Italian Republic
Rating Report

SCOPE BBB+ STABLE OUTLOOK

Credit strengths

- Systemic importance for EU and EA
- Large, wealthy and diversified economy
- Strong external position
- Low private sector debt

Credit challenges

- High public debt and funding needs
- Weak long-run economic growth
- Challenging demographic trends
- Labour market rigidities
- Political fragmentation and instability

Rating rationale:

Core euro area member: Italy benefits from supportive fiscal and monetary policy frameworks under the EU and euro area institutional architecture. The economy's systemic relevance further underpins the high likelihood of support from European institutions under stressed scenarios.

Large, wealthy and diversified economy: Italy's EUR 1.8trn economy is the third largest in the EU and benefits from a wide diversification across sectors, supporting its economic resilience to shocks. Italy is set to receive EUR 191.5bn of Next Generation EU recovery funds (10% of average GDP over 2021-26F), which together with associated reforms should support its economic outlook.

Strong external position: Italy's record of current account surpluses has turned the country into a net creditor. This, alongside the euro's status as a global reserve currency, shield the country from external risks.

Low private indebtedness: Moderate private debt levels among Italian non-financial corporates and households support the stability of the financial system and reduce the risk of private sector liabilities materialising on the government's balance sheet.

Ratings challenges include: i) high government debt and funding needs, which are expected to remain elevated over the long term; ii) weak longer-run economic growth; iii) an ageing population; iv) labour-market rigidities; and v) political fragmentation weighing on the recent reform momentum.

Italy's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aa+	EUR [+1]	0	BBB+
Public Finance Risk		20%	bb-		-2/3	
External Economic Risk		10%	bbb+		0	
Financial Stability Risk		10%	aaa		-1/3	
ESG Risk	Environmental Factors	5%	a		0	
	Social Factors	7.5%	ccc		-1/3	
	Governance Factors	12.5%	bb+		-1/3	
Indicative outcome			**a**		**-2**	
Additional considerations					**0**	

Note: *The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve-currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Stable Outlook reflects our view that risks to the ratings are balanced.

Positive rating-change drivers

- Debt-to-GDP remains on a firm downward trajectory
- Investment and reform implementation raise economic growth potential

Negative rating-change drivers

- Reduced support from European institutions
- Weaker economic growth outlook
- Weaker fiscal outlook

Ratings and Outlook

Foreign currency

Long-term issuer rating	BBB+/Stable
Senior unsecured debt	BBB+/Stable
Short-term issuer rating	S-2/Stable

Local currency

Long-term issuer rating	BBB+/Stable
Senior unsecured debt	BBB+/Stable
Short-term issuer rating	S-2/Stable

