

Rating Object	Rating Information	
ITALIAN REPUBLIC Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Assigned Ratings/Outlook: BBB- /stable	Type: Monitoring, Unsolicited with participation
	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 20-01-2023 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 20 January 2023

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "BBB-" for the Italian Republic. Creditreform Rating has also affirmed Italy's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "BBB-". The outlook remains stable.

Key Rating Drivers

1. Wealthy, large and diversified economy; rebounding tourism, export diversification and a further improving labor market have contributed to a comparatively robust economic recovery over 2022; we expect a sharp slowdown of economic growth, which should remain positive in 2023 and pick up from 2024 onwards; while there are advancements in terms of diversifying away from Russia when it comes to energy imports, economic downside risks from high energy costs are significant, also due to likely weaker external demand
2. Structural challenges presented by low productivity, labor market characteristics and a complex business environment could see marked improvement over the medium term, if momentum in implementing the Recovery and Resilience Program (RRP) as seen in the initial stages can be maintained or even increased, also including efforts underway to enhance the digital transformation in the crucial SME sector
3. Generally strong institutional framework, notwithstanding scope for improvement hinted at by the World Bank's Worldwide Governance Indicators and frequent change of government posing challenges to effective policymaking including implementation of reforms; whilst reform momentum appeared to slow somewhat during the second half of 2022, decisively following through on RRP initiatives could consolidate progress made on improving the quality and efficiency of the judicial system and public administration, likely facilitating exertion of the ambitious reform agenda
4. Risks to fiscal sustainability remain the sovereign's main credit weakness; we expect a decline in the headline deficit over the medium term, which, however, is subject to heightened uncertainty due to mitigating measures regarding energy prices and recent decisions potentially making revenue developments less predictable
5. Extent of our projected decrease in Italy's still very high public debt ratio over the medium term is shrouded in high uncertainty pertaining to energy price developments and the con-

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comitant degree of economic slowdown, as well as to potentially needed further fiscal support measures; more robust banking sector unlikely to see major backlash from current economic downside risks, but contingent liability risks from public guarantees remain elevated; sound debt management and debt affordability constitute risk-mitigating factors, although debt servicing costs will presumably rise over the medium term, mainly reflecting the global monetary policy tightening

6. External risks appear manageable, although the current account position is strongly affected by the deteriorating energy balance and has turned from a solid surplus into a deficit which could persist in the short term; we expect Italy's small positive net international investment position to remain by and large robust

Reasons for the Rating Decision and Latest Developments¹

Macroeconomic Performance

Boasting a large and wealthy economy, Italy's macroeconomic profile also features a good degree of diversification, which adds to economic resilience. A relatively moderate level of private indebtedness provides for risk-bearing capacities, including a sizeable level of private households' net wealth. Balancing these strengths, low productivity growth has been a long-standing challenge, as have been structural deficiencies of the Italian labor market and a complex business environment. While government interventions to mitigate high energy costs should help stabilize economic growth in the short term, a timely and effective implementation of Italy's RRP will be key to maintaining a more constructive medium-term growth outlook, including some boost to its potential growth.

Following the steep decline in its real GDP in 2020 induced by the corona crisis (-9.0%), the Italian economy has recovered, exceeding its pre-pandemic level (Q4-19) from the final quarter of 2021. Overall in 2021, real economic output expanded by 6.7%, primarily driven by private consumption, as pandemic restrictions were eased (growth contribution of 3.0 p.p.), as well as by gross fixed capital formation (3.0 p.p.), with the latter surpassing its pre-pandemic level in 2021. With imports bouncing back more strongly than exports, net exports posed some drag on the economic growth result in 2021 (-0.1 p.p.).

On the back of rebounding growth, GDP per capita increased to an estimated USD 46,165 in 2021 (+11.8%, IMF data, PPP terms, current prices), with the downward trending GDP p.c. as set against the EU average possibly beginning to bottom out. It is estimated to have increased further to about USD 51,062 last year, which would correspond to an increase to roughly 95% of the EU level, up from a recent low of 93% in 2020.

