Italian Republic
Rating Report

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
- Labour market rigidities
- Challenging demographic trends

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 1.9trn 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 (9.4% 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 position, together with the euro's status as a global reserve currency, shields 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) labour-market rigidities; and iv) an ageing and declining working-age population.

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		0	
ESG Risk	Environmental Factors	5%	b+		0	
	Social Factors	7.5%	ccc		-1/3	
	Governance Factors	12.5%	bb+		-1/3	
Indicative outcome			a-		**-1**	
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 over the next 12 to 18 months.

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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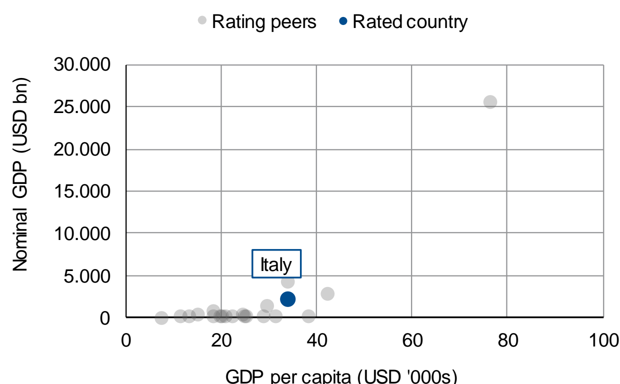
Domestic Economic Risks

- **Growth outlook:** The Italian economy grew robustly by 7.0% in 2021 and 3.7% in 2022, outperforming the euro area. Private consumption was the main driver – supported by households' savings and government support measures – together with a strong investment activity. After a small contraction in Q4 2022, domestic demand continued to support robust economic growth in Q1 2023 (0.6% QoQ). We expect economic growth of 1.2% this year, followed by 0.8% in 2024, balancing still resilient consumption and the contribution from net exports with the expected drag on growth from higher interest rates, particularly on investment. Over the medium-run, we expect growth to converge towards a moderate potential of just 1%, constrained by low productivity growth and a declining working-age population. An efficient implementation of public investments and reforms related to the NGEU programme provides potential upside to our growth estimate, but execution delays remain a key downside risk.
- **Inflation and monetary policy:** HICP inflation peaked at 12.6% YoY in November 2022 and averaged 8.7% over the past year. With decline of energy and food prices, headline inflation fell to 6.7% YoY in June 2023. Inflationary pressures, however, started to feed into other goods and service prices, pushing core inflation up to a peak of 7.0% in February 2023, which then declined to 6.0% YoY in June. We expect headline inflation to continue to decline to an annual rate of 6.5% this year and 3% in 2024. The ECB has accelerated monetary tightening and raised its policy rate to 3.5% in June 2023. Further rate hikes of at least 25bps are likely this year, together with a gradual reduction of the central banks' balance sheet, 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:** The Italian labour market has proved resilient to the recent crises, reflecting some structural improvements. Employment and participation rates were at record high levels in May 2023 (61.2% and 66.3%, respectively), while the unemployment rate continued to decline to 7.6%. Despite such improving trends, bottlenecks remain, which still result in an employment rate almost 10pp below that of euro area peers, as well as in 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 resilient economic outlook, we expect the unemployment rate to remain broadly stable, averaging 7.7% in 2023-24.

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

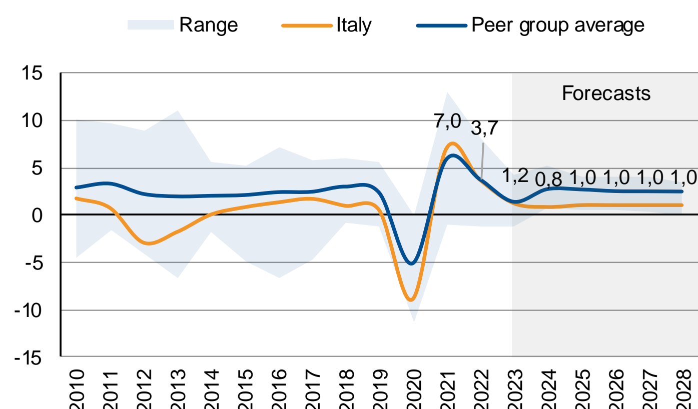
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Growth potential of the economy	Weak	-1/3	Weak growth potential
	Monetary policy framework	Strong	+1/3	ECB is a credible and effective central bank over the cycle
	Macro-economic stability and sustainability	Neutral	0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