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Bloomberg: RESP SCOP

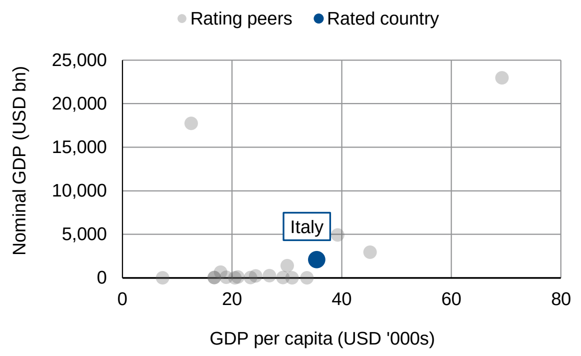
Domestic Economic Risks

- **Growth outlook:** The Italian economy has grown robustly in 2021, by 6.7% after a 9.1% contraction in 2020 following the Covid-19 crisis. Recovery in household consumption, services and investments supported a strong growth momentum also in 2022, despite a slowdown in the second half of the year due to persistent inflationary pressures and lower exports. High inflation driven by the energy price shock will continue to curb private consumption and economic activity in the first half of 2023, although the effects will be mitigated by government support measures and energy diversification strategies to reduce dependence on Russian sources. We expect economic growth of 0.5% this year, after 3.7% in 2022, and of 1.5% in 2024. We then expect growth to slow towards a moderate potential of just 1% in the medium run, constrained by low productivity growth and a declining working-age population. The successful implementation of public investments and reforms related to the NGEU programme provide potential upside to our growth estimate, but implementation delays remain a key downside risk.
- **Inflation and monetary policy:** Headline inflation continued to increase throughout 2022, mostly driven by higher energy prices, and reached 12.3% YoY (HICP) in December, for an overall average rate of 8.7% for the year. Higher energy costs started to feed into goods and services prices, pushing core inflation to a historical-high of 5.8% YoY in December. We expect core inflation to remain elevated over 2023-24, and the headline inflation to decline to 5.2% this year and to around 2.0% in 2024. The ECB has accelerated monetary tightening and raised its policy rate to 2% by end-2022. Further rate hikes of at least 100bps are likely this year, together with a gradual reduction of balance sheet holdings, which will further contribute to a slowdown in economic activity. Still, the ECB's applied flexibility to reinvestments under the PEPP and the announced Transmission Protection Instrument should maintain stable financing conditions for Italy even under scenarios of heightened market volatility.
- **Labour markets:** Despite improving trends, structural bottlenecks in the labour market result in a very low employment rate (around 60%, almost 10pp below the euro area average), high inactivity and youth unemployment. In addition, high labour costs and the widespread use of temporary contracts induce young, highly qualified workers to emigrate, adversely affecting productivity. Given the robust economic performance, unemployment continued to fall to 7.8% in November 2022, from 9% the previous year. We expect the unemployment rate to average 8.3% in 2023-24, after 8.1% in 2022.

Overview of Scope's qualitative assessments for Italy's *Domestic Economic Risks*

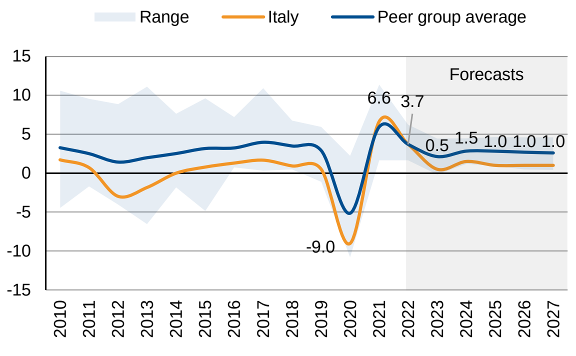
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Weak	-1/3	Weak growth potential
	Monetary policy framework	Strong	+1/3	ECB is a credible and effective central bank over the cycle
	Macro-economic stability and sustainability	Neutral	0	Large and diversified economy, stagnant productivity and weak labour market outcomes