Having experienced an uninterrupted quarter-on-quarter (q-o-q) expansion of its real GDP since the first quarter of 2021, Italy's economic performance has so far remained rather resilient to the burden presented by soaring energy prices in light of the Russian war against Ukraine, posting increases of 1.1% and 0.5% q-o-q in Q2- and Q3-22, respectively. Extensive government measures to shield private households and businesses from negative effects entailed by higher energy costs play their part in this, as does recovering tourism.

¹ This rating update takes into account information available until 20 January 2023.

At the onset of Russia's military attack on Ukraine, Italy's exposure to Russian gas imports was relatively high, reflecting the key role played by natural gas in Italy's energy mix (2020: 40.5%, Eurostat) and a share of about 43.3% of its gas being imported from Russia (EU average: 38.7%). At 12.5%, crude oil dependency on Russia was significantly lower, and well below the EU average (22.9%), while oil represents 32.9% of Italy's energy mix. We note that the sovereign managed to achieve good progress in diversifying its energy import sources, and as opposed to other European peers, existing large LNG terminals were already in place for supplies arriving via the Mediterranean Sea. Nevertheless, at 18.7% of total energy imports as of Jul-22, down from 22.1% in 2021 (Banca d'Italia, Bdl intelligence), Italy's dependence on Russian energy imports still appears significant.

With regard to last year's fourth quarter, economic activity appears to have been weak, e.g. as suggested by the monthly real-time indicator for the Italian economy (Ita-coin) compiled by Bdl. A combination of ongoing pressure on private households from high consumer prices, worsening conditions on financial markets on the back of the global monetary policy tightening and a deteriorating external environment thus seems to have started taking its toll on Italy's private sector. The monthly sentiment indicators provided by the European Commission (EC) show a somewhat mixed picture, with the business climate in the service and construction sectors holding up better than in the industrial sector. While export expectations have dropped markedly in Q4-22, the perceived limiting impact on production from supply bottlenecks has eased somewhat, according to more recent surveys.

Risks to the short-term outlook are heavily skewed to the downside, as high consumer prices may weigh on household expenditure, despite ongoing mitigating fiscal measures. While we expect inflation to moderate throughout this year, HICP inflation has remained in double-digits of late, posting at 12.3% in December 2022, averaging 8.7% in 2022 as a whole (Eurostat data, preliminary). That said, consumer sentiment picked up somewhat towards the end of the year, albeit from a low level.

Apart from fiscal support measures, Italy's labor market should offer some support to private consumption. Following a temporary interruption during the most acute phase of the pandemic, unemployment has continued to trend down amid the economic recovery. Having averaged 9.5% in 2021 (euro area, EA, 7.7%), the unemployment rate dropped to 7.8% in November 2022 (Eurostat data), below levels registered prior to the outbreak of the coronavirus, likely assisted by the wage supplementation scheme which will partly (CIGS) remain in place until end of December 2023. Given continuously decreasing unemployment readings, Italy has recently narrowed the still notable gap to the euro area (Nov-22: 6.5%).

Employment growth, which has lagged behind the euro area over an extended period also including the pandemic phase, accelerated in Q3-22, albeit still posting below the euro area overall (1.2% y-o-y vs. EA 1.7%). At the same time, wage developments may have to be monitored in the context of persistently high inflation rates, but appear relatively moderate so far.

In structural terms, the labor market continues to be restrained by some deficiencies, as among other things suggested by the EC's Social Scoreboard and by the lowest participation rate among the EU countries (Q3-22: 65.5%, EU: 74.5%). That said, labor participation has trended upwards over recent years, and, as particularly women's participation compares as low, the RRP foresees implementation of a comprehensive strategy including enhanced access to childcare and long-term care.