Nominal GDP and GDP per capita, USD



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

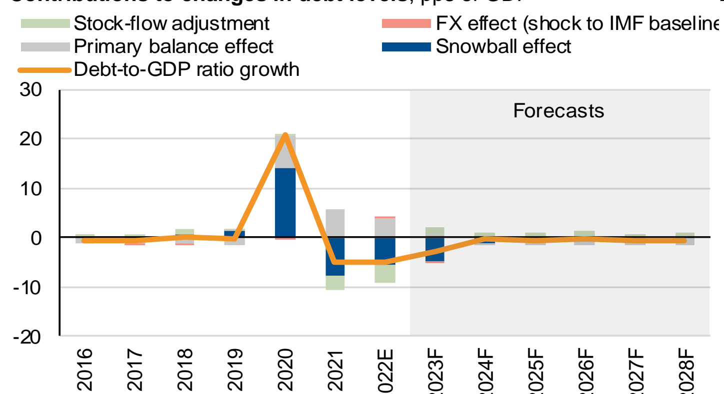
Public Finance Risks

- **Fiscal outlook:** The accounting reclassification of tax credits for building renovations led to significant revisions in the budget deficits, with a deficit of 8.0% of GDP in 2022, after 9.0% in 2021 and 9.7% in 2020. We expect the deficit to decline to about 4.5% of GDP this year, before converging to around 3% of GDP over 2025-28. The consolidation path is underpinned by the government's prudent approach to fiscal policy so far and facilitated by the likely reduction in support measures that helped mitigate the effects of the energy and inflation shock on households and businesses. Still, the required fiscal effort to ensure compliance with the likely re-instated 3% deficit criteria, is substantial, resulting in the need to maintain primary surpluses in the coming years of at least 1.5% of GDP. This also reflects the rising interest burden, which is likely to exceed 4.5% of GDP by 2026. Public investment, boosted by EU and national funding, should remain above 3.5% of GDP over 2023-2026, up from 2.3% over 2015-2019.
- **Debt trajectory:** The public debt-to-GDP ratio declined by over 10pp in the past two years, to 144.4% in 2022, mostly thanks to strong nominal GDP growth and gradually declining government net borrowing needs (in cash terms). We expect the debt ratio to further decline to about 141.7% of GDP this year and to broadly stabilise around 140% by 2028. We assume no severe interruptions in economic growth, gradually declining inflation, an improving primary balance and a gradual increase in interest expenditure to around 4.5% of GDP. 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:** Italy's average debt maturity is long, just below seven years by June 2023, spreading the impact of higher financing costs. The 10-year government bond yield stabilised around 4.2% on average in H1 2023, down from the peak of 4.7% at the end of 2022. The Treasury's average cost at issuance rose to 3.5% in June 2023 (1.7% in 2022), although the average cost of debt should decline to 2.8% in 2023 (3.1% in 2022) thanks to lower servicing costs for the large share of linkers (11.6% of outstanding securities). High borrowing needs and active liquidity management led to a decline in cash holdings to EUR 20-40bn since the beginning of 2023. The Treasury benefits from a large and diversified investor base, including a solid pool of domestic investors (over 70% of total), while over 30% of outstanding securities are held by the Eurosystem via the Bank of Italy. Strong demand in bond markets despite the withdrawal of the ECB's QE programmes underpins favourable financing conditions, reflected in narrower yield spreads to German securities. These aspects ease risks stemming from the elevated annual funding needs, which we expect at around 25% of GDP over the coming years.

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

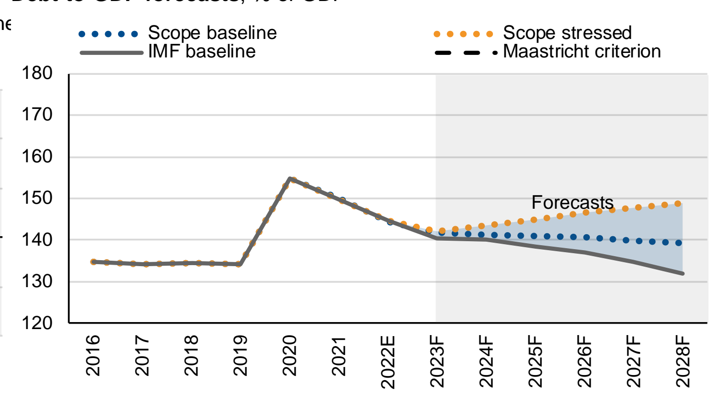
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Fiscal policy framework	Weak	-1/3	Expectation of gradual return to primary surplus; very limited fiscal space; EU fiscal framework in transition
	Debt sustainability	Weak	-1/3	High debt stock vulnerable to permanent increases during shocks; high off-balance sheet debt; rising ageing-related and interest 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

