



*Al Ministro
dell'Economia e delle Finanze
Prot. 41081R*

Rome, 30 October 2017

Dear Valdis, dear Pierre

thank you for your letter dated 27 October 2017, in which you seek clarifications concerning Italy's 2018 Draft Budgetary Plan.

Your letter refers to Italy's budgetary targets and compliance with the requirements of the Stability and Growth Pact (SGP). Let me state at the outset that the Italian Government remains of the view that fiscal consolidation should strike a balance between improving debt sustainability and supporting the ongoing economic recovery.

The latest economic data and survey evidence suggest that real GDP growth is accelerating and the negative growth differential vis-à-vis the euro-area average is diminishing. The government recently revised up the official real GDP growth forecast for 2017 from 1.1 to 1.5 percent and the one for 2018 from 1.0 to 1.5 percent. Employment has continued to grow this year, both in terms of persons and of hours worked. The recovery surely benefited from a favorable European context, but it is also a result of the gradual deficit-reduction approach we have followed since the sharp fiscal policy tightening of 2011-2012.

However, as we have argued in the past, a country characterized by a high degree of slack in economic resources is bound to experience ultra-low inflation, if not outright deflation. According to our statistical office, the deflator of GDP was essentially flat in the first half of this year, which led us to revise down the nominal GDP forecast for 2017 from 2.3 to 2.1 percent even as we raised the real growth estimate. Although the official forecast looks for a moderate rise in wage inflation in the next three years, the unemployment rate, at 11.2 percent in August, is still quite high. A low degree of utilization of productive resources is likely to hinder a return to high rates of nominal GDP growth for some time to come, which will complicate our effort to reduce the public debt-to-GDP ratio and to fulfill the debt rule on a forward-looking basis.

Mr. Valdis Dombrovskis
Vice President

Mr. Pierre Moscovici
Commissioner, Economic and Financial Affairs

European Commission
Brussels

In addition, the assessment of compliance with the fiscal rules hinges critically on the quantification of the output gap. In this regard, it is worth noting that the recalculation of Italy's output gap estimates carried out by the Commission is based on a simplified version of the commonly agreed methodology that by construction, may produce different results.

The government's judgement is that Italy is still experiencing difficult, though improving, cyclical conditions. The output gap is estimated at -2.1 percent of potential GDP in 2017 and -1.2 in 2018. The Commission's estimates in the Spring Forecast were -0.8 percent for 2017 and 0.0 for 2018. In view of a likely revision of the real GDP growth projections in the upcoming Autumn forecast, these figures are likely to be revised up, pointing to a positive output gap in 2018 – a result that we feel is at odds with all the available macroeconomic evidence, from wage and consumer price inflation, to unemployment and capacity utilization figures.

The Commission has recognized that the commonly-agreed methodology may lead to implausible output gap estimates for Italy. In fact, based on a request by the Ecofin Council, the Economic Policy Committee has mandated the Output Gap Working Group to review certain technical aspects of the methodology, both horizontally and with respect to specific countries, including Italy. The risk that Italy's negative output gap could be underestimated was also flagged by the so-called plausibility tool.

Consistent with this ongoing review, the Commission has announced its intention to carry out an overall assessment of compliance to take into account, among other issues, the fact that current measures of the output gap do not adequately describe the slack of the economy of certain countries and therefore need to be flanked by other indicators and considerations.

In 2018 Italy's headline deficit will be reduced to 1.6 percent of GDP, from 2.1 percent in 2017. This implies a fiscal effort of 0.3 percent of GDP, as anticipated in the letter I sent you on 30 May 2017 and then formally announced in the Update of the Stability Program on 23 September 2017. The structural budget balance will then improve more markedly in the two following years, broadly achieving the MTO in 2020. This will engender a decline in the debt-to-GDP ratio from 132.0 percent in 2016 to 123.9 percent in 2020.

The difference of 0.1 percentage point in the estimated fiscal effort for 2018 according to the Commission's estimates is due to a different assessment of the cyclical conditions of Italy, that is, to the above-mentioned output gap estimate.

Concerning the risk of deviation in 2017 and in 2017-2018 combined, the Government has acted fully in line with the Commission's recommendation by adopting additional structural measures worth 0.2 percent of GDP. The current adjustment path is consistent with the Country Specific Recommendation to "take into account the need to strengthen the ongoing recovery".

In addition, with respect to the expenditure benchmark, Italy is facing extraordinary expenses related to exceptional immigration flows. The number of migrants in reception facilities has risen from 176,000 at the end of 2016 to more than 193,000 at the end of September 2017, despite a reduced pace of new arrivals experienced since July thanks to a renewed strategy Italy has taken in Libya. Chances of keeping the inflows low are uncertain while the reception needs will continue to be persistent, mainly because of the very low outflow levels due to the limited cooperation of other Member States. Most refugees are hosted in provisional structures, since conventional services at central and local levels have limited capacity.

This also suggests that in the absence of a EU financial contribution for dealing with the frontier related expenditures, Italy will continue to bear a significant burden over time of at least 0.25 per cent of GDP.

Finally, let me reiterate the Government continued commitment to structural reforms. Several measures announced in April's National Reform Program have already been implemented, including: the approval of the first annual law for the market and competition; the introduction of "inclusion income"; enabling legislation for the reform of the criminal justice system and the statute of limitation; enabling law concerning corporate crises and insolvency; adoption of various legislative decrees to implement the reform of the public administration and the education system. The cumulative effect of structural reforms on the economic growth will be positive, as quantitative estimates of the effects of already enacted reforms suggest that, once fully implemented, they could increase real GDP by 3 percentage points cumulatively over a five-year period. A further boost to the economy will come from public investment that, based on existing legislation, is projected to grow by 5.1 percent in 2018, in nominal terms.

Considering the elements described above, in our view the fiscal targets planned in the DBP are in line with the SGP requirements and reflect the Government's strategy of deficit and debt reduction while supporting the ongoing recovery. We trust that the Commission will take them into account in its overall assessment.

As always, we remain at the disposal of the Commission services should they need additional information on the measures contained in the 2018 Budget. A detailed technical report on each article of the Budget Law was released this past weekend and will surely facilitate an in-depth analysis of the fiscal measures adopted by the government.

Your Sincerely,

Pier Carlo Padoan