As regards further structural changes underway likely also affecting the labor market, the new government decided that the citizenship income concept would be abolished in stages by end-2023. From January 2023, the payment period has been cut for people between 18 and 59 years of age, and with incentives to participate in training and accept first job offers. The citizenship income concept is to be repealed on 1 January 2024 and is to be replaced by anti-poverty and labor inclusion programs. Apart from that, the budget law 2023 (see below) comes with incentives for permanent hiring, albeit only for the current year. Given all these initiatives, we will pay heightened attention to further developments on the labor market.

Whilst companies may be more hesitant to invest in light of persistently high economic uncertainty and less favorable financing conditions, gross fixed capital formation should benefit from RRP-related investment going forward. In November 2022, the EC disbursed EUR 21bn under the RRF, deeming the agreed 45 milestones and targets fulfilled, including investments into ultra-broadband and 5G, research and innovation, and digitalization of schools.

Overall, the RRP is financed by roughly EUR 69bn in grants and EUR 122.6bn in loans via the RRF. The new government submitted a request for disbursement of EUR 19bn in December 2022, although we gather that there have been some postponements of RRP-related investment. This third payment request relates to 55 milestones and targets, among others covering reform initiatives in the areas of competition, justice, education, undeclared work, and water management.

If the sovereign is compliant with the agreed milestones and targets, RRF-funds will thus be concentrated over the next few years until 2026. That said, there are some downside risks to private investment stemming from the tightening financing conditions on the back of the withdrawal of monetary policy accommodation. Moreover, apart from cost pressures related to energy and raw materials, construction investment may additionally be dampened by reduced incentives for renovation in order to increase the energy efficiency of buildings.

Risks to external trade from supply bottlenecks seem to have ebbed somewhat, but uncertainty over the impact of China's changes to its Covid-19 regime may still add to uncertainty regarding an overall challenging external environment. We expect tourism to remain supportive to export growth, but anticipate a drag from overall net exports on GDP growth for the current year and a more or less neutral effect next year.

For 2022 as a whole, we expect Italy's total economic output to have expanded by about 3.8%. Partly due to some carry-over from the solid growth dynamic in the middle of last year, we ultimately expect a moderate expansion of real GDP in 2023, penciling in 0.3%, despite a likely weak winter half 2022/2023. Assuming moderation in energy prices and progressing substitution for Russian energy imports, as well as - more generally - adaptation to changing trading flows, we expect real GDP growth to accelerate to about 1.2% in 2024.

Notwithstanding a still high level of uncertainty emanating from the geopolitical situation and related economic developments, as Italy and its main trading partners will have to adjust to changing energy policies and market dynamics whilst pursuing the green and digital transformation, the medium-term growth outlook, in our view, remains constructive. However, we view a timely and effective implementation of the RRP initiatives as a prerequisite. A wide range of reforms and investment was initiated under the previous government, to strengthen and increase the efficiency of the justice system as well as of the public administration, reduce red tape, improve the business environment and to close educational gaps, to name some key areas

in which long-standing challenges have contributed to a relatively poor longer-term growth and productivity performance as compared to the euro area as a whole.

In addition, and as e.g. suggested by the EC's Digital Economy and Society Index (DESI, 2022), which ranks Italy 18th among its fellow EU members, there also remains ample scope to catch up in terms of digitalization. This applies above all to Italian SMEs, and in particular, to micro enterprises, bearing in mind their relative significance by EU comparison in terms of employment and value added. A voucher scheme to SMEs to facilitate activation of fast broadband connections was among the measures to address shortfalls.

The share of the ICT sector's gross value added (GVA) in total GVA was at 3.6% as of Q3-22, 1.5 p.p. below the share in the euro area as a whole. However, as the most recent DESI report also stresses, Italy has made marked progress on its digital agenda, narrowing e.g. the gap to the EU in the supply of digital public services and with regard to basic digital skills, suggesting that increased efforts to step up on infrastructure and boost skills are beginning to pay off.

In a bid to further address another persistent challenge, namely the comparatively large disparities between the northern and southern parts of the country, the budget law 2023 foresees extension of tax credits and incentives on investments in the Southern regions, in the Special Economic Zones (SEZs), and for investments in research, development and innovation to benefit companies located in the South.