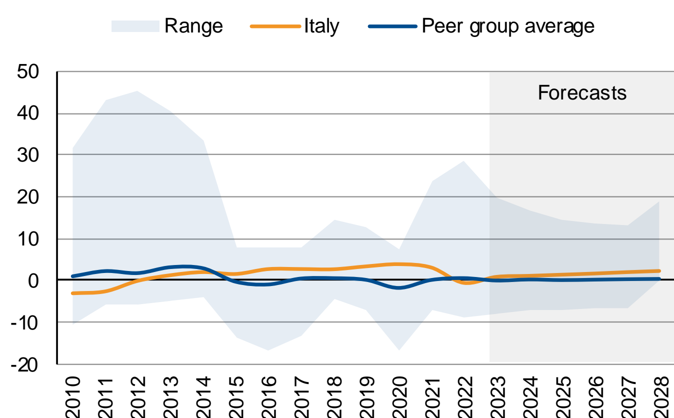
- **Current account:** Italy has recorded annual current account surpluses since 2013. High surpluses of goods and primary-income balances have more than offset deficits in the secondary-income balance. The current account remained resilient also in 2020 and 2021, despite the decline in tourism exports and supply chain bottlenecks, but turned negative in 2022, at -1.4% 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 support the recovery in the current account set to return to a surplus position over the coming years.
- **External position:** Italy has a moderate external debt stock compared with euro area peer economies, at 129% of GDP as of Q1 2023. The largest shares are owed by the government and the central bank (28% and 29% of total respectively, as of Q1 2023). Short-term external debt is moderate, accounting for about 46% of total debt. Foreign investors have been reducing their exposure to Italian portfolio securities in 2022, especially related to the government sector. However, according to the Bank of Italy, foreign direct investment has seen an expansion.

  In recent months, non-resident holdings of Italian government securities have stabilised, though total net sales since the peak in July 2021 are significant (EUR 128bn). Italy's net international investment position has slightly declined to 3.5% of GDP in Q1 2023 from 8.3% in Q4 2021 but remains an important buffer 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. The negative Target II balance of Italy has gradually declined in recent months, down to EUR 623bn in May 2023, from the peak of EUR 715bn in September 2022.

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

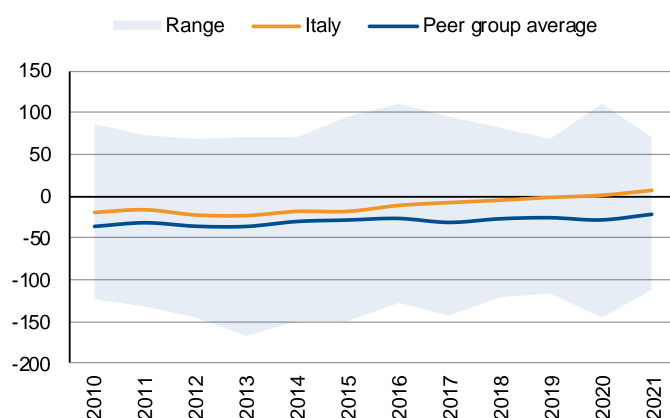
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Diversified and competitive export base; record of current-account surpluses
	External debt structure	Neutral	0	Low external debt stock; composition by sector and maturity similar 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

