

STRICTLY CONFIDENTIAL

Mr. Silvio Berlusconi
Prime Minister
Presidenza del Consiglio dei Ministri
Palazzo Chigi
Piazza Colonna, 370
I - 00187 Roma

Frankfurt/Rome, 5 August 2011

Dear Prime Minister,

The Governing Council of the European Central Bank discussed on 4 August the situation in Italy's government bond markets. The Governing Council considers that pressing action by the Italian authorities is essential to restore the confidence of investors.

The Euro area Heads of State or Government summit of 21 July 2011 concluded that "*all euro countries solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms*". The Governing Council considers that Italy needs to urgently underpin the standing of its sovereign signature and its commitment to fiscal sustainability and structural reforms.

The Italian Government has decided to pursue a balanced budget in 2014 and, to this purpose, has recently introduced a fiscal package. These are important steps, but not sufficient.

At the current juncture, we consider the following measures as essential:

1. We see a need for significant measures to **enhance potential growth**. A few recent decisions taken by the Government move in this direction; other measures are under discussion with social partners. However, more needs to be done and it is crucial to go forward decisively. Key challenges are to **increase competition**, particularly in services, to improve the quality of public services and to design regulatory and fiscal systems better suited to support firms' competitiveness and efficiency of the labour market.

a) A comprehensive, far-reaching and credible reform strategy, including the full liberalisation of local public services and of professional services is needed. This should apply particularly to the provision of local services through large scale privatizations.

b) There is also a need to further reform the collective wage bargaining system allowing firm-level agreements to tailor wages and working conditions to firms' specific needs and increasing their relevance with respect to other layers of negotiations. The June 28 agreement between the main trade unions and the industrial businesses associations moves in this direction.

c) A thorough review of the rules regulating the hiring and dismissal of employees should be adopted in conjunction with the establishment of an unemployment insurance system and a set of active labour market policies capable of easing the reallocation of resources towards the more competitive firms and sectors.

2. The government needs to take immediate and bold measures to ensuring the **sustainability of public finances**.

a) Additional corrective fiscal measures are needed. We consider essential for the Italian authorities to frontload the measures adopted in the July 2011 package by at least one year. The aim should be to achieve a better-than-planned fiscal deficit in 2011, a net borrowing of 1.0% in 2012 and a balanced budget in 2013, mainly via expenditure cuts. It is possible to intervene further in the pension system, making more stringent the eligibility criteria for seniority pensions and rapidly aligning the retirement age of women in the private sector to that established for public employees, thereby achieving savings already in 2012. In addition, the government should consider significantly reducing the cost of public employees, by strengthening turnover rules and, if necessary, by reducing wages.

b) An automatic deficit reducing clause should be introduced stating that any slippages from deficit targets will be automatically compensated through horizontal cuts on discretionary expenditures.

c) Borrowing, including commercial debt, and expenditures of regional and local governments should be placed under tight control, in line with the principles of the ongoing reform of intergovernmental fiscal relations.

In view of the severity of the current financial market situation, we regard as crucial that all actions listed in section 1 and 2 above be taken as soon as possible with decree-laws, followed by Parliamentary ratification by end September 2011. A constitutional reform tightening fiscal rules would also be appropriate.

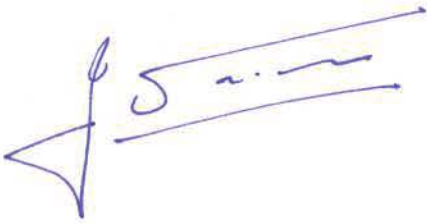
3. We also encourage the government to immediately take measures to ensure a major overhaul of the **public administration** in order to improve administrative efficiency and business friendliness. In public entities the use of performance indicators should be systematic (especially in the health, education and judiciary systems). There is a need for a strong commitment to abolish or consolidate some intermediary administrative layers (such as the provinces). Actions aimed at exploiting economies of scale in local public services should be strengthened.

We trust that the Government will take all the appropriate actions.

With best regards,

Jean-Claude Trichet

Mario Draghi

A handwritten signature in blue ink, consisting of a stylized 'J' followed by 'c. Trichet'.A handwritten signature in black ink, reading 'Mario Draghi'.

Cc: Finance Minister Giulio Tremonti



*Al Presidente
del Consiglio dei Ministri*

Dear President,

I would like to thank you for the suggestions and recommendations that you and Governor Draghi decided to put forward to the Italian Government, contained in the letter that you sent me last Friday.

The current market situation is indeed extremely serious, revealing a deep confidence crisis in the Euro Area. It is now urgent that all Members States and Institutions responsible for the present and future stability of the Area and its currency take, without any further delay, all the necessary actions, individually and collectively.

As far as Italy and its Government are concerned, I would like to reassure you of our commitment to honor our sovereign signature and of our determination to take all actions required to restore full confidence in the structural equilibrium of the public finance and in the growth potential of our economy.

As you recalled in your letter, we have acted quickly and resolutely by passing last July an emergency budget law that will allow Italy to achieve balance budget by 2014. The Bill also introduced several unprecedented growth enhancing measures.

But we are ready to do more. Following your letter and according to your recommendations, I have immediately announced my Government intention to quickly take the following additional actions:

1. To Front load the measures already passed by Parliament last July in order to achieve balance budget one year earlier, i.e. in 2013. This will be done by accelerating the announced reform of our Welfare system, reinforced by a safeguard clause that will guarantee the required savings, if necessary, through linear cut across all expenditure items in that broad budget category. We stand ready to take any further necessary action.

2. To introduce in our Constitution an explicit Balance budget rule requirement.

3. To reinforce Art. 41 of our Constitution in order to state beyond any doubt the right to complete freedom of economic initiative. This will be complemented by a decree law that will provide widespread liberalization in local services and professional activities.

4. To introduce further liberalization in the labor market in order to substantially increase contractual flexibility at the firm level, and to remove the segmentation of the labor market between permanent and temporary work force.

We intend to proceed with utmost urgency, in order to complete the necessary Parliamentary approval by September for ordinary law bills, and by the end of the year in the cases in which Constitutional changes are required.

Best regards

A handwritten signature in black ink, reading "Silvio Berlusconi". The signature is fluid and cursive, with the first name "Silvio" and the last name "Berlusconi" clearly distinguishable.

Rome, August 7th 2011