Hence, we think that potential growth, currently estimated at 1.0% in 2022, 0.6% in 2023, and 1.1% in 2024, could see sustainably higher levels than registered in the past (avg. 2012-21: -0.2%, AMECO data), not least through the enhancement of persistently low productivity growth.

Apart from paying close attention to the degree to which authorities follow through on RRP measures in the current challenging geopolitical and economic environment, we will also monitor developments around Italy's export competitiveness, given a continued decrease in its global market share regarding goods exports in 2021. Having said this, the share in global service exports recovered somewhat in 2021, partially aided by resuming tourism, but remained well below the pre-pandemic share. While only ranking in the lower third among the EU members in IMD's global competitiveness index, occupying rank 41 out of the 63 countries considered overall in the 2022 edition, Italy has maintained a relatively stable performance in this respect over recent years.

Institutional Structure

Italy's generally strong institutional framework remains underpinned by the advantages associated with EU/EMU membership, including extensive EU-level funding. Political volatility as illustrated by frequent changes in government constitutes a balancing factor. While we would monitor government stability, Italy's new three-party government formed relatively quickly following the September elections and commands over a majority in both houses of parliament, increasing chances of a timely follow-through on reform proposals. The recent vintage of Worldwide Governance Indicators suggests ample scope to improve on the quality of public administration and the judicial system, which will be addressed by ambitious RRP reforms. Although we gather that some RRP projects were subject to delays, we think that incentives to remain committed to timely implementation of the RRP remain pronounced.

As a result of the national election held on 25 September 2022, representing a snap election called following waning support for the former broad-based government coalition and the resignation of former prime minister Draghi, Fratelli d'Italia, which had not been part of the previous broad-based coalition, emerged as the strongest single party. New prime minister Georgia Meloni leads the center-right coalition, which also includes the Lega, Forza Italia and Noi moderati. In the election, the alliance obtained 237 of the 400 seats in the Chamber of Deputies and 115 of the 200 seats in the Senate, and is thus backed by comfortable majorities in both chambers.

We will monitor government stability, given Italy's track record of high volatility in this regard, and any possible risks to timely implementation of RRP initiatives as well as to coherent policy formulation. In our perception, there has been tangible progress over the last two years in terms of implementing structural reforms to improve the institutional backdrop, laying the ground for a more effective roll-out of further RRP measures and beginning to remove long-standing obstacles to higher growth. Any backtracking, in our view, would pose substantial risks to this.

The EC's most recent rule of law report (Jul-22) echoes a positive assessment of recent steps taken, including for measures to improve the efficiency of the justice system, highlighting that implementing legislation to reduce disposition times across instances in the fields of civil and criminal justice, long-standing challenges and some RRF-financed commitments, was still pending at the time. Political priorities as set out by the Ministry of Justice at the beginning of the current year (11 Jan 2023) seem to suggest that these issues are about to be addressed.

Meanwhile, there have been advancements in terms of numbers of judicial staff as well as in terms of digitalization. In June 2022, parliament approved a new law reforming the High Council for the Judiciary to enhance judicial independence in June 2022. Drawing on the 2022 EU Justice Scoreboard, there has been continuous improvement concerning perceived independence of judges since 2016.

With regard to the combat of corruption, there have been further steps towards strengthening corruption prevention and increasing the speed with which such cases are dealt with. December 2022 saw the publication of the National Anti-Corruption plan 2022, which aims to strengthen safeguards against corruption in the public sector as well as simplify administrative procedures. Moreover, a recent OECD report, adopted in October 2022, acknowledges significant progress made by Italy over recent years in terms of strengthened legislation and enforcement when it comes to foreign bribery, while highlighting some remaining issues.

Representing a further step to revamping parts of the institutional set-up, crucial reforms to tax litigation procedures were approved, partly entering into force from September 2022. These reforms aim at reducing the length of tax procedures and strengthening the quality of final decisions, potentially enhancing tax certainty and possibly improving Italy's attractiveness to foreign investors.