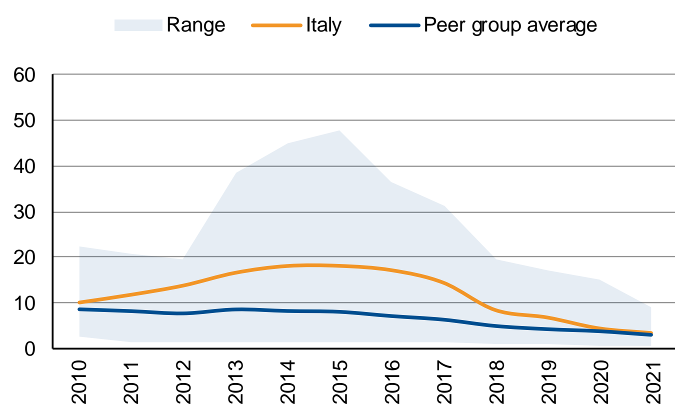
Financial Stability Risks

- **Banking sector:** The banking system's profitability improved in 2022, with the ROE reaching 9.2% in Q4, up from 5.6% the year before, and outperforming the EU average, driven by an increase in net interest income due to higher interest rates. The non-performing loan ratio reached a historical low (2.4% as of Q4 2022) but remains above the euro-area average (1.8%), thanks to continuous sales of non-performing exposures and the application of loan moratoriums. The capital position improved both for significant banks, mostly due to an increase in RWAs, and less significant banks due to higher profit reserves and lower intangible assets. This was reflected in a system-wide Tier 1 ratio of 17.3% as of Q4 2022, above pre-Covid levels. Italian banks' holdings of government bonds remain elevated. However, banks also benefit from solid liquidity positions, which should protect them from potential episode of heightened global volatility.
- **Private debt:** Private-sector debt remains moderate against euro area peers and further declined to 107.7% of GDP in Q1 2023, below pre-Covid-19 levels. This comprises household debt of 40.7% of GDP (Euro area: 57.4% as of Q4 2022) and non-financial corporations' debt of 66.9% of GDP (Euro area: 104.9%). Tighter financing conditions are gradually affecting corporate lending, which however continued to grow in Q1 2023 by 0.2% YoY (1.0% in Q4 2022). Loans to households continued to grow as well, though similarly at a more moderate pace (1.7% YoY vs 3.0% in Q4 2022). We expect the slowdown in lending to continue in the coming months as the impact of higher interest rates becomes more visible.
- **Financial imbalances:** Heightened geopolitical tensions, an economic slowdown, the rapid normalisation of monetary policies and the recent tensions in the international banking sector have resulted in higher sovereign bond yields and significant volatility in equities in the past months. Nevertheless, financial stability risks in Italy are mitigated by Italian banks' solid balance sheet position and low private indebtedness. Real estate price dynamics started to show some signs of slowdown since the second half of 2022, consistent with the tightening of financing conditions, reflected in lower price growth (1.1% YoY in Q1 2023, against 5.2% in Q2 2022, before the first hike in the ECB policy rates). The volume of real estate transactions started declining YoY in Q3 2022.

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

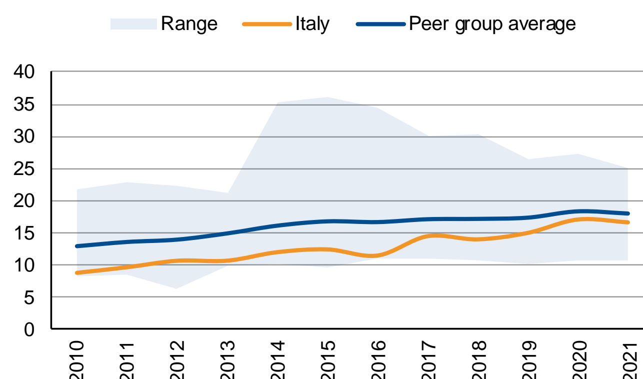
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Solid capital buffers, high liquidity and improved profitability; sovereign-bank nexus remains a core risk
	Banking sector oversight	Neutral	0	Effective oversight under European Banking Union and the Bank of Italy
	Financial imbalances	Neutral	0	Low private-sector indebtedness; declining 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