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

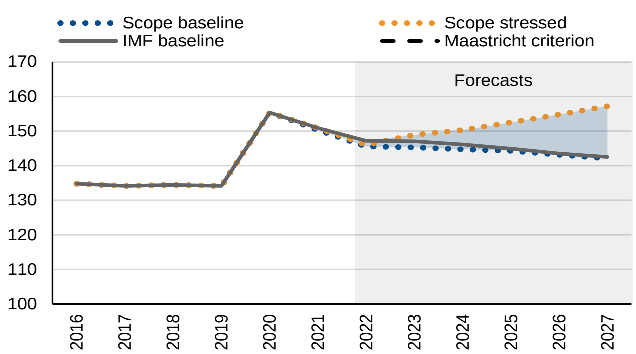
Public Finance Risks

- **Fiscal outlook:** Fiscal performance continued to recover in 2022, thanks to the phase-out of Covid support measures, solid government revenue growth and contained expenditures. Tax revenues grew by 11.5% in the first ten months of last year, reducing the fiscal deficit further to an expected 5.2% of GDP in 2022, from 7.2% in 2021. The 2023 Budget Bill of EUR 35bn earmarks 60% (EUR 21bn or 1.1% of GDP) to shield vulnerable households from the high energy prices at least until the end of Q1 2023. We thus expect the deficit to decline this year only modestly to 4.8% of GDP. Still, we expect the primary balance to gradually improve and turn into a 1% of GDP surplus by 2026. However, the higher interest burden, which we expect to exceed 4% of GDP over the coming years, will keep the headline deficit close or above 3% of GDP over the medium term. Public investment, boosted by EU and national funding, should remain above 3.5% of GDP over 2023-2025, up from 2.3% over 2015-2019.
- **Debt trajectory:** The public debt-to-GDP ratio declined by 5pp in 2021 to 150.3% of GDP, thanks to the economic rebound and recovering government balance following the pandemic shock. We expect the debt ratio to have further rapidly declined to 145.5% of GDP by end-2022 and to stabilise around 145% of GDP in 2023-24, before further declining to around 142% by 2027. We assume no severe interruptions in economic growth, gradually declining inflation, an improving primary balance and a material increase in interest expenditure. Over the long run, Italy's debt trajectory is challenged by its weak growth outlook and rising fiscal pressures from a rapidly ageing population.
- **Debt profile and market access:** Despite the material increase in financing costs, Italy's average debt maturity remains long at over seven years by end-2022. The 10-year bond yield peaked at 4.6% in Q4 2022, up from 0.6% in mid-2021, and declined to below 4% in January 2023. As a result, the average cost of issuance rose to 1.7% in 2022 (0.1% in 2021) and the average cost of debt to 2.9% in 2022 (2.5% in 2021). Cash holdings have decreased from EUR 95bn in July but remain at a comfortable level of EUR 42.5bn as of December 2022. The Treasury benefits from a large and diversified investor base, including a solid pool of domestic investors (over 70% of total), while more than 25% of total debt is held by the Eurosystem via the Bank of Italy. These aspects ease risks stemming from the elevated annual funding needs, which we expect to remain above 25% of GDP over the coming years.

Overview of Scope's qualitative assessments for Italy's *Public Finance Risks*

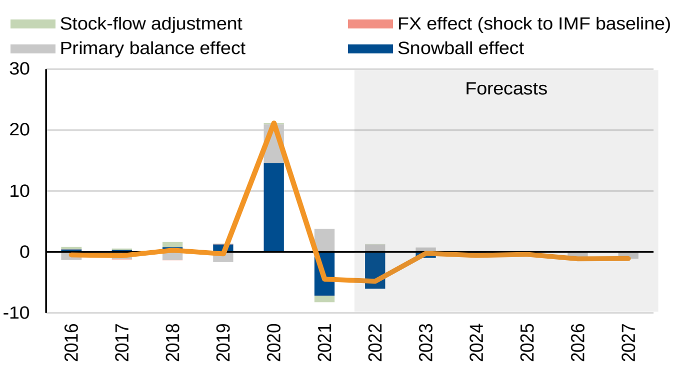
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Fiscal policy framework	Weak	-1/3	Expectation of gradual return to primary balance only by 2026; EU fiscal framework in transition
	Debt sustainability	Weak	-1/3	High debt stock vulnerable to permanent increases during shocks; significant off-balance sheet debt; rising ageing-related expenditure
	Debt profile and market access	Neutral	0	Strong domestic investor base; large central-bank holdings of public debt; resilient debt structure, but significant financing requirements

