Republic of Italy
Rating Report

STABLE OUTLOOK
BBB+

Credit strengths

- Systemic importance as core euro area member state
- Credible reform and investment policies
- Strong external sector
- Low private-sector debt

Credit challenges

- High public debt and funding needs
- Weak long-run economic growth outlook
- Challenging demographic evolution
- Outstanding slack in the labour market

Rating rationale:

Core euro area member state: Italy benefits from supportive fiscal and monetary frameworks of the EU institutional architecture and innovations made to the architecture of past years; the economy's systemic relevance within the euro area underpins furthermore a high likelihood of support from European institutions under stressed scenarios. Italy's EUR 1.9trn economy is the third largest of the European Union, well diversified across sectors, supporting economic resilience to shocks.

Credit reform and investment agenda: The EUR 191.5bn (around 9.8% of average 2021-26 GDP) Italy is set to receive under Next Generation EU recovery funding through 2026, and associated credible structural reform agenda, support an economic outlook.

Strong external sector: a track record of current-account surpluses, together with improvements in a modest net international *asset* position as well as the euro shield against external-sector risk.

Low private indebtedness: comparatively moderate levels of private debt of Italian non-financial corporates and households support financial-system stability, curtail obstacles to private investment and ease risk of private-sector liabilities materialising on the government balance sheet.

Ratings challenges include: i) high government debt and funding requirements, which are expected to stay structurally on an increasing trend (through the cycle); ii) tepid longer-run economic growth; iii) an ageing population, weighing on government finances in the long run; and iv) inadequate labour-market outcomes – in low employment and labour force participation rates.

Italy's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa+		0	BBB+
Public Finance Risk		25%	bb		-2/3	
External Economic Risk		10%	aa		0	
Financial Stability Risk		10%	aa+		-1/3	
ESG Risk	Environmental Risk	5%	aa-		0	
	Social Risk	5%	b-		-1/3	
	Governance Risk	10%	bb		-1/3	
Overall outcome		**a-**		**+1**	**-2**	

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 Scope's view that risks to the ratings are balanced.

Positive rating-change drivers

- Debt-to-GDP remains on a firm downward trajectory
- Effective public investment and reform implementation result in further upside for nominal economic growth potential

Negative rating-change drivers

- Support from European institutions weakened even under adverse scenarios
- Debt sustainability outlook deteriorates materially
- Nominal growth outlook weakens significantly

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

Lead Analyst

Dennis Shen
+49 69 6677389-68
d.shen@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

