# Italian Republic
## Rating Report

SCOPE BBB+ STABLE OUTLOOK

| Credit strengths | Credit challenges |
|---|---|
| Systemic importance for EU and EA | High public debt and funding needs |
| Large, wealthy and diversified economy | Weak long-run economic growth |
| Strong external position | Challenging demographic trends |
| Low private-sector debt | Labour market rigidities |
| Favourable debt structure | Political uncertainty |

## 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, together with improvements in its net international *asset* position, 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:** The moderate private debt levels among Italian non-financial corporates and households support financial system stability and reduce the risk of private sector liabilities materialising on the government's balance sheet.

**Favourable debt structure:** Only 30% of public debt is held by non-residents, the average cost of debt is low (2.5%), average debt maturity is long (7 years) and the cash buffer is high (EUR 80bn).

**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 uncertainty weighing on the recent reform momentum.

**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% | aaa | | 0 | |
| 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 | BBB+ |
| | 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. In line with our methodology, movements between indicative ratings are not immediate but are executed after analyst review of CVS results. The rating committee approved a core variable scorecard (CVS) rating of 'a-'. 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 | Negative rating-change drivers |
|---|---|
| Debt-to-GDP remains on a firm downward trajectory | Reduced support from European institutions |
| Effective public investment and reform implementation result in further upside for nominal economic growth potential | 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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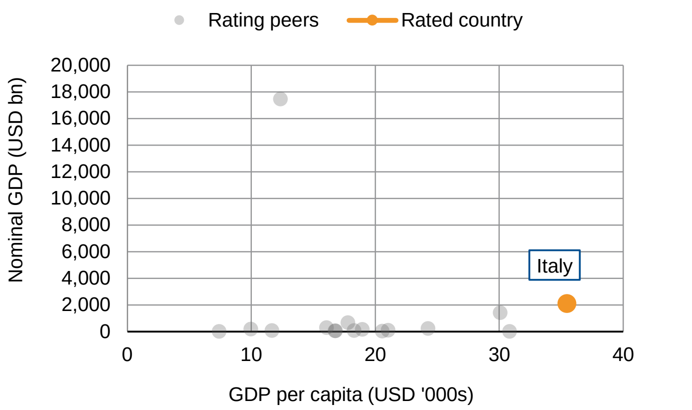
## Domestic Economic Risks

- **Growth outlook:** The Italian economy has rebounded strongly from the Covid-19 crisis, growing 6.6% last year after contracting by 9% in 2020. This was driven by recovering domestic consumption, robust net exports and resilient investment, which will continue to benefit from EUR 191.5bn in Next Generation EU funds allocated to Italy over the next years. In Q1 2022, economic growth continued, albeit modestly (0.1% QoQ), and retained strong momentum in Q2. Still, high inflation and the energy price shock pose downside risks to the outlook in the second half of this year, also given Italy's heavy reliance on Russian gas. We expect economic growth of 3% this year (revised from about 4% before the Russia-Ukraine war) and 1.5% in 2023. We also forecast growth to slow over the next five years to just 1%, constrained by stagnating productivity and a declining working-age population.
- **Inflation and monetary policy:** Inflation continued to increase over the past months, reaching 8% in June, from 4.8% in January, driven mostly by energy prices. Core inflation also rose by 2.3pp to 3.8% from January, despite moderate wage growth. Supply-side costs are likely to remain elevated throughout 2022, with inflation expected to average above 7% this year before falling to about 3% in 2023 and 2% in 2024. Given similar price dynamics in the euro area, the ECB is accelerating monetary tightening, with its first 50bp policy rate hike implemented this month after it halted net asset purchases under its quantitative easing programmes. Financing conditions should, however, remain broadly favourable and benefit from higher stability also supported by the ECB's recently announced Transmission Protection Instrument.
- **Labour markets:** Despite recent improvements, structural bottlenecks in the labour market are resulting in a very low employment rate (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 result in young, highly qualified workers to emigrate, adversely affecting productivity. Given the economic recovery, unemployment gradually fell to 8.1% in May 2022, from 9% in December last year. We expect the unemployment rate to average 8.3% in 2022 and decline to 8.1% in 2023.

