COMMISSION OF THE EUROPEAN COMMUNITIES

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# REPORT FROM THE COMMISSION

## Italy

## Report prepared in accordance with Article 104(3) of the Treaty

## 1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate attention needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

## 2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Italy and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 104(3) of the Treaty.

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a

[1] OJ L 209, 2.8.1997, p.6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

Since the start of stage III of economic and monetary union, an EDP for Italy was initiated in June 2005 by the Commission with the adoption of a report under Article 104(3), based on a general government deficit of 3.1% of GDP in both 2003 and 2004 and government debt at around 106-107% of GDP, both above the respective reference values of 3% and 60% of GDP[2]. On 28 July 2005, the Council decided, on a recommendation from the Commission, that Italy was in excessive deficit according to Article 104(6). At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to Italy with a view to bringing the situation of an excessive government deficit to an end, by 2007 at the latest. In June 2008, following an overall assessment which showed that the correction of the excessive deficit was completed in 2007, the Council decided, again on a recommendation from the Commission, to abrogate its earlier decision on the existence of an excessive deficit according to Article 104(12).

**Table 1: General government deficit and debt** [a]

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | | 2010 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | COM | IT | COM |
| General government balance | -3.5 | -3.5 | -4.3 | -3.3 | -1.5 | -2.7 | -4.5 | -3.7 | -4.8 |
| General government gross debt | 104.4 | 103.8 | 105.8 | 106.5 | 103.5 | 105.7 | 113.0 | 110.5 | 116.1 |

Note:
[a] In percent of GDP.
*Source: Eurostat, Commission services' spring 2009 forecasts (COM) and spring 2009 EDP notification (MS).*

In April 2009, the Italian authorities notified[3] a planned general government deficit at 3.7% of GDP in 2009, thus exceeding the 3% of GDP reference value, and a general government gross debt at 110.5% of GDP, well above the 60% of GDP reference value and on a rising trend. Since then, the authorities have revised upwards the above figures. According to the update of the Economic and Financial Planning Document (DPEF)[4] adopted by the government on 22

2 After successive revisions, the general government deficit is currently reported at 3.5% of GDP in both 2003 and 2004. For the same years, the debt ratio has been revised downwards to around 104% of GDP, essentially due to the revision of nominal GDP levels. All EDP-related documents for Italy can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2

3 According to Council Regulation (EC) No 479/2009 (previously Council Regulation (EC) No 3605/93), Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Italy can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables

4 The document is available at: http://www.tesoro.it/documenti/open.asp?idd=22421. The macroeconomic scenario underlying its budgetary projections is laid out in the forecast/programmatic report (RPP) adopted by the government on the same day (http://www.tesoro.it/documenti/open.asp?idd=22423).

September 2009, the general government deficit is planned to reach 5.3% of GDP in 2009, and general government gross debt would be 115.1% of GDP.

The planned figures for the deficit and debt in 2009 provide prima facie evidence on the existence of an excessive deficit in Italy in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Italy with the adoption of this report. Section 2 of the report examines the deficit criterion and Section 3 the debt criterion. Section 4 deals with public investment and other relevant factors. The report takes into account the Commission services' spring 2009 forecast, released on 4 May, and their evaluation of subsequent developments, in particular the Commission services' September 2009 interim forecast, released on 14 September.

## 3. DEFICIT CRITERION

The planned 2009 general government deficit in the April 2009 EDP notification is 3.7% of GDP. In the meantime, it has been revised upwards to 5.3% of GDP.

Well in excess of 3% of GDP, the planned deficit is <u>not close</u> to the Treaty reference value.

The planned excess over the 3% of GDP reference value is <u>exceptional</u>. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' spring 2009 forecast projects real GDP in Italy to contract by 4.4% in 2009, after decreasing by 1% in 2008. A very moderate recovery is anticipated for 2010. Based on these projections, the output gap is estimated to turn sharply negative in 2009 and to widen further in 2010. Based on more recent information, the Italian authorities presented an even less favourable macroeconomic outlook for 2009 in the update of the DPEF, with real GDP growth estimated at -4.8%.