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

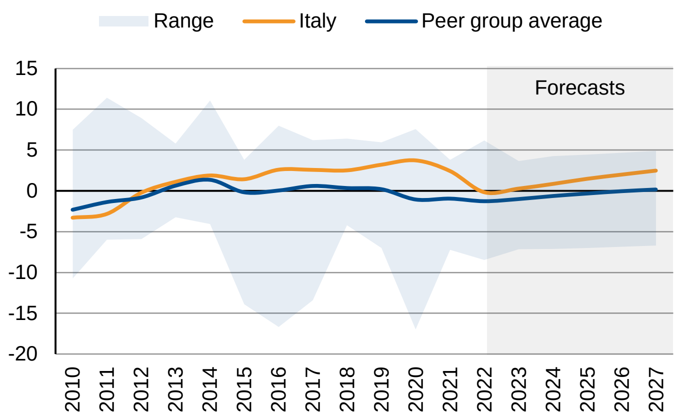
External Economic Risks

- **Current account:** Italy has recorded annual current account surpluses since 2013. High surpluses of goods and primary-income balances have more than offset deficits in the secondary-income balance. The current account remained resilient also in 2020 and 2021, despite the decline in tourist services and supply bottlenecks, but turned negative in 2022 at -0.2% of GDP, due to the widening of the energy balance, the recovery in imports and the stagnation of exports amid the slowdown in international trade. We expect the gradual fading of the energy price shock to lead to a recovery in the current account over the coming years.
- **External position:** Italy has a moderate external debt stock compared with euro area peer economies, at 135% of GDP as of Q3 2022. The largest shares are owed by the government and the central bank (29% and 30% of total, respectively). Foreign investors have been reducing their exposure to Italian securities, including to the government sector, since the summer of 2021. While the pace has slowed in recent months, non-resident holdings of Italian government securities have decreased by EUR 109bn between July 2021 and October 2022. Short-term external debt is moderate, accounting for about 40% of total debt. Italy's positive net international investment position has slightly deteriorated to 5.7% of GDP in Q3 2022 from the 8.1% peak reached at the end of 2021, although remaining solid and supporting the country's resilience against external shocks.
- **Resilience to shocks:** Italy, like all euro area member states, benefits from the euro's status as a reserve currency, easing risk from currency sell-offs and sudden stops of capital flows. However, the negative Target II balance of Italy continued to widen and reached EUR 715bn in September 2022 from EUR 628bn in June.

Overview of Scope's qualitative assessments for Italy's *External Economic Risks*

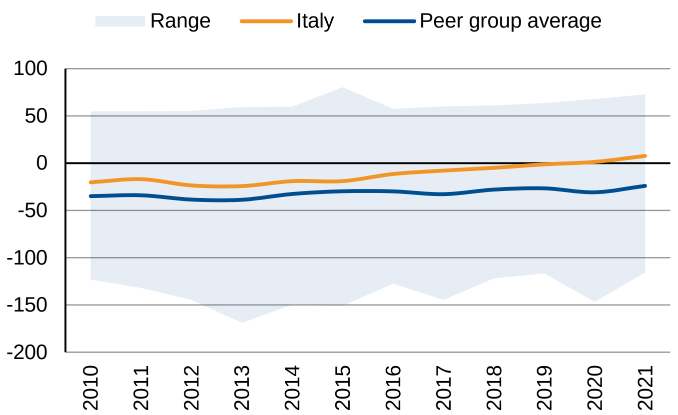
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Current account resilience	Neutral	0	Diversified and competitive export base; record of current-account surpluses
	External debt structure	Neutral	0	Low external debt stock; composition by sector and maturity similar to peers
	Resilience to short-term external shocks	Neutral	0	Euro-area membership protects against short-term external shocks