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

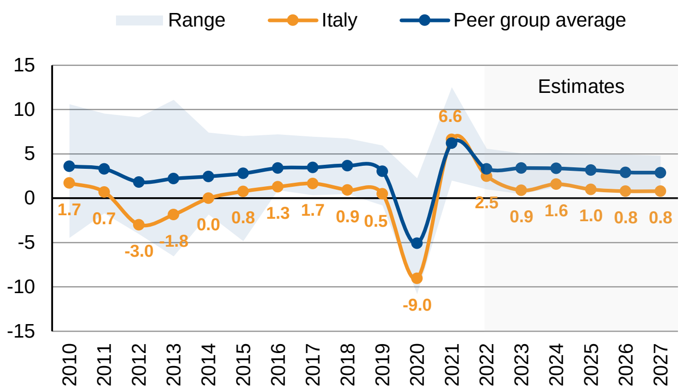
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aaa | Growth potential of the economy | Weak | -1/3 | Weak growth potential |
| | Monetary policy framework | Strong | +1/3 | ECB is a credible and effective central bank |
| | Macro-economic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

**Nominal GDP and GDP per capita**, USD '000s




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

**Real GDP growth**, %




Source: IMF WEO, Scope Ratings forecasts

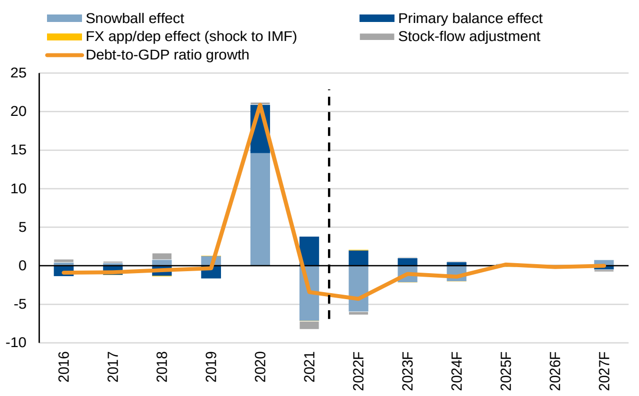
## Public Finance Risks

- **Fiscal outlook:** Italy's long record of primary surpluses was interrupted during the Covid-19 crisis. Fiscal performance started recovering last year, with solid government revenue growth and contained expenditure pushing the fiscal deficit to 7.2% of GDP in 2021 from 9.6% in 2020. We expect the deficit to further decline to 5.5% of GDP this year and 4.7% in 2023, reflecting a robust recovery in government revenue, the phase-out of Covid support measures, and fiscal prudence regarding support measures to dampen the effects of the energy crisis. In the longer run, we expect a primary balance by 2025-26 and a higher interest burden to keep the headline deficit at around 3.5% of GDP over the medium term. Public investment, boosted by EU and national funding under the Recovery and Resilience Plan, should remain above 3.5% of GDP over 2023-2025, up from 2.3% on average in 2015-2019.
- **Debt trajectory:** The public debt-to-GDP ratio declined by 5pp in 2021 to 150.8% of GDP, thanks to the economic rebound and a recovering government balance following the pandemic shock, which in 2020 caused the ratio to increase significantly by more than 20pp. We project the ratio to reduce to 146.6% for end-2022 before declining slightly to around 144% by 2027. We assume no severe interruptions in economic growth, higher but gradually declining inflation, an improving primary balance and a moderate increase in interest expenditure as debt is gradually rolled over at a higher cost. Over the long run, Italy's debt trajectory is challenged by its weak growth outlook and rising fiscal pressures from a rapidly ageing population. Until end-2050, the IMF estimates a cumulative increase in healthcare and pension spending of a net present value of 60% of GDP. Public guarantees also constitute a contingent risk to the sovereign balance sheet, accounting for 15.9% of GDP by end-2021, up from 13% in 2020.
- **Debt profile and market access:** Debt maturities averaged 7.1 years in June 2022, broadly unchanged since 2021. Italy has already implemented more than 55% of its medium- to long-term funding planned until 2022, with funding conditions remaining favourable despite the significant increase in financing costs (10-year bond yield at 3.3% at the moment of writing, up from a record low of 0.6% last year). The cash position remains very solid at EUR 85bn as of June. More than 25% of total debt is held by the Eurosystem via the Bank of Italy. All these aspects ease risks stemming from the elevated annual funding needs, expected to remain above 25% of GDP over the coming years.

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

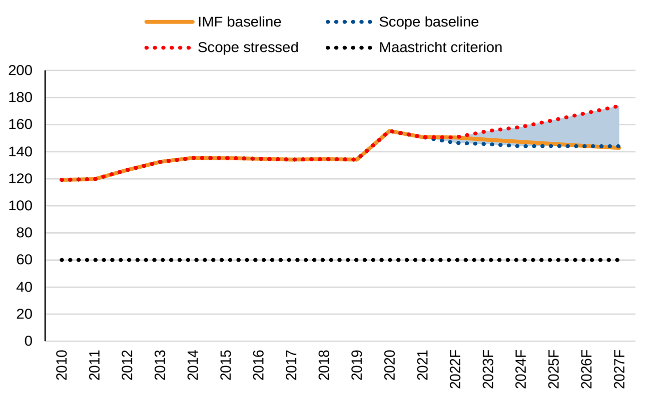
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| bb+ | Fiscal policy framework | Weak | -1/3 | Expectation of gradual return to primary balance only by 2026; EU fiscal framework in transition |
| | Debt sustainability | Weak | -1/3 | 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**, pp of GDP




Source: IMF WEO, Scope Ratings forecasts

**Debt-to-GDP forecasts**, % of GDP




Source: IMF WEO, Scope Ratings forecasts

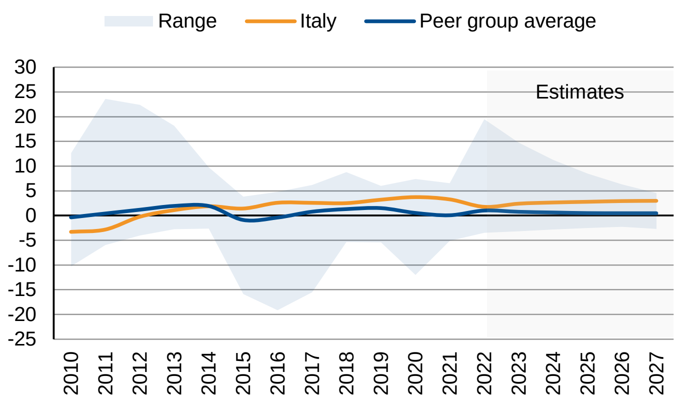
## External Economic Risks

- **Current account:** Italy has kept its current account in surplus since 2013. High surpluses of goods and primary-income balances have more than offset the deficit of the secondary-income balance. In 2020, the services balance fell modestly due to the Covid-19 effect on tourism. In 2021, exports recovered strongly despite supply bottlenecks and a worsening energy balance, with the current account at a surplus of 2.4% of GDP. This year, given the significant energy price shock, we expect the current account to turn negative before recovering over the coming years.
- **External position:** Italy has a moderate external debt stock compared with euro area peer economies, at 137% of GDP at Q1 2022. The largest shares are owed by the government and the central bank (33% and 26% of total, respectively). Disinvestment of Italian public sector securities by foreign investors accelerated in H1 2022 amid increasing market volatility. Short-term external debt is moderate, accounting for about 40% of total debt. Italy's net international investment position strengthened further to 6.5% of GDP at Q1 2022 after reaching a net asset position in Q3 2020 for the first time in over a decade, supporting its resilience against adverse 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 widened to EUR 628bn in June 2022 from EUR 590bn in December 2021.

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

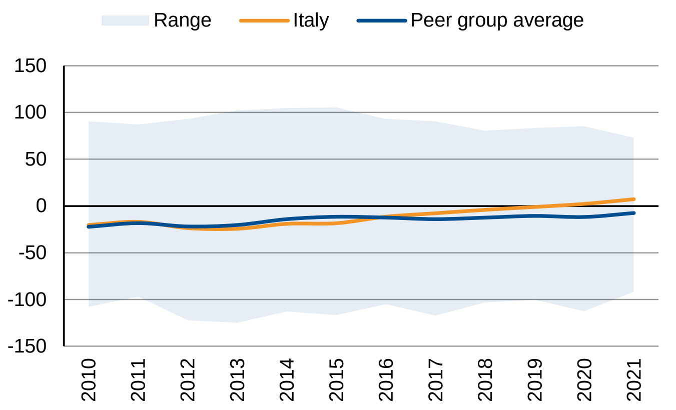
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aa | Current account resilience | Neutral | 0 | Diversified and competitive export base; record of current-account surpluses |
| | External debt structure | Neutral | 0 | Low external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

**Current account balance**, % of GDP




Source: IMF WEO, Scope Ratings GmbH

**Net international investment position**, % of GDP




Source: IMF, Scope Ratings GmbH

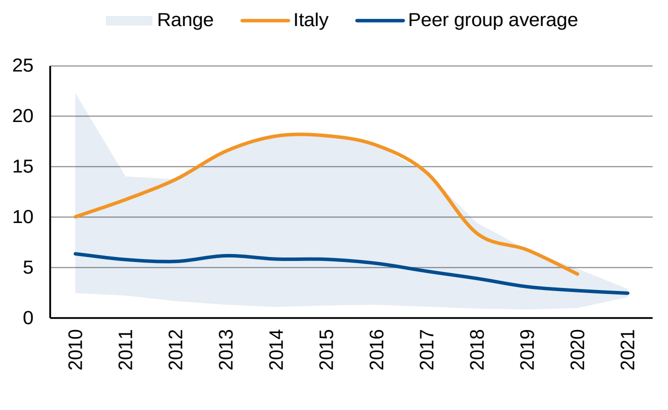
## Financial Stability Risks

- **Banking sector:** Banking system profitability improved in 2021 and recovered to pre-pandemic levels, with the return on equity peaking at 7.9% in Q3, reflecting a reduction in loan loss provisions. The non-performing loan ratio reached a historical low (3%) but remains above the euro-area average (1.9%), 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 16.1% of risk-weighted assets as of Q1 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 114.2% of GDP in Q1 2022, from 122.3% in Q1 2021, close to pre-Covid-19 levels. The balance comprises household debt of 43% of GDP and non-financial corporations' debt of 71% of GDP. Loans to corporates continued to shrink (down 0.6% YoY as of Q1 2022) due to less demand for new loans amid ample accumulated liquidity and solid cash flows supported by the economic recovery. At the same time, loans to households grew (up 3.7% YoY), largely driven by home purchases.
- **Financial imbalances:** An uncertain economic recovery and the expected monetary policy tightening by the ECB have affected Italian capital markets over the last months, seen 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 4.5% YoY as of Q4 2021 but remain 20% under 2011 highs), with limited financial stability risk.

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

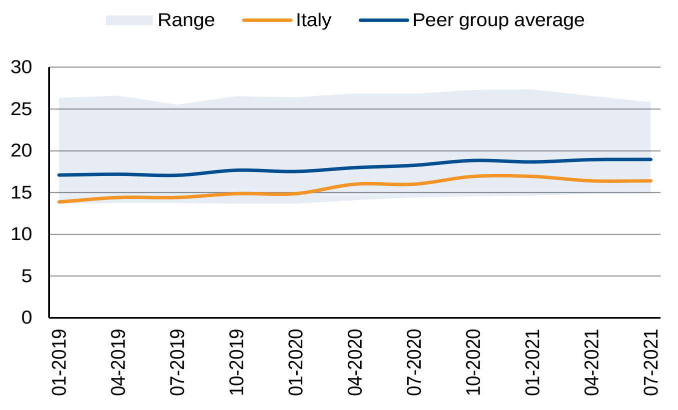
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aa+ | Banking sector performance | Weak | -1/3 | Sovereign-banking nexus remains core risk; weak performance of Italian banks under stress examination despite improved fundamentals |
|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

**Non-performing loans (NPLs)**, % of total loans




Source: World Bank, Scope Ratings GmbH

**Tier 1 ratio**, % of risk-weighted assets




Source: IMF, Scope Ratings GmbH

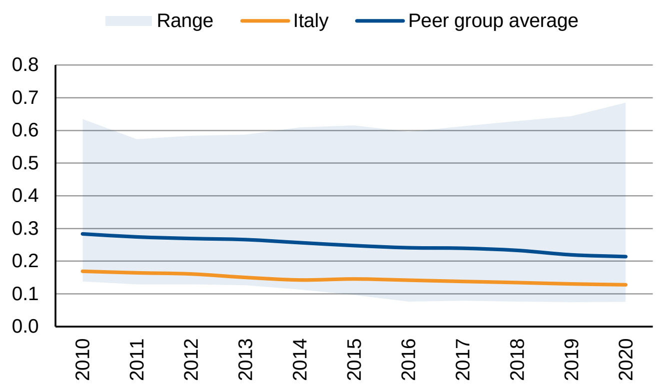
## ESG Risks

- **Environment:** Italy's economy is among the lowest of European peers for carbon emission intensity, despite being slower at reducing emissions over the past 30 years. Italy is also in line with EU peers for its share of renewable energy in aggregate consumption (20%). However, its energy consumption is dominated by gas and oil (over 75%). The share of gas in Italy's energy mix is much higher than the EU average (42% vs 24%). Moreover, the country imported 43% of its gas from Russia before the Russia-Ukraine war but is well on track to diversifying its gas sources. 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 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 22% of NEETs (Not in Education, Employment, or Trainings).
- **Governance:** The administration of Prime Minister Mario Draghi has been advancing ambitious reforms of the public administration, judiciary, taxation and competition under the national recovery and resilience programme. However, elevated political volatility and the upcoming snap elections scheduled for September 25 may now hinder these efforts. Still, the formation of a political majority that would reverse current policies is less likely given the high political fragmentation. The prospect of significant EU funds over the coming years will also incentivise all parties to broadly continue with the reforms agreed with the European Commission.

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

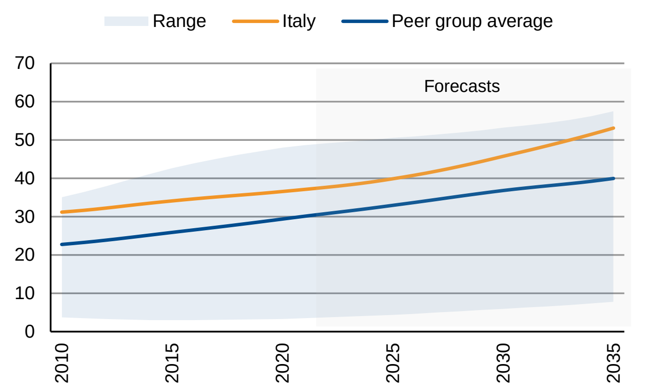
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| bb+ | Environmental risks | Neutral | 0 | Exposure to natural disaster risk; ambitious ecological transition investment programme |
| | Social risks | Weak | -1/3 | Adverse demographics, 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**, $mtCO_2e$



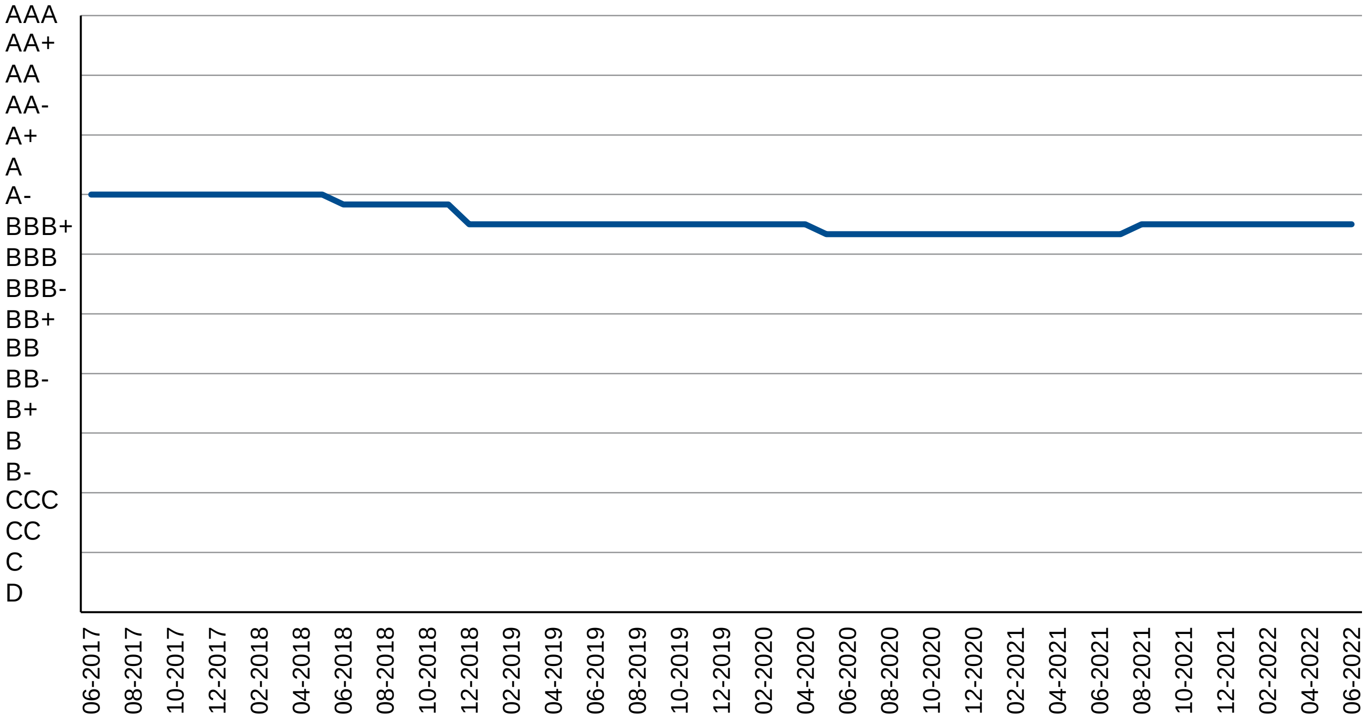

Source: European Commission, Scope Ratings GmbH

**Old-age dependency ratio**, %




Source: United Nations, Scope Ratings GmbH

## Appendix I. Rating history




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 embedding a methodological reserve-currency adjustment.

| Peer group* |
|---|
| Belgium |
| Czech Republic |
| Estonia |
| France |
| Italy |
| Japan |
| Latvia |
| Lithuania |
| Malta |
| Poland |
| Portugal |
| 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 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021E | 2022F | 2023F |
|---|---|---|---|---|---|---|---|---|
| **Domestic Economic Risk** | | | | | | | | |
| **GDP per capita, USD '000s** | 31.2 | 32.6 | 34.9 | 33.6 | 31.7 | 35.5 | 34.8 | 36.7 |
| **Nominal GDP, USD bn** | 1,876.6 | 1,961.1 | 2,092.9 | 2,011.5 | 1,891.1 | 2,101.3 | 2,058.3 | 2,169.4 |
| **Real growth, %[1]** | 1.3 | 1.7 | 0.9 | 0.5 | -9.0 | 6.6 | 3.0 | 1.5 |
| **CPI inflation, %** | -0.1 | 1.3 | 1.2 | 0.6 | -0.1 | 1.9 | 5.3 | 2.5 |
| **Unemployment rate, %[1]** | 11.7 | 11.3 | 10.6 | 9.9 | 9.3 | 9.5 | 8.3 | 8.1 |
| **Public Finance Risk** | | | | | | | | |
| **Public debt, % of GDP[1]** | 134.8 | 134.2 | 134.4 | 134.1 | 155.3 | 150.9 | 146.5 | 145.5 |
| **Interest payment, % of government revenue** | 8.0 | 7.8 | 7.5 | 6.8 | 6.9 | 7.0 | 6.3 | 5.9 |
| **Primary balance, % of GDP[1]** | 1.3 | 1.2 | 1.3 | 1.7 | -6.3 | -3.8 | -2.0 | -1.0 |
| **External Economic Risk** | | | | | | | | |
| **Current account balance, % of GDP** | 2.6 | 2.6 | 2.5 | 3.2 | 3.7 | 3.3 | 1.8 | 2.4 |
| **Total reserves, months of imports** | 2.9 | 2.9 | 2.7 | 3.3 | 4.7 | 4.0 | - | - |
| **NIIP, % of GDP** | -12.0 | -7.4 | -5.0 | -1.1 | 2.0 | 7.4 | - | - |
| **Financial Stability Risk** | | | | | | | | |
| **NPL ratio, % of total loans** | 17.1 | 14.4 | 8.4 | 6.7 | 4.4 | - | - | - |
| **Tier 1 ratio, % of risk-weighted assets** | 11.3 | 14.3 | 13.9 | 14.9 | 16.9 | 16.5 | - | - |
| **Credit to private sector, % of GDP** | 84.9 | 80.8 | 76.7 | 74.0 | 83.3 | - | - | - |
| **ESG Risk** | | | | | | | | |
| **$CO_2$ per EUR 1,000 of GDP, mt$CO_2$e** | 141.8 | 138.0 | 134.6 | 130.5 | 127.9 | - | - | - |
| **Income quintile share ratio (S80/S20), x** | 6.8 | 7.0 | 6.8 | - | - | - | - | - |
| **Labour participation, %** | 65.0 | 65.5 | 65.7 | 65.8 | - | - | - | - |
| **Old-age dependency ratio, %** | 34.7 | 35.1 | 35.6 | 36.1 | 36.6 | 37.1 | 37.7 | 38.3 |
| **Composite governance indicator[2]** | 0.5 | 0.5 | 0.5 | 0.6 | 0.5 | - | - | - |

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

## Appendix IV. Economic development and default indicators

IMF Development Classification — Advanced economy

5Y USD CDS spread (173 bps)

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