The planned excess over the 3% of GDP reference value is <u>not temporary</u> in the sense of the Treaty and the Stability and Growth Pact. The Commission services' spring 2009 forecast, based on the usual no-policy change scenario, projects the deficit to increase further in 2010, while real GDP growth is forecast to recover to mildly positive growth. According to the update of the DPEF, the deficit is planned to remain above the reference value until 2011 and to go down to 2.7% of GDP in 2012, also on the back of positive real GDP growth estimated at 2% in each of the last two years.

In sum, the planned deficit is not close to the 3% of GDP reference value and, while the excess over the reference value can be regarded as exceptional, it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

**<u>Table 2</u>: Macroeconomic and budgetary developments** [a]

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | | 2010 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | COM | IT [b] | COM | IT [b] |
| Real GDP (% change) | 0.0 | 1.5 | 0.7 | 2.0 | 1.6 | -1.0 | -4.4 | -4.8 | 0.1 | 0.5 |
| Potential GDP (% change) | 0.9 | 0.8 | 0.6 | 0.7 | 0.9 | 0.6 | 0.1 | 0.5 | 0.5 | 0.6 |
| Output gap (% of potential GDP) | -0.2 | 0.5 | 0.6 | 1.9 | 2.6 | 0.9 | -3.7 | -4.5 | -4.0 | -4.3 |
| General government balance | -3.5 | -3.5 | -4.3 | -3.3 | -1.5 | -2.7 | -4.5 | -5.3 | -4.8 | -5.0 |
| Primary balance | 1.6 | 1.2 | 0.3 | 1.3 | 3.5 | 2.4 | 0.2 | -0.5 | 0.1 | 0.0 |
| One-off and other temporary measures | 1.7 | 1.3 | 0.6 | -0.4 | 0.1 | 0.2 | 0.0 | 0.0 | 0.1 | 0.1 |
| Gov't gross fixed capital formation | 2.5 | 2.4 | 2.5 | 2.3 | 2.3 | 2.2 | 2.5 | 2.7 | 2.4 | 2.3 |
| Cyclically-adjusted balance | -3.5 | -3.8 | -4.6 | -4.3 | -2.8 | -3.2 | -2.6 | -3.0 | -2.7 | -2.8 |
| Cyclically-adjusted primary balance | 1.6 | 1 | 0 | 0.3 | 2.2 | 1.9 | 2.0 | 1.8 | 2.1 | 2.1 |
| Structural balance [c] | -5.2 | -5.1 | -5.2 | -3.9 | -2.9 | -3.4 | -2.6 | -3.3 | -2.8 | -2.8 |
| Structural primary balance | -0.1 | -0.3 | -0.6 | 0.7 | 2.1 | 1.7 | 2.0 | 1.6 | 2.0 | 2.1 |

<u>Notes</u>:
[a] In percent of GDP unless specified otherwise.
[b] DPEF update and RPP.
[c] Cyclically-adjusted balance excluding one-off and other temporary measures. The planned figures for 2009-10 (IT) are estimated by the Italian authorities according to the commonly agreed methodology.
*<u>Source</u>: Eurostat, Commission services' spring 2009 forecasts; Italian government's September 2009 update of the Economic and Financial Planning Document (DPEF) and forecast/programming document (RPP) for 2010.*

## 4. DEBT CRITERION

According to the latest information provided by the Italian authorities, the general government gross debt is planned to be 115.3% of GDP in 2009, well above the 60% of GDP Treaty reference value.

From a peak of more than 120% of GDP in 1993, the debt ratio fell gradually to around 104% of GDP in 2004, also thanks to sizeable privatisation proceeds and other extraordinary operations. It increased in 2005 and 2006 but was brought back to 103.5% of GDP in 2007. In 2008 the debt ratio rose to 105.7% of GDP, driven by a rising interest rate burden and declining real GDP, as well as the government's decision to increase its liquidity held with the Bank of Italy.