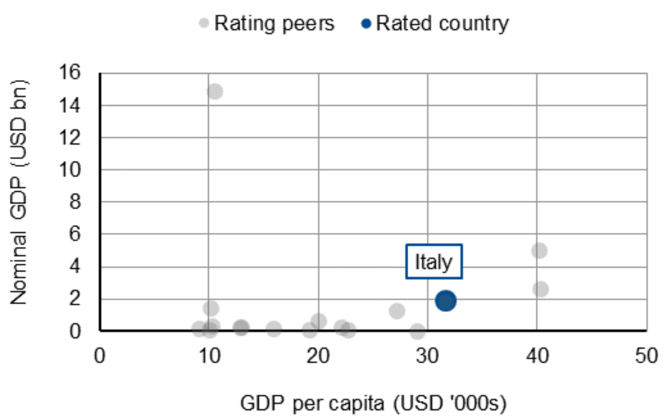
Domestic Economic Risks

- **Growth outlook:** The Italian economy has rebounded from 2020's Covid-19 crisis depths with economic growth of 6.5% in 2021 – in line with Scope above-consensus expectations of 6.6% with regard to 2021, despite marked slowdown since the last months of the year, due to record Covid-19 case counts, supply chain disruption alongside rising energy costs. We expect recovery to continue over 2022, with growth of 4.1% (revised from 4.5% under a Dec-2021 estimate), thereafter 1.9% in 2023 (revised from 2.1%). Output is seen returning to pre-pandemic levels by Q2 2022. The EUR 191.5bn Italy is set to receive through 2026 under Next Generation EU funding, and associated structural reform agenda, support an economic outlook. The medium-run growth outlook, however, remains tepid, with potential growth estimated of 0.8% (real growth averaged 0.3% over 2010-19), constrained via stagnant labour productivity and declining working-age population (of 0.5% per year over 2022-26).
- **Inflation and monetary policy:** The inflation rate reached elevated levels of 5.3% in January 2022 (although core inflation was a more moderate 1.8%), driven mostly by energy prices. Supply-side costs are likely to remain elevated over 2022, resulting in an average annual *headline* inflation rate of 3.5%, followed by gradual normalisation, to annual averages of 1.7% over 2023-24, even as wage growth sees potential improvement. The ECB monetary policy stance remains accommodative at this stage, after a December 2021 Governing Council decision to gradually reduce pace of asset purchases, with a halt of net purchases under the Pandemic Emergency Purchase Programme by March 2022 in part compensated for via temporary expansion of the Public Sector Purchase Programme (PSPP). The Feb-2022 ECB Governing Council raised likelihood of faster normalisation of monetary policy – such as more rapid drawdown of the PSPP and/or an earlier timetable of rate increases.
- **Labour market:** The Italian labour market is enervated via structural bottlenecks, resulting in a low employment rate, of under 60%, alongside tepid wage dynamics (0.7% YoY in December), constraining retention of talent and resulting in a degree of brain drain across younger generations. The unemployment rate is now under a pre-pandemic level: 9% in December 2021 (under a Jan-2021 peak of 10.2%) and expected to moderate to 8.6% (2022) and 8% (2023).

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

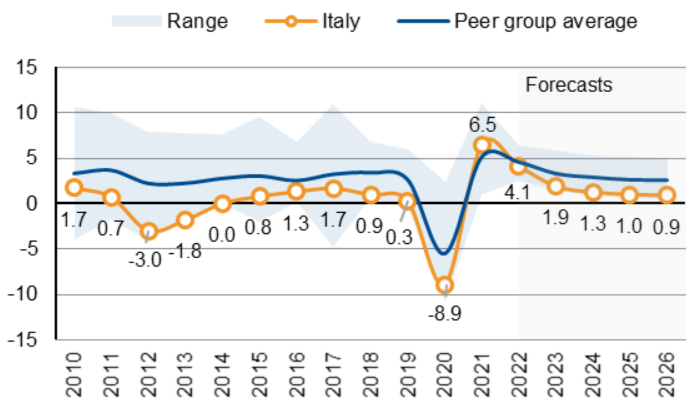
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Weak	-1/3	Weak growth potential
	Monetary policy framework	Strong	+1/3	ECB is a credible and effective central bank; ECB support especially significant as regards vulnerable euro-area borrowers
	Macro-economic stability and sustainability	Neutral	0	Large and diversified economy, however stagnant productivity and weak labour market outcomes