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

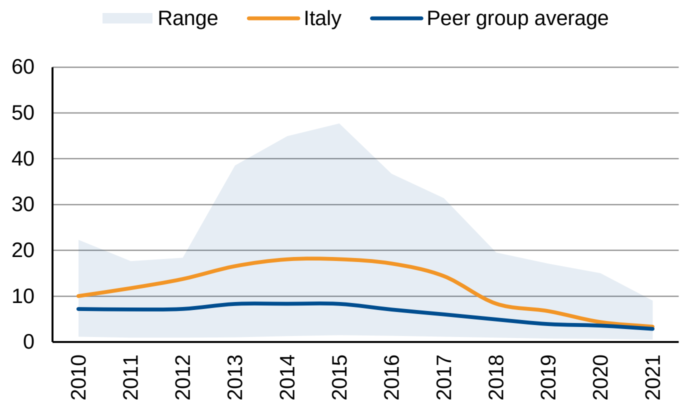
Financial Stability Risks

- **Banking sector:** Banking system profitability improved in the first nine months of 2022, with the ROE reaching 8.9% in Q3 from 7.9% in the same period the year before, mainly reflecting an increase in net interest income due to higher interest earned on bonds held in portfolios. The non-performing loan ratio reached a historical low (2.6%) but remains above the euro-area average (1.8%), due to high-volume sales of non-performing exposures and the continued application of loan moratoriums. Capital ratios among significant banking groups have modestly declined since dividend distribution limits were relaxed. Still, system-wide capital adequacy remains within regulatory limits, with regulatory Tier 1 ratios of 16.4% of risk-weighted assets as of Q2 2022 – above a pre-crisis level of 14.9%. Bank holdings of government bonds remain elevated.
- **Private debt:** Private-sector debt remains moderate against euro area peers and declined to 112.2% of GDP in Q3 2022, almost in line with pre-Covid-19 levels, from the recent peak of 121.9% in Q1 2021. The balance comprises household debt of 42.6% of GDP and non-financial corporations' debt of 69.6% of GDP. Loans to corporates reversed their downward trend and increased by 3.9% YoY as of Q3 2022, due to higher demand for investments especially among larger firms, despite the tightening credit conditions. Similarly, loans to households grew by 3.9% YoY, largely driven by home purchases.
- **Financial imbalances:** The uncertain economic recovery and the ECB's monetary policy tightening have resulted in higher sovereign bond yields and significant volatility in equities. Nevertheless, financing conditions remain supportive by historical standards, while economic agents benefit from abundant liquidity and a recovering economy. The real estate market also continues to recover in line with economic conditions (prices of existing dwellings grew 3% YoY as of Q3 2022 compared to a euro area average of 6.8%), with limited financial stability risk.

Overview of Scope's qualitative assessments for Italy's *Financial Stability Risks*

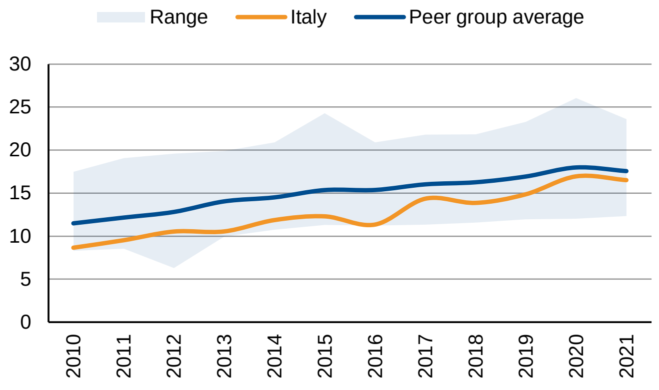
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Weak	-1/3	Sovereign-banking nexus remains core risk; weak performance of Italian banks under stress examination despite improved fundamentals
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union and the Bank of Italy
	Financial imbalances	Neutral	0	Low private-sector indebtedness; moderate credit growth; real estate price dynamics in line with economic conditions