The Commission services' spring 2009 forecast projects the debt ratio to rise to 113% in the current year and 116.1% in the next. Overall, the increase of the debt ratio in 2009 stems from the reduction in the primary balance and the GDP contraction, while the impact of the stock-flow adjustment remains negligible. The larger expansion of the debt ratio assumed in the update of the DPEF for 2009 and 2010 (115.1% and 117.3%, respectively) is due to higher contributions from these factors. Concerning the stock-flow adjustment in 2009, this primarily reflects the fact that the government set aside around 0.7% of GDP for capital injections in the banking sector (not included in the spring forecast).

The planned deficit levels and growth projections for 2009-2010 imply that the government debt ratio will move further away from the 60% of GDP reference value. Therefore, the debt ratio can<u>not</u> be considered as <u>"sufficiently diminishing and approaching the reference value at a satisfactory pace"</u> in the sense of the Treaty and the Stability and Growth Pact.

This analysis suggests that the debt criterion in the Treaty is not fulfilled.

**Table 3: Debt dynamics** [a]

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | | 2010 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | COM | IT [b] | COM | IT [b] |
| Government gross debt ratio | 104.4 | 103.8 | 105.8 | 106.5 | 103.5 | 105.8 | 113.0 | 115.1 | 116.1 | 117.3 |
| Change in debt ratio [c] (1=2+3+4) | -1.3 | -0.5 | 2.0 | 0.7 | -3.0 | 2.3 | 7.2 | 9.3 | 3.1 | 2.2 |
| *Contributions:* | | | | | | | | | | |
| • Primary balance (2) | -1.6 | -1.2 | -0.3 | -1.3 | -3.5 | -2.4 | -0.2 | 0.5 | -0.1 | 0.0 |
| • "Snowball" effect (3) | 1.9 | 0.5 | 1.9 | 0.6 | 0.9 | 3.3 | 7.4 | 7.7 | 2.9 | 2.4 |
| *of which:* | | | | | | | | | | |
| *Interest expenditure* | *5.1* | *4.7* | *4.6* | *4.6* | *5.0* | *5.1* | *4.7* | *4.8* | *4.8* | *4.9* |
| *Real GDP growth* | *0.0* | *-1.6* | *-0.7* | *-2.1* | *-1.6* | *1.1* | *4.8* | *5.3* | *-0.2* | *-0.8* |
| *Inflation (GDP deflator)* | *-3.2* | *-2.6* | *-2.1* | *-1.9* | *-2.5* | *-2.9* | *-2.1* | *-2.5* | *-1.7* | *-1.7* |
| • Stock-flow adjustment (4) | -1.6 | 0.2 | 0.5 | 1.3 | -0.4 | 1.4 | 0.0 | 1.1 | 0.2 | -0.2 |

Notes:
[a] In percent of GDP.
[b] DPEF update and RPP.
[c] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where $t$ is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and $i$ and $y$ represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

*Source: Eurostat, Commission services' spring 2009 forecasts; Italian government's September 2009 update of the Economic and Financial Planning Document (DPEF) and forecast/programming document (RPP) for 2010.*

## 5. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State; and (4) other factors considered relevant by the Commission.

### 5.1. Medium-term economic position

**Cyclical conditions and potential growth.** Real GDP growth in Italy has been below the euro area average since the 1990s, under the impact of weak productivity growth. The global downturn has therefore hit an already weak economy. A marked slowdown of real GDP growth had been under way well before the deepening of the financial crisis, and turned into recession in spring 2008, driven by accelerating commodity prices, growing uncertainty and risk aversion. When inflation started its rapid descent towards the end of 2008, the collapse in global trade and tightening financing conditions took over as the key drivers of a deepening recession, even though the relatively low indebtedness of the private sector provided some shelter from the direct impact of the financial crisis. The Commission services expect real GDP growth to recover very mildly in the second half of 2009, in line with an assumed moderate improvement of the global economic environment and with some recent indicators hinting at a slow improvement in the coming months. For 2009 as a whole, the Commission services spring forecast expected real GDP growth at -4.4%. As the growth outturn in the first two quarters of 2009 was even worse than projected in spring and despite a somewhat faster recovery in the second half of 2009 this projection was revised down to -5% in the September 2009 interim forecast. In 2010, economic activity is projected to stabilise at a low level, thanks to the assumed rebound in external demand and a recovery in private consumption. The output gap is estimated to turn sharply negative in 2009 and to widen further in 2010, while potential growth is projected to weaken. While these estimates are strongly influenced by the downturn in 2009, the structural weaknesses that are at the root of the slow productivity dynamics in Italy will continue to take their toll on economic growth. As a result, the recovery is likely to be slow.