Nominal GDP and GDP per capita, USD thousands



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

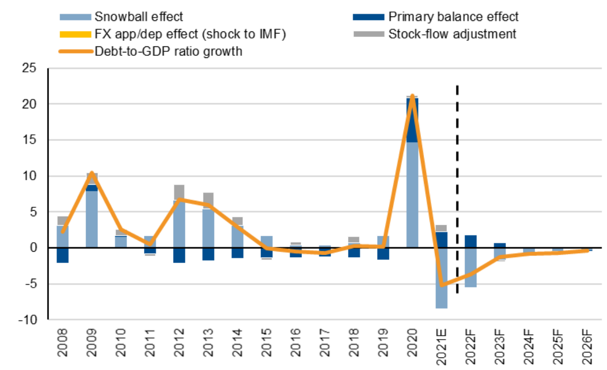
Public Finance Risks

- **Fiscal outlook:** Italy's record of primary surpluses (achieved each year pre-crisis over 2000-19 except 2009) was interrupted during the Covid-19 crisis. The fiscal balance recovered last year, however, to an estimated deficit of 5.4% of GDP (revised down from Scope's previously (already below-consensus) estimate of 7.5% with respect to 2021), after a 9.6% of GDP deficit in 2020. We expect a deficit to recede to 4.8% of GDP and 3.6% of GDP this and next year. Longer run, a primary balance is seen by 2025-26, with the headline deficit under 3% during those years. The government budget position remains expansionary, however, with measures of the 2022 Budget embedding a deficit-increasing effect of 1.2% of GDP this year and mostly of permanent nature. Public investment will remain above 3% of GDP over the next three years. Italy has achieved all 51 goals programmed for 2021 under the Recovery and Resilience National Plan, with a payment request made for a EUR 21bn further tranche of EU funding.
- **Debt trajectory:** A significant economic rebound in 2021, higher inflation and recovery of the government balance drove a 5pp decline of the public debt ratio to around 150% of GDP last year – nevertheless still well higher than pre-crisis levels of 134%. For end-2022, we anticipate a debt ratio of 147%, before 144% by 2026 under benign assumptions of no severe interruption to recovery over the forecast horizon (assuming 1.8% average growth and 1.4% average GDP deflator changes over 2022-26). Over a longer run, Italy's debt trajectory is seen remaining structurally on an increasing trend, however, factoring in sharp debt increases during future economic crises. Italy has provided significant liquidity support to companies and households during the pandemic, with guarantees representing a contingent risk to the sovereign balance sheet, with take-up of such loans of around 8.8% of GDP by October 2021. The IMF estimates a NPV of spending increase on pensions and health care from 2020 to 2050 of 79% of GDP.
- **Debt profile & market access:** Italy has extended its average maturity of debt to 7.1 years by end-2021 (from 6.7 in August 2020). Funding conditions remain moderate even acknowledging a recent increase of funding yields – with the 10-year generic yield around 145bps above last year's historical low to about 1.9% (165bps to Germany) at time of writing. Italy's average cost of the existing debt portfolio has been cut over the years to around 2%, from circa 5% as of 2008. The Bank of Italy holds 24.9% of Italian government debt as of November 2021, with 70% of debt held via the resident sector (as of October 2021). These aspects ease risk from elevated annual government financing requirements.

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

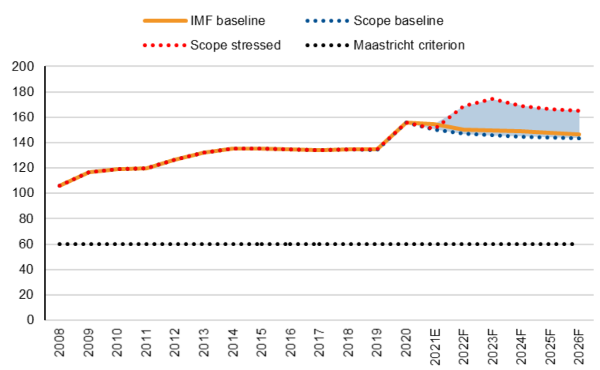
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Fiscal policy framework	Weak	-1/3	Expectation of budget deficits and an expansionary fiscal stance over the coming years, EU fiscal framework in state of transition
	Debt sustainability	Weak	-1/3	Elevated debt stock vulnerable 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, moderate financing costs but significant financing requirements

Contributions to changes in debt levels, pps of GDP



Source: IMF, Scope Ratings GmbH forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