With a view to the World Bank's Worldwide Governance Indicators (WGIs), on which we put high emphasis when assessing the institutional quality of a sovereign, Italy continues to show room to improve compared to the euro area median, focusing on voice and accountability, government effectiveness, rule of law and control of corruption.

That said, we note that Italy made some progress on three of these with the latest release of the indicators (reference year 2021), in terms of relative rank among all sovereigns considered, with the exception of government effectiveness. Concerning the latter, Italy was ranked 74th out of

209 sovereigns considered (EA median: 36), slipping two places. A somewhat more noticeable improvement is reflected in the sovereign rising to relative rank 32 (out of 209) when it comes to voice and accountability, moving roughly in line with the euro area median (26). By contrast, we observe a still considerable gap between the sovereign and the euro area average as regards rule of law (rank 85 vs. 32) and control of corruption (rank 65 vs. 42).

On the issue of the green transformation, Italy continues to score above the EU average when looking at the EC's 2022 Eco-Innovation Index (reference year 2021), ranking 10th among the 27 member states. Moreover, greenhouse gas emissions per capita, standing at 6.5 tons of CO₂ equivalent in 2020 (-2.4 tons compared to 2010, Eurostat), remain well below the level observed for the EU-27 (2020: 7.5 tons). In terms of its overall share of energy from renewable sources, Italy remains slightly behind the EU average, displaying an overall share of 19.0% in 2021 (EU: 21.8%), mainly due to a lower share of renewables used in heating/cooling.

Nevertheless, use of renewables continues to trend upward, and Russia's war against Ukraine certainly increases the pressure to step up the share of renewables in the energy mix. That said, measures such as the suspension of the implementation of the plastic tax for 2023, as per the budget law 2023, are likely to be seen as aiming not to add to the cost pressure on the private sector exerted by the high energy prices. Some of the recent green initiatives include the adoption of the National Strategy for the Circular Economy adopted in June 2022. The PNRR bis Decree Law came with incentives for the development of hydrogen, including a plan to promote its use.

Fiscal Sustainability

We continue to view risks to fiscal sustainability as Italy's main credit weakness, against the backdrop of a very high general government debt level, as well as repeated fiscal slippages and postponements in reducing fiscal targets. Frequent changes in government, partly affecting budget execution, tend to add to such risks. Prospects for a shrinking debt ratio over the medium term, which had improved more recently, have become more uncertain again in light of higher fiscal spending to cushion the blow from soaring energy costs and some doubts over a sufficiently stable political context to follow through on the ambitious RRP agenda. Contingent liabilities in the form of public guarantees have increased amid the recent succession of crises. The banking sector appears more solid meanwhile, as also mirrored by improved asset quality, but may have to be monitored against the backdrop of tightening monetary policy and a weakening macroeconomic environment. Apart from financial relief via NGEU funding, sound debt management and debt affordability remain to some extent mitigating factors to fiscal risks, although interest outlays are set to rise in the medium term. In the longer term, age-related costs could increasingly become a source of fiscal pressure, with the latest decisions on pension policies potentially reinforcing some concern in this respect.

After a phase of gradual declining headline deficits from 2015-2019, the Covid-19 pandemic had Italy's general government deficit surge to -9.5% of GDP in 2020. In the following year, the deficit shrank to -7.2% of GDP, amid continued economic recovery, improved tax collection and expiry of some support measures. While somewhat smaller than we had estimated in our last rating report (Feb-22), at this level, Italy's deficit still compared as high in the euro area context (EA-19 2021: -5.1% of GDP). While economic growth continued in 2022, benefiting the revenue side via rising tax revenue and social contributions, the government expenditure side was burdened by having to mitigate negative effects from soaring energy prices.