**Recent structural reforms.** Since the euro adoption, progress in implementing the structural reform agenda in Italy has been most visible in the labour market area and the financial sector. In the latter, important regulatory reforms have brought greater market contestability. In recent years, some progress has been achieved in liberalising services and goods markets and in improving the business environment. Initial steps have been taken towards a flexicurity-based approach in the labour market, but a comprehensive approach is still lacking. In the area of R&D, Italy has made some progress in supporting innovation and strengthening links between research and industry. However, R&D spending has not increased since 2005 and remains well below the target of 2.5% of GDP. The challenge of improving the quality of education, and in particular of overcoming the large disparities in education outcomes across the territory, is being addressed by an ongoing reform of the education system.

### 5.2. Medium-term budgetary position

**Structural deficit and fiscal consolidation in good times.** Based on the output gap estimates in the Commission services' spring 2009 forecast according to the commonly agreed methodology, the structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, improved by around 2½ percentage points of GDP during 2006-2007, which can be qualified as good times for the Italian economy, and then worsened by ½ percentage points in 2008. In the presence of a wide negative output gap, the structural balance is expected to improve in 2009 (by ¾ pp of GDP) and then worsen slightly in 2010 on the back of higher interest expenditure, remaining far away from the medium-term objective (MTO) of a balanced budgetary position in structural terms.

**Public investment.** Since 2000 the general government deficit ratio has consistently exceeded the government gross fixed capital formation, except in 2007. After decreasing in 2008, the government investment share in GDP is projected to increase by 0.4 percentage points in 2009, mainly as a result of the economic recovery packages. Still, according to the Commission services' spring forecasts, the deficit ratio will continue exceeding the public investment ratio in 2009 and 2010. The picture does not change if instead of the headline deficit the structural deficit is used in the comparison.

**Quality of public finances.** The composition of public expenditure in Italy is marked by a high cost of the debt service and high pension spending, which crowd out more productive expenditure as well as other social spending and contribute to the overall rigidity of Italy's public spending. Evidence suggests that there is large scope for improving the quality of services provided. Public sector wages exhibit trends that are unrelated to underlying economic conditions. Improving the quality of public finances, with particular attention to their composition and to spending efficiency, has been one of the invitations to Italy made by the Council in its opinion of 10 March 2009 on the February 2009 stability programme update. Some recent reform efforts in the area of the public administration and education are aimed at improving spending efficiency and cost effectiveness, but it is too early to assess their impact. The adoption, for the first time in July 2008, of a multi-annual budgetary consolidation package has considerably improved Italy's medium-term budgetary framework, by enshrining the budgetary targets in legislation and spelling out the measures that enable their achievement. However, partly due to the discretionary policies supporting domestic demand in line with the EERP, current primary expenditure is planned to grow significantly faster in 2009 than originally targeted. Further changes to the domestic budgetary framework could allow enhancing expenditure control in Italy. These include several initiatives aimed at improving transparency and performance budgeting, as well as gradual improvements to the budgetary rules to better control expenditure at local level – the Domestic Stability Pact. In May 2009 the Parliament adopted a Delegation Law setting out the main principles of fiscal federalism in Italy. Within the existing structure of sub-national governments, it envisages more autonomy for regions and municipalities in collecting and spending tax revenue, while foreseeing solidarity mechanisms. The law stipulates that the implementation of fiscal federalism must be consistent with Italy's commitments under the Stability and Growth Pact. A reform of the budgetary process, expected to enter into force in 2010, will imply a change in the budgetary cycle and planning instruments so as to allow a greater involvement of the sub-national administrations in setting the budgetary targets and the medium-term strategy for fiscal consolidation.