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

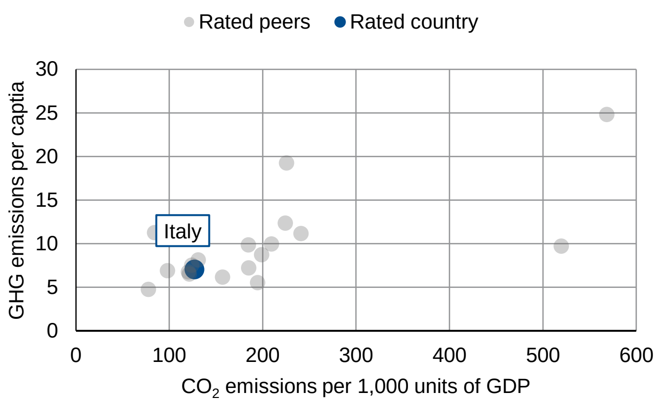
ESG Risks

- **Environment:** Italy's economy has one of the lowest carbon emission intensity levels among European peers, despite a slower reduction pace over the past 30 years. The country is in line with EU peers for its share of renewable energy in consumption (20%), which is however, dominated by gas and oil (over 75%), with the share of gas being much higher than the EU average (42% vs 24%). While the country imported 43% of its gas from Russia before the Russia-Ukraine war, it has significantly diversified its gas sources in 2022, reducing its reliance on Russian gas to around 10% only. More investment will be required to achieve its ambitious goals by 2030 to improve emissions, renewable energy use and energy efficiency under its National Energy and Climate Plan, as well as to mitigate the effects of the climate crisis, with Italy being particularly exposed to earthquakes, floods, volcanic eruption, droughts and wildfires. The government has allocated 37.5% of its Recovery Plan to green policies, is advancing environmental sustainability in budgeting and issued a first BTP Green in 2021.
- **Social:** Social risk factors are elevated for Italy. Demographic dynamics are unfavourable, with the second highest old-age dependency ratio in the euro area (37%). Income inequality, while modest under an international comparison, is high in the euro area, increasing the risk of poverty, including of in-work poverty. Labour force participation is the lowest in the euro area, at around 65% of the working-age population, which also reflects a high rate of undeclared work. Labour force inactivity is high among youth and women, with 23.1% of NEETs (Not in Education, Employment, or Trainings).
- **Governance:** While Italy has a strong governance system with multiple checks and balances, its highly fragmented political environment leads to frequent episodes of political instability. After snap elections in September 2022, Brothers of Italy's leader Giorgia Meloni became prime minister supported by a far-right coalition with Forza Italia and the Lega. Together the parties hold a clear – although not a two-thirds – parliamentary majority with 228 out of 400 seats. The prospects of significant EU funds to be received over coming years is likely to incentivise the new government to broadly continue with the reforms agreed with the European Commission.

Overview of Scope's qualitative assessments for Italy's *ESG Risks*

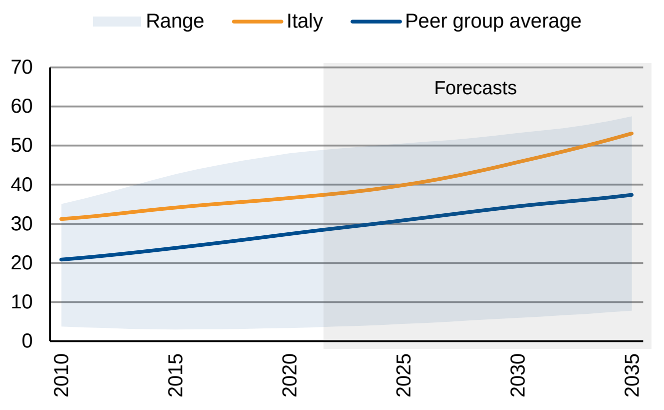
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Environmental factors	Neutral	0	Exposure to natural disaster risk; ambitious ecological transition investment programme
	Social factors	Weak	-1/3	Adverse demographics, moderate educational outcomes, risk of social exclusion
	Governance factors	Weak	-1/3	Parliament remains fragmented with risks to political stability likely to re-emerge