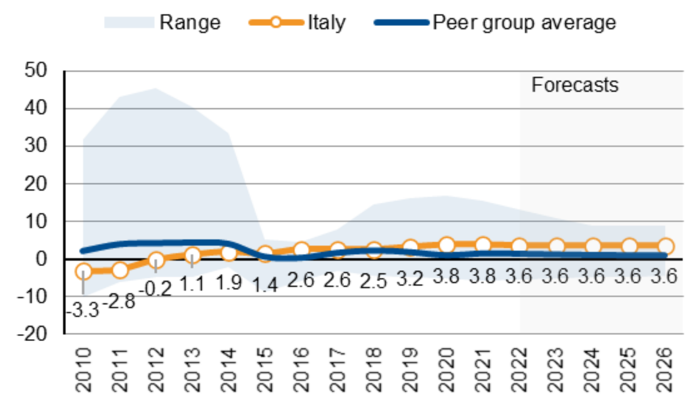
External Economic Risks

- **Current account:** The Italian economy's current-account balance has been in surplus since year 2013, sustained by elevated surpluses of goods and primary-income balances that (more than) offset a deficit of the secondary-income balance. The services balance worsened modestly during 2020, due to adverse effects of the crisis on tourism receipts. More recently, exports have been recovering, with the current account remaining in sizeable surplus, despite a worsening energy balance, of 3.8% of GDP in a year to Q3 2021. The current account is expected to remain in surplus of above 3% of GDP over the medium run.
- **External position:** Italy has a comparatively moderate external debt stock vis-à-vis euro area peer economies, of 138% of GDP, although with this ratio on an overall increasing trend over the past decades. The largest segment (circa 60% of an aggregate) refers to external debt of the government and central bank. Short-term external debt accounts for 39% of an aggregate. After entering a net asset position during Q3 2020, the net creditor position of the Italian economy has strengthened further since this time, to 6.1% of GDP by Q3 2021 – supporting resilience against adverse external shocks.
- **Resilience to external shocks:** Italy, alongside other euro area member states, benefits from the euro's status as an international reserve currency, easing risk from currency sell-off and sudden-stops of capital flows. In 2020, 23% of outstanding international debt securities, 26% of international loans as well as 25% of international deposits were denominated in euro, with the euro being the second most used currency in this respect internationally (after the US dollar). However, a Target-II balance of Italy reached a low of -34% of GDP in December 2021, from circa -21% of GDP entering the Covid-19 crisis.

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

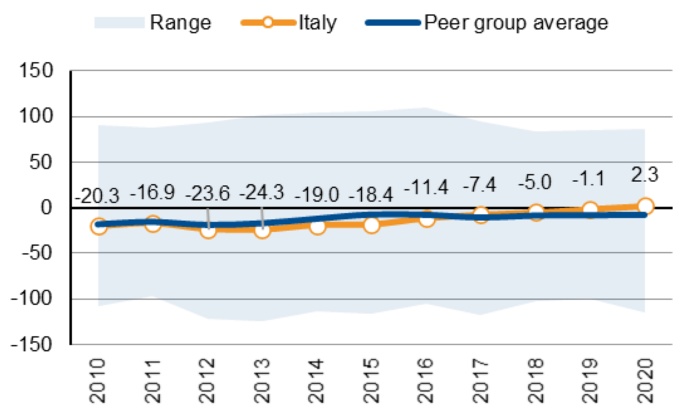
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Current account resilience	Neutral	0	Diversified and competitive export base, track record of current-account surpluses
	External debt structure	Neutral	0	Low external debt stock, composition by sector and maturity similar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

