Il Ministro dell'Economia e delle Finanze

Rome, 21st November 2014

Dear Valdis, Dear Pierre

in view of the forthcoming discussion of euro area Member States Draft Budgetary Plans, let me provide you with further details on the comprehensive and forward-looking Italian policy agenda complementing and reinforcing the measures described in the DBP.

In 2014, the Italian economy will post a negative rate of GDP growth for the third year in a row. Prospects for 2015 suggest a very timid and fragile recovery. As you well know, Italy has lost nearly one tenth of its GDP since the onset of the crisis. The Italian Government is firmly committed to address the deeply rooted structural weaknesses of the economy and is currently engaged in the implementation of an ambitious and wide-ranging reform agenda aimed at providing the country with the institutional set-up, the rules and the incentives most appropriate to boost growth, competitiveness and employment.

Over recent months, the Government has introduced interrelated packages of structural reforms. More reforms are under way. They focus on job creation, improving competitiveness, strengthening growth and, therefore, fostering debt sustainability. Policy action includes:

1) reform of the labour market – Jobs act;

2) measures to improve the efficiency of the public administration;

3) reform of the civil justice system, as well as the reinforcement of the anti-corruption authority;

4) deregulation of credit and improved access to capital markets that will increase financing alternatives for businesses, especially small- and medium-size firms;

5) simplification of the tax system; shifting the tax burden from productive factors; and strengthening the fight against tax evasion;

6) reform of the educational system to ultimately improve the quality of human capital.

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In particular, the Jobs Act will allow for a more rapid response in adjusting production to cyclical and structural changes, with beneficial effects on investment and participation in the labour market, and a related reduction in the segmentation of the work force. By increasing employment, it will also foster the long term sustainability of the pension system, which is already one of the most solid thanks to past reforms. The Jobs Act is recognized by international organizations as a welcome step to put Italy on a more dynamic growth path. According to the OECD Economic Outlook projections, released at the beginning of November, in 2016 Italy's GDP growth is expected to achieve 1.0 per cent, confirming the policy scenario of the DBP.

Attached to this letter you will find a timeline which details the various steps for approving and implementing wide-ranging structural measures over the next few months as well a synthetic description organized on the basis of country specific recommendations. Let me underline that on top of the measures aimed at reforming the economy, the Government has put a considerable amount of political capital into an overhaul of the institutional system, i.e. the electoral law, the reform of the Senate and a review of federalism. These are crucial and long due innovations which, in the end, will significantly improve the design of economic reforms, e.g. they will facilitate and speed up the law-making process and enhance the effectiveness of government action.

Fiscal sustainability remains a key pillar of the reform agenda. Reducing the burden of public debt and freeing up resources for more productive uses is indeed essential for a balanced and equitable growth pattern.

The fiscal consolidation process has already delivered impressive results. Over the 2012-14 period, despite negative GDP growth rates, the structural deficit has been reduced by a cumulative 3 percentage points. The primary surplus hovers around 2 per cent of GDP, one of the highest values in the Eurozone and the whole European Union. This comes after twenty years of primary surpluses – with 2009 as the only exception – which testifies the effort made by Italy since the outset of monetary union.

Despite these remarkable results, public debt dynamics remains negatively affected by very weak nominal growth and other relevant factors which are independent of national fiscal policy orientation. As it emerges from the information provided in the DBP and in the analyses from the Commission, the increase in the public debt-to-GDP ratio in Italy in the recent past is not due to a loose fiscal policy. Instead, it reflects the contributions to the Euro area financial stability programmes, the settlement of commercial debt arrears and negative nominal GDP growth.

Given exceptionally low price dynamics also for 2015, restoring nominal GDP growth is crucial especially because the very low inflation undermines the positive impact of any fiscal effort on the public debt dynamics. Should inflation have performed in line with ECB targets, debt dynamics would have been already on a downward path.

Within this context, the Government has designed a fiscal strategy aimed at implementing a growth-friendly adjustment that tries to minimize the risk of a self-defeating fiscal consolidation: in weak economic conditions, fiscal consolidation may very likely produce an adverse outcome in terms of economic activity thus off-setting any fiscal improvement and consequently worsen public debt dynamics. This risk is to be avoided by all means especially after the additional effort to increase the budget correction for 2015 upon the request of the EU Commission. In spite of weak recovery prospects, the Government agreed to lower the deficit to 2.6 per cent and to increase the structural adjustment to 0.3 per cent of GDP. This envisaged correction is consistent with the rules of the Stability and Growth Pact, which make explicit reference to supporting structural reforms enhancing sustainability and considering adverse economic circumstances. Any additional correction would further clip the wing of a fragile recovery deteriorating rather than improving, debt dynamics. In passing, it may worth recalling that an updated and more accurate methodology is needed to evaluate the severity of the macroeconomic circumstances and to assess the fiscal stance.

The ongoing structural reform process and the composition of the fiscal manoeuvre fall, as documented in the attached Annex 2, perfectly in line with the country-specific recommendations and aim to increase the growth potential of the economy and debt sustainability in the long run. Full implementation of the reform agenda will develop along a specified timeline and benefits for economic activity will materialize over a multiannual horizon.

Italy's fiscal policy for 2015 is based on a very significant reduction of the tax wedge, as well as on a durable improvement in the efficiency and quality of public expenditure at all levels of government. Growth enhancing spending such as R&D, innovation, education and essential infrastructure projects is increased. The budget composition – while directly supporting demand - will also complement the structural reform described above, as well as making further progress in budget consolidation.

It is worth reminding that all key indicators of long term sustainability show that Italy's debt is more sustainable than that of most EU countries as liabilities emerging from the ageing of population have been offset by far-reaching pension reforms introduced over past years and the tight control on health and long-term care expenditures. The sustainability indicators produced by the Commission show a good performance also in the short and medium term. Moreover, the maturity structure and the currency denomination of public debt compare very favorably at international level. This also applies to the level of private debt.

In addition, I would like to restate the commitment of the Italian government to its ambitious plan of privatisation of state owned companies and assets. In 2014, a number of assets, including stakes in Fincantieri and Rai Way through IPOs and in CDP through trade sale, have been put on the market. Over the period 2015-2017, privatisation proceeds are expected to amount to 0.7 per cent of GDP on average and to be fully allocated to debt reduction.

I am confident that the unprecedented reform effort currently undertaken by Italy will be clearly supported by the EU institutions. The best strategy in the current juncture is to implement the Government plan which is consistent with the recommendations aimed to increase the competitiveness of the country and to build the conditions for future growth. As you can see from the information provided in the annexes, the coming months will be crucial in this respect. The Government is determined to advance the whole agenda. I am convinced that a successful implementation of the strategy would be beneficial for Italy and the European economy as a whole.

Yours

(Pier Carlo Padoan)