**Long-term sustainability of public finances.** In its opinion of 10 March 2009 on the February 2009 stability programme update, the Council assessed the long-term sustainability of Italy’s public finances. In particular, the Council was of the opinion that, thanks to the adopted pension reforms, the long-term budgetary impact of ageing in Italy is lower than the EU average, with pension expenditure showing a more limited increase than on average in the EU. Yet, pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the assumption that the adopted reforms are fully implemented, in particular that revised actuarial coefficients that are fully consistent with the contributory principle underlying the reformed pension system are applied as of 2010. Moreover, as the current level of gross debt is well above the Treaty reference value, achieving and maintaining high primary surpluses over the medium term would contribute to reducing the medium risks to the sustainability of public finances[5].

### 5.3. Other factors put forward by the Member State

In a letter of 26 August 2009, the Italian authorities listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The analysis presented above already covers most of the items put forward by the authorities. The remaining items on their list are the following: unexpected outlays related to the Abruzzo earthquake (around 0.04% of GDP in 2009-2010); one-off public investment to repurchase previously securitised real estate (around 0.1% of 2009 GDP); high net contribution to the EU budget (0.5% of GDP); expenses for peace-keeping operations and development aid. Overall, these items add relevant

5 Since the submission of the stability programme, risks to the long-term sustainability may have changed in view of the worsened economic and budgetary situation. The new assessment will be published in the upcoming report on the long-term sustainability of public finances in the European Union.

information, but they do not substantially alter the assessment of the deficit and debt criteria presented above.

### 5.4. Other factors considered relevant by the Commission

Lower revenue and higher primary expenditure reflecting the work of the automatic stabilisers account for the deterioration in the headline deficit between 2008 and 2009. The discretionary measures taken with the successive recovery packages to respond to the crisis are not expected to appreciably weigh on the government balance, as they are planned to have an overall neutral budgetary impact thanks to financing measures. This is in line with the recommendations of the EERP to design recovery measures according to fiscal room for manoeuvre. The measures are targeted and timely, provided that the planned acceleration of public investment is achieved, and most of them are temporary in nature. The package is an adequate response to the economic downturn in view of the very high debt ratio.

A series of measures were adopted in late 2008 and early 2009 to ensure the stability of the financial system, guaranteeing higher protection of savers and adequate levels of bank liquidity and capitalisation. To this end, the Ministry of Economy and Finance has been allowed to underwrite financial instruments, issued by sound listed banks, that would qualify as regulatory capital. This scheme is intended for voluntary use by banks. It has been officially estimated that around € 10 billion (0.7% of GDP) would be devoted to the scheme. To date, securities have been issued for only € 1.95 billion (0.1% of GDP).

In its opinion on the most recent update of the stability programme, the Council considered that the achievement of the deficit targets throughout the programme period (2009-2011) might be hampered by a lower-than-planned economic growth and by possible slippages in the implementation of the planned restraint in primary expenditure, even though the improved fiscal framework enhances the conditions for fiscal discipline and spending efficiency. The Council therefore invited Italy to carry out with determination the adjustment path planned over the programme period in order to set the very high debt ratio on a steadily declining path and ensure the long-term sustainability of public finances, as well as to continue the progress made to improve fiscal governance and the work on a new framework for fiscal federalism that ensures the accountability of local governments and underpins fiscal discipline.

## 6. CONCLUSIONS

The planned deficit for 2009 in the April 2009 EDP notification is 3.7% of GDP. According to new projections published in July, the government is now planning to reach a deficit of 5.3% of GDP in 2009. The planned deficit is above and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, but cannot be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

The general government gross debt has consistently been well above the 60% of GDP reference value since before euro adoption and is planned to stand at 115.1% of GDP in 2009. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. This suggests that the debt criterion in the Treaty is not fulfilled.

In line with the Treaty, this report has also examined “relevant factors”, which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition – that the deficit remains close to the reference value and that its excess over the reference value is temporary – is fully met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The existence of a severe economic downturn, with public finance implications, increases the need to undertake enhanced surveillance under the EDP.