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

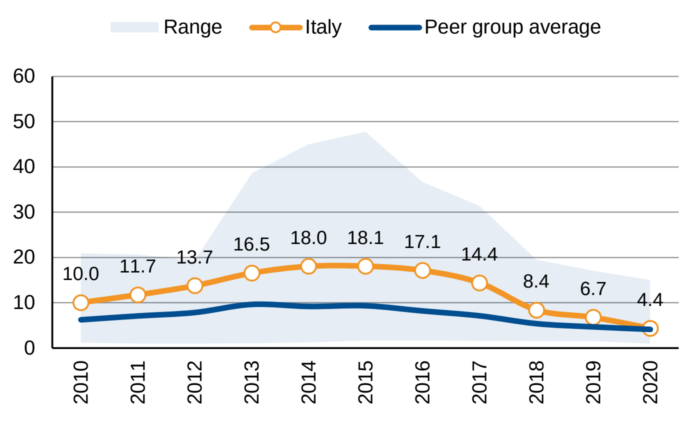
Financial Stability Risks

- **Banking sector:** Over an initial 3Q of 2021, banking-system profitability improved, after reduction of loan loss provisioning. Return on equity stood at 7.9% by Q3 2021. Furthermore, the non-performing loan (NPL) ratio has declined to historical lows (3.6%), albeit still above a euro-area average (2.1%), as disposal of non-performing loans continues. The phasing out of loan moratoria for small and medium-sized enterprises is continuing and, by end-2021, an aggregate amount was 17% of a sum granted from March 2020. Capital ratios among significant banking groups have modestly declined, after relaxation of dividend distribution limits; nevertheless, system-wide capital adequacy remains within regulatory limits, with regulatory tier 1 ratios of 16.4% of risk-weighted assets as of Q3 2021 – above a pre-crisis (level of) 14.9%. On the whole, Italian banks performed poorly on 2021 European Banking Authority stress examinations, however, with systemic banks each coming in under a 10% capitalisation mark. Bank holdings of government bonds remain elevated.
- **Private debt:** Non-financial private-sector debt as share of GDP declined modestly over second and third quarters of 2021, to 117.1% (from 122.5% as of Q1 2021). Loan growth to non-financial corporates during 2021 stayed weak (-0.5% YoY as of Q4 2021), given low demand for new loans amid ample liquidity accumulated over the past years, although loan growth was more robust in the household sector (+3.5% YoY), especially with respect to home purchasing. Overall, credit conditions remain favourable.
- **Financial imbalances:** Uncertainty surrounding the economic recovery, spread of an Omicron variant as well as ECB contemplation of a more accelerated removal of accommodative monetary policy have affected Italian capital markets since the last months of 2021, with an increase of sovereign yield spreads as well as volatility in equity indices. Nevertheless, financing conditions remain moderate under historical standards, while economic agents are supported via abundant liquidity and a recovering economy. Recovery of the real estate market (price growth of existing dwellings of 4.2% YoY as of Q3 2021, although prices remain 20% under 2011 highs) continues in line with economic conditions, with limited financial-stability risk.

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

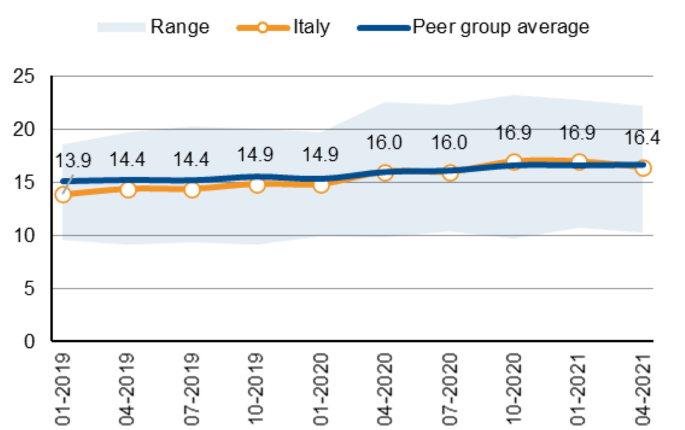
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Banking sector performance	Weak	-1/3	Sovereign-banking nexus remains core risk; weak performance of Italian banks under stress examination despite improved fundamentals
	Banking sector oversight	Neutral	0	Effective oversight 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

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Regulatory tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