According to the Ministry of Economy and Finance (MEF), cumulative monthly tax revenue from Jan-Nov-22 rose by 10.1% y-o-y, to roughly EUR 486bn (cash basis). Over the first ten months of 2022, tax and social security revenue combined rose by 9.9% y-o-y. On the other hand, the gross amount of measures to counter high energy prices in 2022 came to roughly EUR 57.6bn (Nov-22). Structural one-off measures in 2022, mostly on the revenue side, could amount to about 0.4% of GDP in 2022 (MEF). While public finances seem to be on a somewhat more favorable course than estimated in the Stability Program 2022 (SP22), the new government envisages to use the assumed budget margin to finance measures to mitigate energy costs, in our view suggesting a prudent approach.

Overall, we think that a general government deficit of about 5.6% of GDP in 2022 remains realistic. Looking at the current year, the budget law 2023, which was finally approved by the parliament on 29 December 2022, foresees energy support to the tune of approximately EUR 21bn, primarily via tax relief and bonuses to private households and enterprises. The budget law also prolongs the reduction of the tax wedge on labor for lower income earners and, as mentioned above, offers social contribution reductions to employers to incentivize open-ended contracts in 2023. On the revenue side, the budget law foresees, among others, a temporary tax on certain windfall profits of energy companies for 2023.

Given the ongoing economic risks linked to the war in Ukraine along with associated price developments, changes to trade flows and energy supplies, uncertainty over the near-term outlook for public finances is still pronounced, and further government support might be considered necessary, as some of the hitherto budgeted measures only cover the first quarter of 2023. At this stage, we expect the general government deficit to decrease slightly to about -4.8% of GDP in 2023 and further to about -3.8% in 2024. A primary surplus in 2024 appears feasible from our point of view, in line with the authorities' expectations, earlier than e.g. assumed in the SP22.

As to the medium-term outlook, we are aware that the government envisages to lower the headline deficit to 3.0% of GDP in 2025. We follow closely developments around the increased threshold for the use of cash transactions as well as some tax waivers, as these could potentially reverse some of the progress made on tax evasion and sustainably strengthening the government revenue base, as well as potentially on the combat of money laundering.

On the back of a rebounding economy and eased restrictions, Italy's debt-to-GDP ratio decreased slightly in 2021, to a still very high 150.3% of GDP by European comparison (EA-19: 95.4% of GDP), after having soared by 20.8 p.p. to 154.9% of GDP in 2020 due to the pandemic. We expect the public debt ratio to come in at about 144.8% of GDP in 2022, and to edge down to roughly 144.6% in 2023, continuing its gradual decrease to about 142.8% of GDP in 2024. Uncertainty over the path remains high given the abovementioned economic risks, potential reverberations on reform implementation and the considerations on budgetary execution.

Contingent fiscal risks relate to public guarantees, estimated to have gone up from 13.2% of GDP in 2020 to about 15.8% of GDP as of Jun-22. 10.1 p.p. of these are linked to the pandemic response, most of which, 8.5 p.p., consisting of SMEs' accessing the Central Guarantee Fund provided to them (Draft Budgetary Plan 2023 update). With a view to Italy's intention to sell its stake in Monte dei Paschi (64%), we gather that the sovereign reached an agreement with the EC on extending the deadline. More generally, the sovereign-bank nexus remains relatively prominent among EU countries, with the share of domestic general government debt securities held by Italian banks at 9.7% of banks' total assets (Nov-22, EA: 2.7%, ECB data).

Italy's banking sector appears more resilient at this stage, with asset quality as measured by the NPL ratio having further improved. That said, despite standing at a low of 2.6% as of Q3-22 (EBA data), the sovereign's NPL ratio remains somewhat above the EU average (Q3-22: 1.8%). Over the Covid-19 phase, Italian banks also stepped up their capitalization, with the CET1 ratio almost on par with EU level as of Q3-22 (IT: 14.7%, EU: 15.0%). In addition, following the challenging pandemic phase, banks have turned more profitable again of late, as measured by return on assets.

Amid continued monetary policy tightening and weaker near-term economic prospects, we will closely monitor banks' balance sheets. While the higher interest-rate environment could generally benefit profitability, funding costs may go up in light of maturing TLTROs and a changing funding structure. Apart from that, some debtors may struggle to service or repay their debt in view of rising interest rates.