Emissions per GDP and per capita, $mtCO_2e$



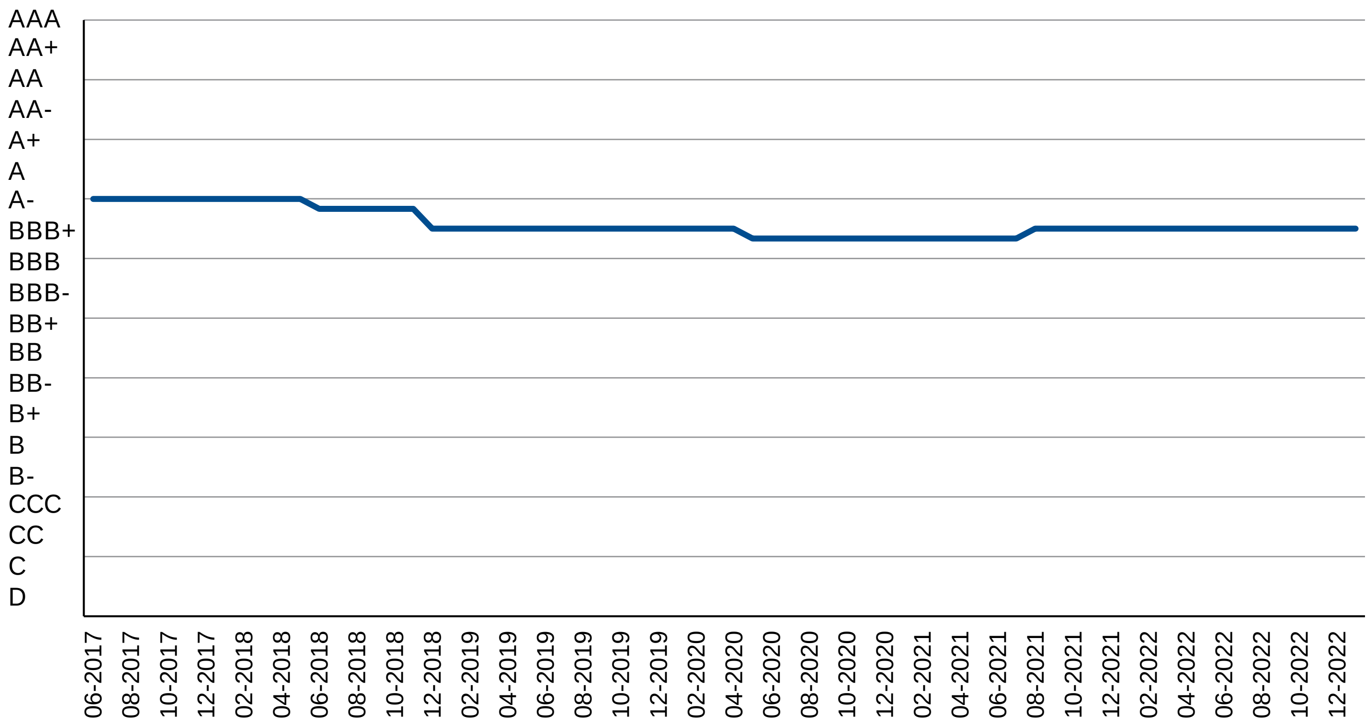
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term debt)



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard, including a methodological reserve-currency adjustment.

Peer group*
China
Croatia
Cyprus
Czech Republic
France
Japan
Latvia
Lithuania
Malta
Poland
Portugal
Slovakia
Slovenia
Spain
United States

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	GDP per capita, USD '000s	IMF	32,649	34,918	33,628	31,707	35,473
	Nominal GDP, USD bn	IMF	1,961.1	2,092.9	2,011.5	1,891.1	2,101.3
	Real growth, %	IMF	1.7	0.9	0.5	-9.0	6.6
	CPI inflation, %	IMF	1.3	1.2	0.6	-0.1	1.9
	Unemployment rate, %	WB	11.2	10.6	10.0	9.2	9.8
Public Finance	Public debt, % of GDP	IMF	134.2	134.4	134.1	155.3	150.9
	Interest payment, % of revenue	IMF	7.8	7.5	6.8	6.9	7.0
	Primary balance, % of GDP	IMF	1.2	1.3	1.7	-6.3	-3.8
External Economic	Current account balance, % of GDP	IMF	2.6	2.5	3.2	3.7	2.4
	Total reserves, months of imports	IMF	2.9	2.7	3.3	4.7	3.9
	NIIP, % of GDP	IMF	-7.8	-4.8	-1.2	1.5	7.8
Financial Stability	NPL ratio, % of total loans	IMF	14.4	8.4	6.7	4.4	3.3
	Tier 1 ratio, % of risk-weighted assets	IMF	11.3	14.3	13.9	14.9	16.9
	Credit to private sector, % of GDP	WB	80.8	76.7	74.0	83.1	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	138.0	134.8	130.9	127.1	129.1
	Income share of bottom 50%, %	WID	20.5	20.4	20.6	20.7	20.7
	Labour-force participation rate, %	WB	65.5	65.7	65.8	-	-
	Old-age dependency ratio, %	UN	35.2	35.6	36.1	36.7	37.2
	Composite governance indicators*	WB	0.5	0.5	0.6	0.5	0.6

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 16 January 2023	112.6

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