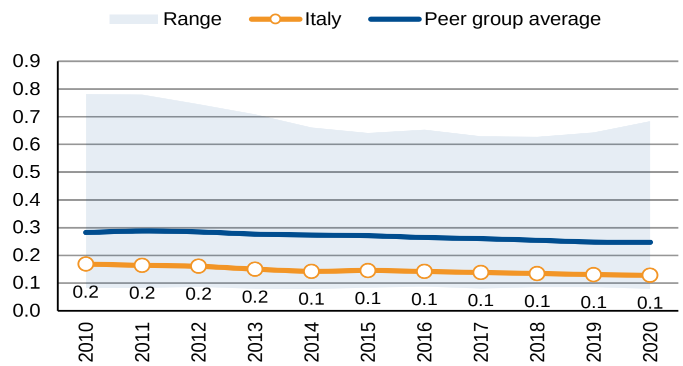
ESG Risks

- **Environment:** Italy compares well in terms of the economy's carbon emissions intensity against that of European peer economies, despite a slower pace of emissions reduction over a past thirty years. Italy is in line with EU peers with respect to shares of renewable energy in aggregate consumption (20%) and among economies with the *lowest* energy intensity. Enhanced investment is required to achieve ambitious 2030 emissions-cut, renewable-energy and energy-efficiency objectives under the National Energy and Climate Plan, as well as climate change mitigation objectives, with Italy being vulnerable to climate-change-related and environmental hazards such as earthquakes, floods, volcanic eruption and wildfire. The government is advancing environmental sustainability in budgeting and issued last year a first BTP Green, while 37% of Recovery Plan allocations are dedicated to the green transition.
- **Social:** Social-risk factors are elevated, partially a reflect of adverse demographic evolution, such as the second highest old-age dependency ratio of the euro area (37%). Income inequality, while modest under international comparison, is among the highest of the euro area, resulting in elevated risk of poverty, including of in-work poverty. In addition, labour force participation, of around 65% of the active labour force, is the lowest of the euro area and reflects elevated undeclared work. High labour force inactivity rates are furthermore present among youth segments, resulting in an elevated ratio of NEETs (Not in Education, Employment, or Trainings), of 23%. The share of the population with tertiary education is under 20%.
- **Governance:** Italy ranks below a 70th percentile under World Bank Worldwide Governance Indicators with respect to institutional strength. The Mario Draghi administration is currently, however, advancing an ambitious agenda of reform, such as with respect to the public administration, judiciary, budgeting and pensions. Risk of fresh confrontation with the European Union are presently eased via an ample majority of a government of national unity, also abetted via front-loading of significant policymaking priorities to a 2021-23 window of the Prime Minister's minimum window in office. Recent re-election of President Sergio Mattarella as Head of State supports government stability over a longer horizon, although political uncertainty is set to escalate over the coming months ahead of 2023 general elections.

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

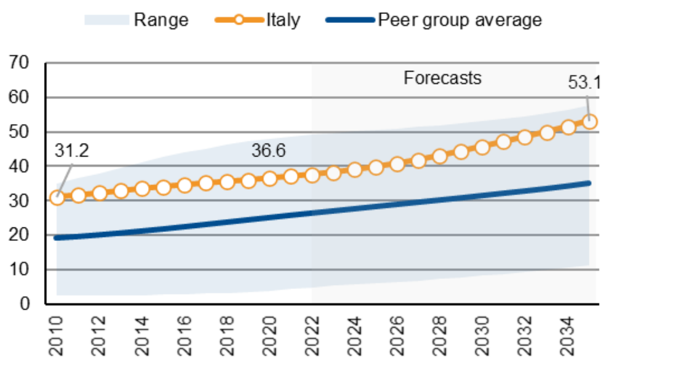
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Environmental risks	Neutral	0	Exposure to natural disaster risk; ambitious ecological transition investment programme
	Social risks	Weak	-1/3	Adverse demographics, moderate educational outcomes, risk of social exclusion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