As concerns exposure of the banking sector to Russia, according to Bdl, direct exposure to counterparties resident in Russia, Belarus and Ukraine to the total financial assets of the banking sector has remained broadly stable, whereas their coverage ratio rose markedly. At the same time, exposure of banks resident in Italy and more affected by sanctions or impaired trade is small (0.35% of loans, Bdl).

Demographic developments and related costs of ageing are likely to add to fiscal sustainability risks with a view to the medium-to-longer term. While an early retirement scheme remains available and may well increase age-related costs, the measures decided with the budget law 2023 also contain some incentives to work longer, rendering the net effect of the measures uncertain at this stage.

We continue to assess sound debt management and the favorable debt profile as risk-mitigating factors concerning fiscal sustainability. Over the medium term, debt affordability looks set to deteriorate from very benign levels amid global monetary policy tightening and related financial market developments, although new issues will still replace some higher-interest bearing securities in the near term. Standing at roughly 4.69% as of 30 December 2022, the yield on 10-year government bonds had climbed to levels last seen during the euro debt crisis, whereas the Bund spread remained well below that, posting at about 213 basis points (bp). Since the end of 2021, the yield has risen by about 350 bp, and the spread versus 10-year German government bonds has increased by roughly 77 bp since then (weekly data). That said, cash payments related to interest on government bonds were still lower by approx. EUR 1.86bn from Jan-Nov-22 than in the corresponding period in 2021 (MEF intelligence).

In December 2022, the ECB lifted its policy rates by another 50bp and signaled more steps ahead. At this stage, we expect the ECB to hike by another 125 bp overall in 2023, acknowledging that the central bank's decisions are highly data-dependent. While for now the ECB keeps reinvesting principal payments of maturing government bonds purchased under the PSPP and the PEPP, this policy will be wound down from the beginning of March 2023 as regards the APP portfolio. The monthly decline of the portfolio is to amount to EUR 15bn on average until the end of Q2-23, with the subsequent pace to be determined over time. More details are to come with the Feb-23 monetary policy meeting.

As concerns the PEPP, principal payments from maturing securities purchased are to be reinvested until at least the end of 2024. By the end of 2023, the ECB envisages to review its operational framework for steering short-term interest rates, which will provide information regarding the endpoint of the balance sheet normalization process.

As of Nov-22 (PEPP) and Dec-22 (PSPP), respectively, cumulative Italian government bond purchases under the PEPP and the PSPP amounted to about EUR 287bn and EUR 443.6bn, respectively, together corresponding to about 26.6% of Italy's gross general government debt as of Q3-22 (ECB and Bdl data). Providing some shield against any perceived unwarranted market disturbances, the ECB's Transmission Protection Instrument (TPI), the announcement of which in Jun-22 calmed an episode of surging bond price volatility on the back of market expectations of a more aggressive hiking cycle, remains available.

Foreign Exposure

We overall consider risks associated with the sovereign's external position to be manageable. Italy's diversified export sector has contributed to the current account balance's relative resilience to the pandemic shock, whereas dependence on energy imports and high energy prices have prompted more pronounced movements, especially in the goods trade balance. The NIIP, which has turned positive over recent years, partly due to changes in private sector portfolio investment and valuation effects, has remained by and large solid.

Having posted a surplus of 3.1% of GDP in 2021, broadly in line with the average over the five years up to and including 2020, Italy's current account balance has deteriorated further over recent quarters, mainly in light of the worsening energy balance. Measured as a four-quarter moving sum, Italy's current account position turned into a deficit of 0.6% of GDP as of Q3-22. We expect the current account balance to conclude 2022 in a somewhat more pronounced deficit. With only first signs that energy price pressure is abating somewhat, and some more sustainable price moderation assumed for the current and the following year, the position could move closer to balance.

Despite these developments, we expect the positive NIIP to remain in moderately positive territory. As of Q3-22, Italy's NIIP stood at 5.7% of GDP (Eurostat data). Excluding non-defaultable investment (NENDI), the position has been displaying small positive values as well since the end of 2020, posting at 1.3% of GDP as of Q3-22.