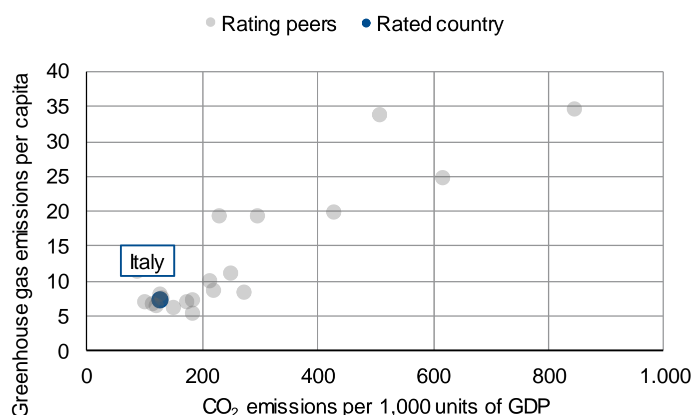
ESG Risks

- **Environment:** Italy's economy has one of the lowest carbon emission intensity levels among European peers, despite a slower pace in emission reduction over the past 30 years. The country's share of energy from renewable sources lags EU peers (19% against 22% in 2021). As of 2021, Italy's energy mix was still heavily reliant on gas and oil (over 75%), with the share of gas being much higher than the EU average (41% vs 24%). Italy has significantly diversified its gas import sources Russia's war in Ukraine, reducing its reliance on Russian gas to around 10% of total, from about 40% before the war. Italy will need significant further investments to achieve its ambitious 2030 goals to cut emissions and boost renewable energy and energy efficiency under its National Energy and Climate Plan, as well as to mitigate the effects of climate crises, given the country's high exposure 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 highest old-age dependency ratio in the euro area (37.5%). Income inequality, while modest under an international comparison, is high compared to 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 65.5% of the working-age population, which also reflects a high rate of undeclared work. Labour force inactivity is high among youth and women, with 16.6% of NEETs (Not in Education, Employment, or Trainings).
- **Governance:** While Italy has a strong governance system with institutional checks and balances in place, its highly fragmented political environment leads to frequent episodes of instability. However, 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 comfortable parliamentary majority with 228 out of 400 seats, which should support stability and governability in the near term. The prospects of significant inflows of conditional EU funding over the coming years is likely to incentivise continuity with the reform agenda agreed with the European Commission.

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

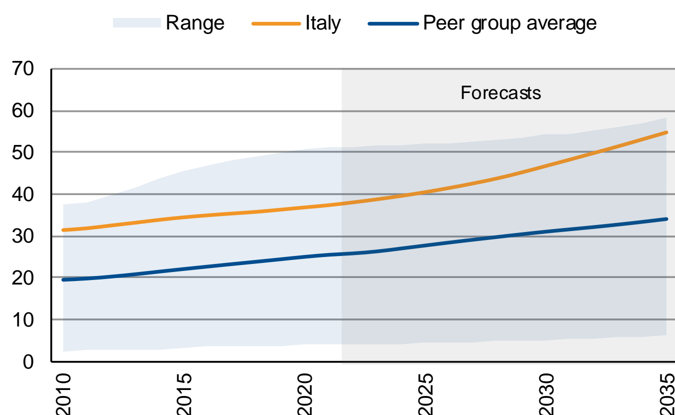
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b+	Environmental factors	Neutral	0	Exposure to natural disaster risk; ambitious green transition investment programme
	Social factors	Weak	-1/3	Adverse demographics, moderate educational outcomes, risk of social exclusion
	Governance factors	Weak	-1/3	Fragmented political environment leading to frequent episodes of political instability; government has clear parliamentary majority

Emissions per GDP and per capita, $mtCO_2e$



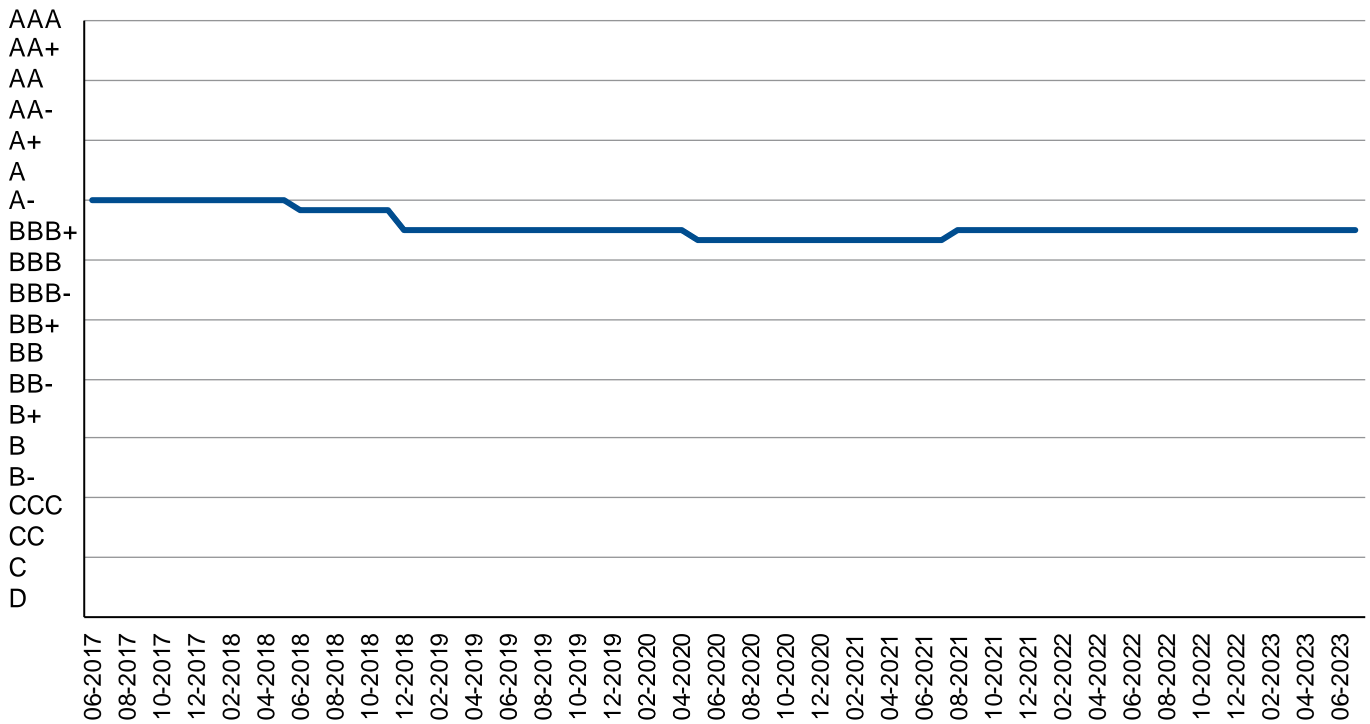
Source: European Commission, Scope Ratings

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*
Bulgaria
Croatia
Cyprus
Estonia
France
Japan
Latvia
Lithuania
Poland
Portugal
Slovakia
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	2018	2019	2020	2021	2022	2023
Domestic Economic	GDP per capita, USD '000s	IMF	34.9	33.6	31.8	35.8	34.1	36.8
	Nominal GDP, USD bn	IMF	2,092.9	2,011.5	1,895.7	2,115.8	2,012.0	2,169.7
	Real growth, %	IMF	0.9	0.5	-9.0	7.0	3.7	0.7
	CPI inflation, %	IMF	1.2	0.6	-0.1	1.9	8.7	4.5
	Unemployment rate, %	WB	10.6	10.0	9.2	9.5	8.1	-
Public Finance	Public debt, % of GDP	IMF	134.4	134.1	154.9	149.8	144.7	140.3
	Net interest payment, % of revenue	IMF	7.5	6.8	6.9	7.0	8.6	8.2
	Primary balance, % of GDP	IMF	1.3	1.7	-6.4	-5.6	-3.8	0.4
External Economic	Current-account balance, % of GDP	IMF	2.6	3.3	3.9	3.0	-0.7	0.7
	Total reserves, months of imports	WB	2.7	3.3	4.7	3.9	3.2	-
	NIIP, % of GDP	IMF	-5.0	-1.5	1.6	8.0	3.9	-
Financial Stability	NPL ratio, % of total loans	IMF	8.4	6.7	4.4	3.3	2.8	-
	Tier 1 ratio, % of risk-weighted assets	IMF	14.3	13.9	14.9	16.9	16.5	-
	Credit to the private sector, % of GDP	WB	76.7	73.7	83.1	78.3	-	-
ESG	CO_2 per EUR 1,000 of GDP, $mtCO_2e$	EC	134.8	130.9	127.1	129.1	-	-
	Income share of bottom 50%, %	WID	16.4	16.5	16.6	16.6	-	-
	Labour-force participation rate, %	WB	66.0	66.1	64.4	64.7	-	-
	Old-age dependency ratio, %	UN	35.6	36.1	36.7	37.2	37.9	38.6
	Composite governance indicators*	WB	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 July 14, 2023	89.33

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