VALDIS DOMBROVSKIS
Vice-President of the European Commission

PIERRE MOSCOVICI
Member of the European Commission

Brussels, 22 November 2017

Dear Minister,

The Commission today adopted its Opinion on Italy's 2018 Draft Budgetary Plan, concluding that the Plan is at risk of non-compliance with the provisions of the Stability and Growth Pact. We are writing to underline the broader context in which this year's Opinion is adopted and to recall the next steps in the Commission's ongoing evaluation of Italy's fiscal situation.

First of all, we acknowledge the efforts Italy has made in recent years both to enhance its competitiveness and growth potential and to strengthen its public finances. Important reforms have been enacted to improve the functioning of the labour market, the justice system, the public administration and the fight against corruption, to strengthen competition and anti-poverty measures, as well as to address vulnerabilities in the banking sector. These and other reforms are beginning to have a positive impact, supporting the recovery in growth and employment that Italy is now enjoying.

Similarly, Italy has made progress in stabilising its public finances. Following the major consolidation that took place at the height of the sovereign debt crisis in 2012, the headline deficit fell from a peak of 5.3% of GDP in 2009 to 2.5% in 2016 and is projected to reach 1.8% in 2018 according to the Commission 2017 Autumn Forecast. This has been achieved also thanks to Italy maintaining some of the highest primary surpluses in the euro area.

Italy was one of the first countries to exit the Excessive Deficit Procedures opened after the outbreak of the crisis and has been in the preventive arm of the Pact since 2013. Since 2015, the Commission has accommodated, within the framework of the Stability and Growth Pact, several requests from Italy for flexibility in order to support investment and structural reforms, as well as for unusual events related to the refugee crisis, security issues and natural disasters. We have also recognised the need to ensure that the pace of consolidation strikes the appropriate balance between supporting growth and ensuring fiscal sustainability. All in all, this has supported the recovery process.

Nonetheless, Italy's public debt remains a key vulnerability. In 2016, it was notified at 132.0% of GDP, thereby confirming insufficient progress towards compliance with the debt criterion in that year. Looking ahead, we forecast that Italy's debt-to-GDP ratio will broadly stabilise in 2017 and only slightly decrease to 130.8% in 2018. There are risks to these projections for 2018, related to a worse-than-anticipated nominal growth outlook, lower privatisation proceeds, and the expected statistical recording of the banking sector support operations, as well as a large existing stock of trade debt arrears of the public administration. Overall, Italy's sustainability challenges remain high in the medium term.

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Such high public debt constrains the government's room of manoeuvre for more productive investment for the benefit of its citizens. Given the size of the Italian economy, it is a source of common concern for the euro area as a whole.

In spite of the fact that Italy did not respect the debt criterion in 2015, the Commission concluded, after assessing all relevant factors, that a debt-based Excessive Deficit Procedure should not be opened – provided that Italy ensured broad compliance with the requirements of the preventive arm in 2016. However, outturn data for 2016 shows that this broad compliance was only achieved thanks to the flexibility that Italy was provisionally granted in that year for structural reforms and investment. Part of this flexibility was made conditional on Italy being broadly compliant with the requirements of the preventive arm in 2017.

This now appears at risk. The Commission spring forecast had projected a structural deterioration of the general government budget deficit in the magnitude of 0.2% of GDP in 2017, after taking into consideration the 0.2% of GDP of additional measures implemented in spring. This indicated broad compliance with the preventive arm, after discounting the allowance for the unusual events of the refugee crisis and seismic activity. However, under our autumn forecast the deterioration is projected to be 0.4% of GDP, implying a risk of significant deviation from the requirements even after accounting for these unusual events. As this is also the case according to the government's own plans, we would welcome clarifications on the reasons for this higher deterioration in the structural balance in 2017.

We acknowledge that uncertainty continues to surround the fiscal outlook in 2017. In particular, important revenues from the fight against tax evasion through the so-called *split payment* are projected in the last months of the year and the amount of the allowance for unusual events will have to be reassessed based on outturn data next spring. The Commission therefore intends to reassess Italy's compliance with the debt criterion in spring 2018, based on outturn data for 2017 and the final 2018 budget to be adopted by the Italian Parliament in December.

Looking ahead, the decline in the debt-to-GDP ratio in 2018 and beyond projected in the 2018 Draft Budgetary Plan crucially hinges on a sustained level of nominal growth, large privatisation proceeds and still enacted safeguard clauses for 2019-2020. The adoption of the 2018 budget with no watering down of its key provisions will be crucial, as will its subsequent strict implementation to deliver a structural effort of at least 0.3% of GDP. We would also like to underline the importance of avoiding backtracking on the important fiscal structural reforms, notably as regards pensions, which underpin the long-term sustainability of Italy's debt.

Lastly, we would welcome further information on Italy's overall strategy to reduce the stock of debt, as well as any details on the concrete steps that are planned to decisively put Italy's debt-to-GDP ratio on a downward path and ensure compliance with the debt criterion.

Yours sincerely,

V. D — Pierre Moscovici

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