CO_2 emissions per GDP, $mtCO_2e$



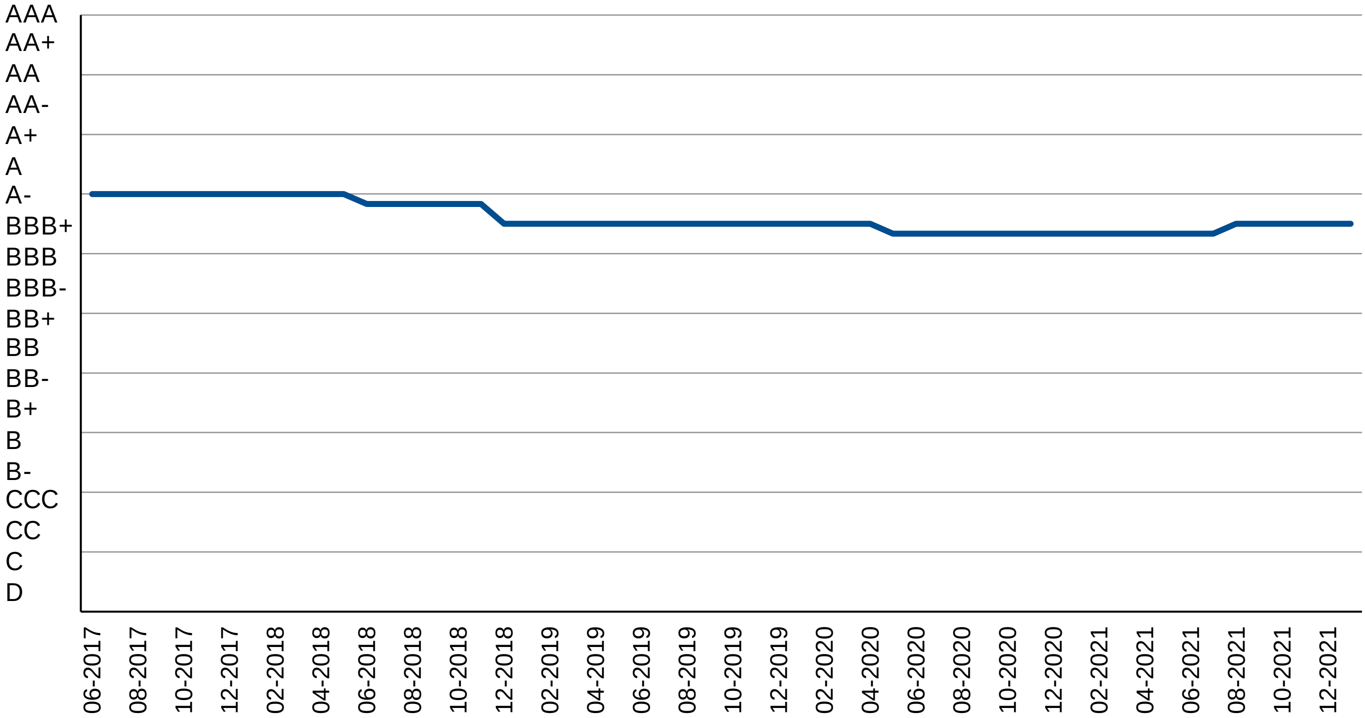
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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 after the reserve-currency adjustment.

Peer group
Spain
Portugal
France
Malta
Slovakia
Bulgaria
Hungary
Romania
Russia
China
Japan

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 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk							
GDP per capita, USD '000s	32.6	34.9	33.5	31.6	35.6	38.2	39.8
Nominal GDP, USD bn	1,961.1	2,093.1	2,005.1	1,884.9	2,120.2	2,272.3	2,369.7
Real growth, %[1]	1.7	0.9	0.3	-8.9	6.5	4.1	1.9
CPI inflation, %[1]	1.3	1.2	0.6	-0.1	1.9	3.5	1.7
Unemployment rate, %[1]	11.3	10.7	10.0	9.3	9.5	8.6	8.0
Public Finance Risk							
Public debt, % of GDP[1]	134.2	134.4	134.3	155.6	150.4	146.8	145.5
Net interest payment, % of government revenue	7.8	7.5	6.8	6.9	6.6	6.2	5.9
Primary balance, % of GDP[1]	1.4	1.5	1.8	-6.1	-2.3	-1.8	-0.6
External Economic Risk							
Current account balance, % of GDP[1]	2.6	2.5	3.2	3.8	3.8	3.6	3.6
Total reserves, months of imports	2.9	2.7	3.3	4.7	-	-	-
NIIP, % of GDP	-7.4	-5.0	-1.1	2.3	-	-	-
Financial Stability Risk							
NPL ratio, % of total loans	14.4	8.4	6.7	4.4	-	-	-
Tier 1 ratio, % of risk-weighted assets	14.3	13.9	14.9	16.9	16.4	-	-
Credit to private sector, % of GDP	80.8	76.7	74.1	83.5	-	-	-
ESG Risk							
CO_2 per EUR 1,000 of GDP, mtCO_2e	138.0	134.6	130.5	127.9	-	-	-
Income quintile share ratio (S80/S20), x	7.0	-	-	-	-	-	-
Labour-force participation rate, %	65.4	65.6	65.7	-	-	-	-
Old-age dependency ratio, %	35.1	35.6	36.1	36.6	37.1	37.7	38.3
Composite governance indicator[2]	0.5	0.5	0.6	0.5	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of six World Bank Worldwide Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 11 February 2022	103

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 8295 8254

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer