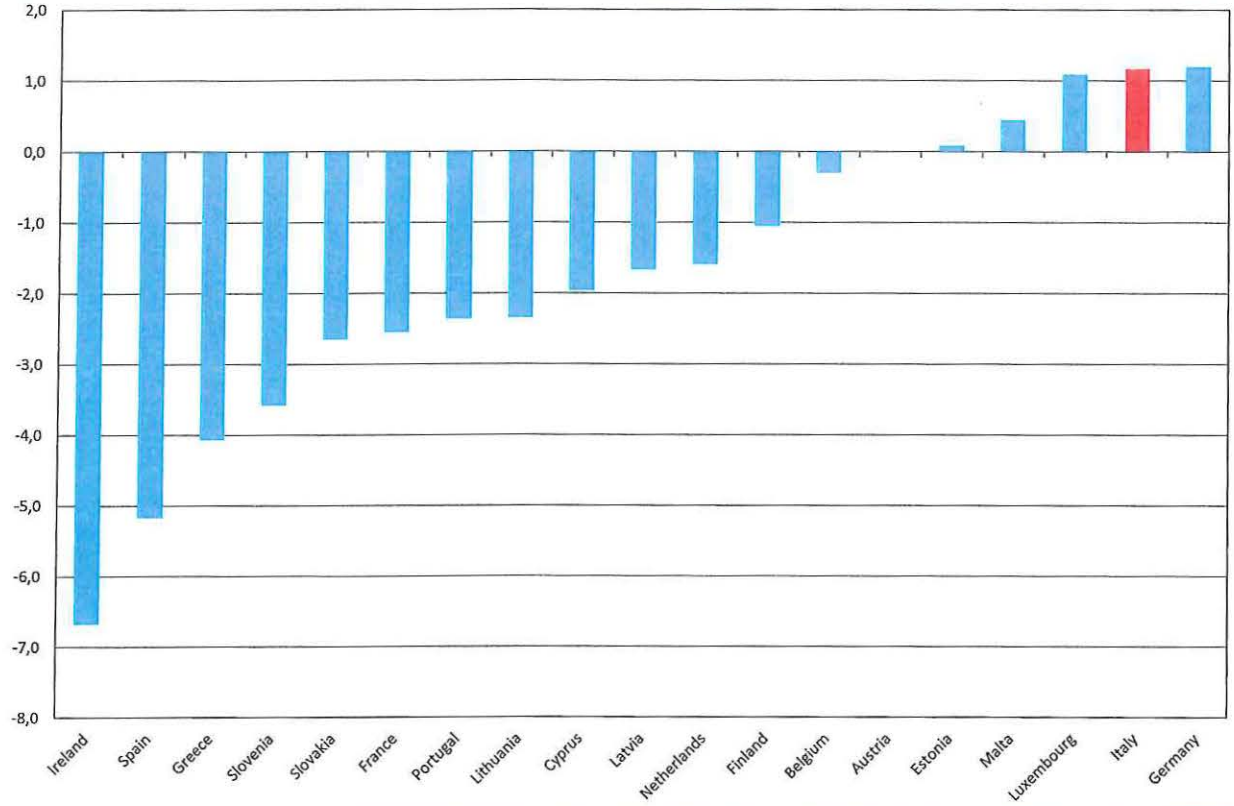
Source: *Annual macro-economic database*.

To fully appreciate the effort made in Italy one needs to look at the primary balance, excluding the public debt burden: Italy turns out to be the country that, together with Germany, maintained the highest primary surplus on average (1.2 percent; fig. 2) over the 2009-16 period. It also ranks among the few to register a positive balance, as most Eurozone member states saw their positions deteriorating during the same time period. For example, in this same period, Spain had an average primary deficit of 5.2 percent of GDP while France had 2.6 percent.

Fig. 2

NET LENDING EXCLUDING INTEREST AS A PERCENTAGE OF GDP

(2009-16 AVERAGE; PERCENT)



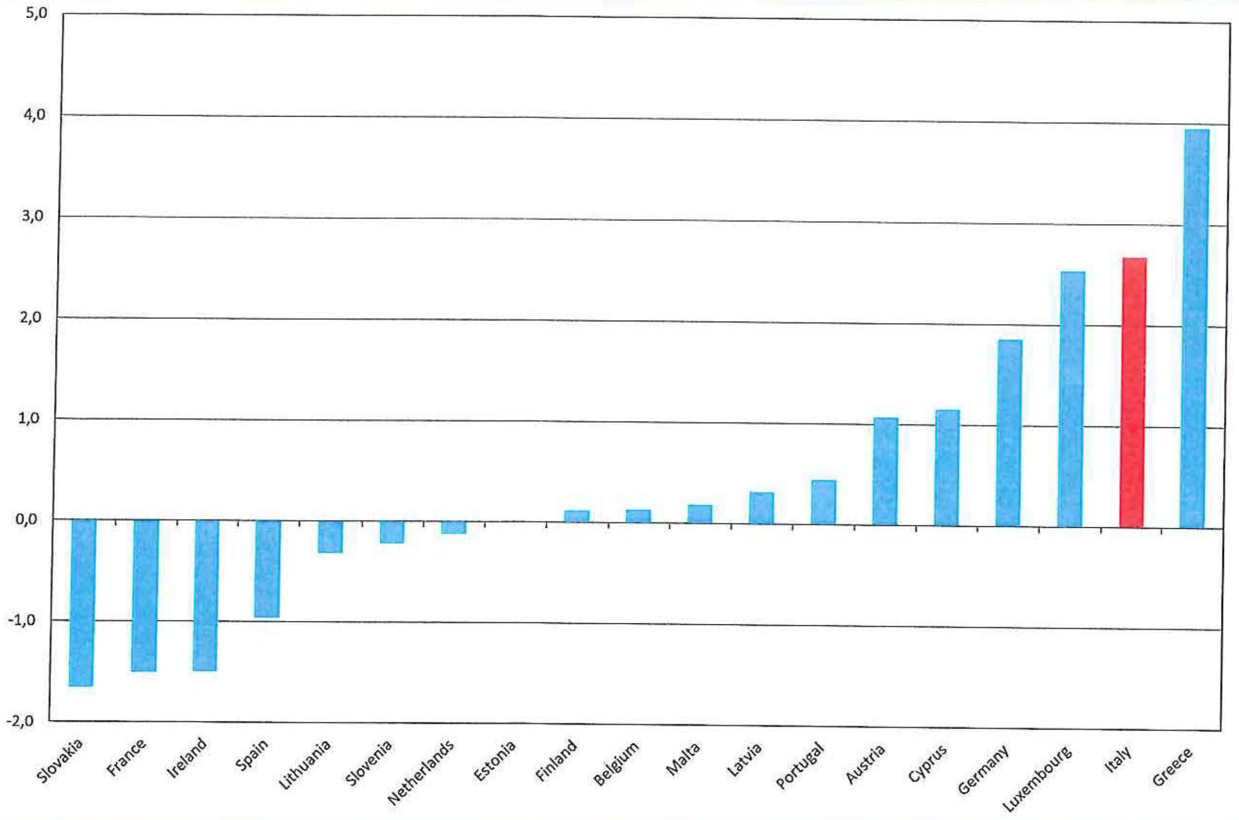
Source: *Annual macro-economic database*.

Aside from the debt burden, the current balance should be adjusted for the effects of the economic cycle. If we correct the primary balance series for the cycle, Italy's consolidation effort comes out as even stronger; exception made for Greece – that with the aim of receiving financial assistance implemented a long set of significant adjustments – Italy clearly emerges as the country that put in place the most significant consolidation of public finances within the area (fig. 3).

Fig. 3

STRUCTURAL BALANCE EXCLUDING INTEREST AS A PERCENTAGE OF POTENTIAL GDP

(2009-16 AVERAGE; PERCENT)



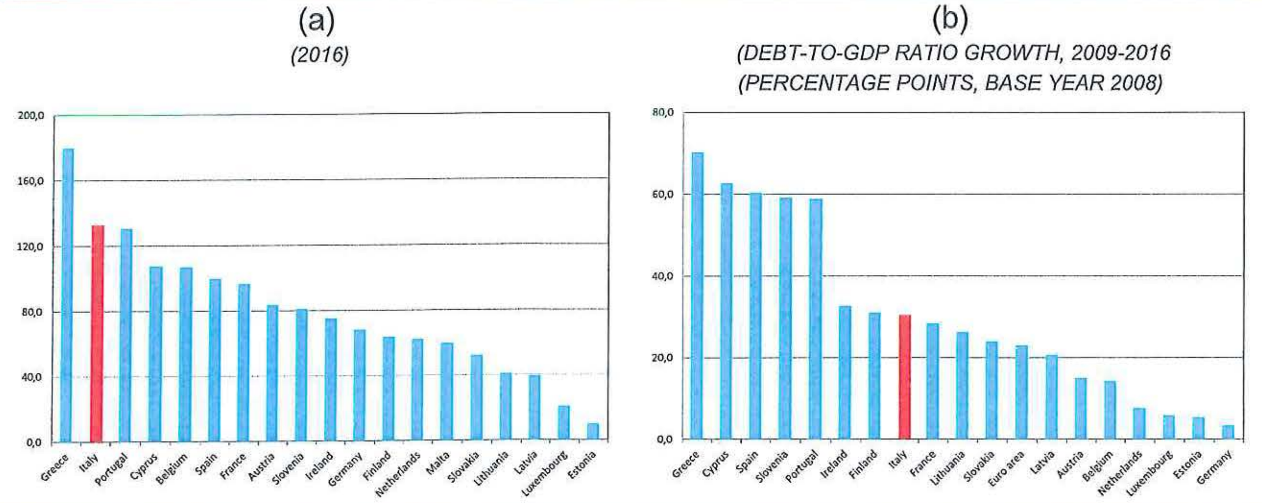
Source: Annual macro-economic database.

There is obviously a good reason behind the choice of a prudent fiscal policy: our high public debt country profile (fig. 4a). Nevertheless, it is precisely thanks to this prudent budgetary policy that the Italian debt has increased during this period at a considerably lower rate than that of other EMU countries (fig. 4b). Furthermore, even if so far the debt-to-GDP ratio substantially stabilised, it is due to decline as of 2017.

Fig. 4

DEBT TO GDP RATIO

(%GDP)

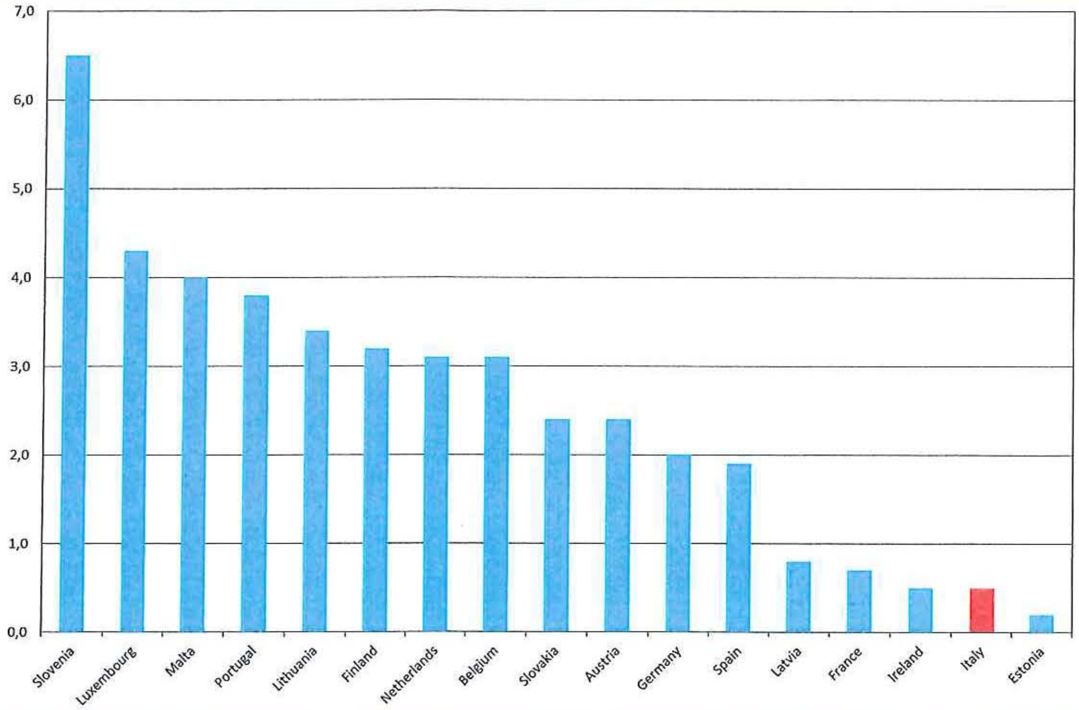


Source: *Annual macro-economic database*.

These results correspond to European Commission's computations according to which Italy ranks among low risk countries with regard to long-term public finance sustainability (fig. 5).

Fig. 5

S2 INDICATOR (1)
(BASELINE SCENARIO; PERCENT)



(1) The S2 indicator shows the long-term public finance sustainability of countries that are not covered by macroeconomic adjustment programmes based on a methodology agreed at European level, over the infinite horizon and on the basis of the government's inter-temporal budget constraint and projected macroeconomic variables under the assumption of a fiscal policy that remains unchanged with respect to the latest projection issued by the Commission. Greater (positive) S2 indicator rates are associated with greater fiscal adjustments needed to ensure public fiscal sustainability.

Source: *Debt Sustainability Monitor 2016*, European Commission.

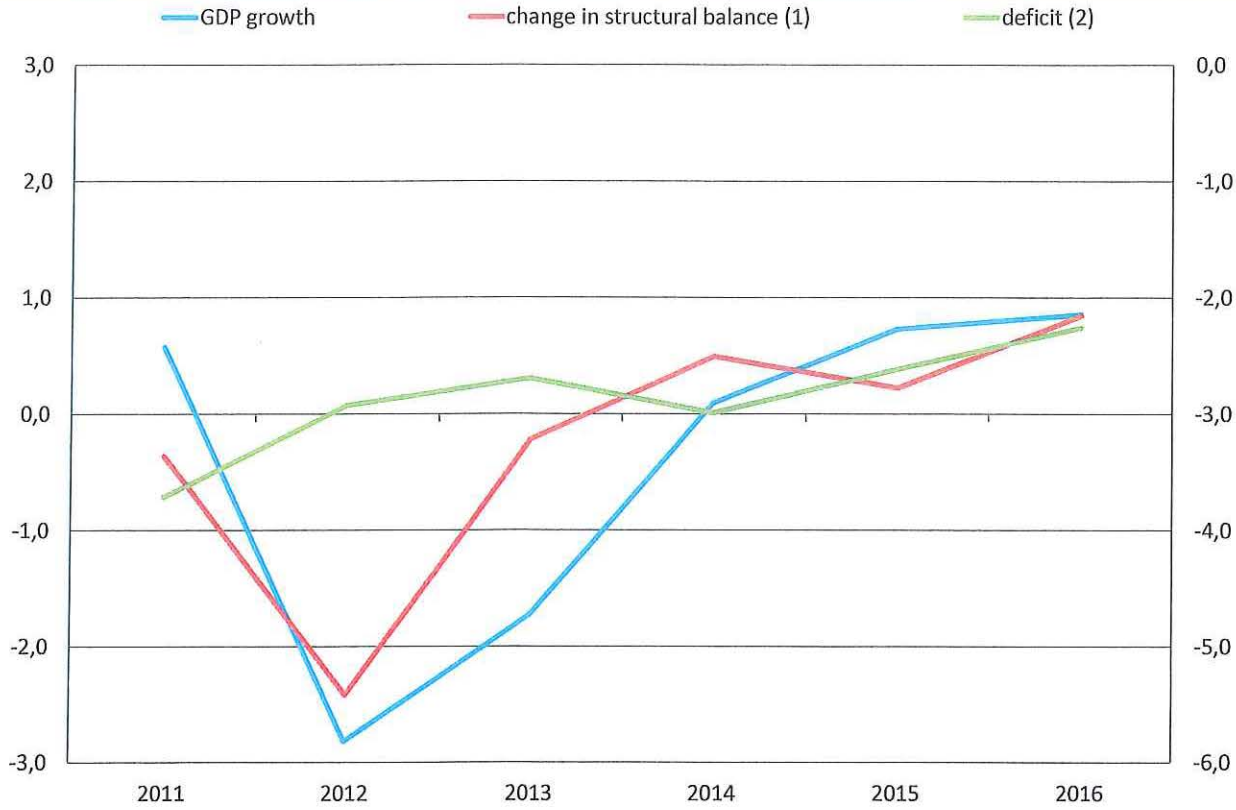
Italy's fiscal consolidation effort preserved the independence of its fiscal authority that allowed the Government to adopt a series of growth-enhancing measures which, in turn, proved effective in achieving fiscal stability. In other words, Italy's fiscal consolidation takes growth completely into account. As a result of this strategy, Italy emerged from recession, and during the past three years its deficit-to-GDP ratio fell below 3% (from 3.0 per cent in 2014 to 2.6 e 2.3 per cent in 2015 e 2016, respectively; fig. 6).

The Government intends to continue alongside this path of fiscal consolidation, ensuring control of its public accounts and scrutinising decisions about revenues and expenditures to favour economic growth. These measures are part of a political and economic strategy that prioritises fiscal stability while providing support for growth and ultimately job creation by also re-launching public and private investment.

Fig. 6

GDP growth and fiscal policy

(year on year change; %GDP)



Source: *Annual macro-economic database*.

(1) The change in the structural balance (potential GDP ratio) is in absolute value; positive (negative) values of the indicator are associated with expansionary (restrictive) fiscal policies.

(2) GDP ratio, right scale axis.