Rating Outlook and Sensitivity

Our rating outlook on the Italian Republic is stable. We consider downside risks to fiscal sustainability to be mitigated by recent reform advancements, potentially strengthening the institutional framework, and still constructive medium-term growth perspectives based on our assumption that Italy will stick with the envisaged RRP roll-out.

We could raise the sovereign's credit rating or outlook, if confidence in a firm downward trajectory of the public debt ratio is strengthened, corroborated by a high degree of conviction over steadfast further implementation of RRP reforms and stronger economic growth prospects, also pointing to increased resilience against economic shocks. In particular, convincing signs of a rising productivity level and rising potential growth, likely on the back of consequently following through on the RRP, could prompt us to contemplate lifting the rating or the outlook.

By contrast, we could lower our ratings or the outlook, if the debt-to-GDP ratio fails to embark on a persistent downward trajectory, or if there are major setbacks to the roll-out of or backtracking on the RRP, potentially leading to some reversal of improvements on the institutional side and jeopardizing the targeted boosts to productivity and potential growth, with negative repercussions on economic growth and the fiscal outlook. Materializing contingent liability risks could also result in a negative rating action, possibly exacerbated by larger-than-expected rises in debt servicing costs and the impression of rising pressure via age-related costs.

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Ratings*

Long-term sovereign rating	BBB- /stable
Foreign currency senior unsecured long-term debt	BBB- /stable
Local currency senior unsecured long-term debt	BBB- /stable

*) Unsolicited

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down [key principles of the impact of ESG factors on credit ratings](#).

ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demographics	
Labor	Equality	Technology & Infrastructure	Safety & Security	Judicial system	Quality of Public Services	
Integrity of Public Officials	Quality and Efficacy of Regulations	Civil Liberties/ Political Participation	Market Access	Business Environment	Data Transparency	
Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank’s Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating’s assessment of the sovereign’s institutional set-up, which we regard as a key rating driver, we consider the ESG factors ‘Judicial System and Property Rights’, ‘Quality of Public Services and Policies’, ‘Civil Liberties and Political Participation’, and ‘Integrity of Public Officials’ as highly significant to the credit rating.

Since indicators relating to the assessment of a economy’s competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, and IMD Business School add further input to our rating or adjustments thereof, we judge the ESG factor ‘Business Environment’ as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating’s considerations on macroeconomic performance of the sovereign, and we regard the ESG factor ‘Labor’ as significant to the credit rating or adjustments thereof. Indicators or projections providing insight into likely demographic developments and related cost represent a social component affecting our rating or adjustments thereof. We regard the ESG factor ‘Demographics’ as less significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	1.7	0.9	0.5	-9.0	6.7	3.8	0.3
GDP per capita (PPP, USD)	42,112	43,610	44,703	41,279	46,165	51,062	52,825
Credit to the private sector/GDP	98.1	93.6	91.8	99.9	92.8	n/a	n/a
Unemployment rate	11.3	10.6	9.9	9.3	9.5	n/a	n/a
Real unit labor costs (index 2015=100)	98.5	99.4	99.7	101.3	100.7	100.4	99.5
World Competitiveness Ranking (rank)	44	42	44	44	41	41	n/a
Life expectancy at birth (years)	83.1	83.4	83.6	82.3	82.9	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	0.3	0.3	0.3	0.2	0.3	n/a	n/a
WGI Control of Corruption (score)	0.2	0.2	0.3	0.5	0.5	n/a	n/a
WGI Voice and Accountability (score)	1.0	1.0	0.9	1.1	1.1	n/a	n/a
WGI Government Effectiveness (score)	0.5	0.4	0.5	0.4	0.4	n/a	n/a
HICP inflation rate, y-o-y change	1.3	1.2	0.6	-0.1	1.9	8.7	7.1
GHG emissions (tons of CO2 equivalent p.c.)	7.3	7.3	7.2	6.5	n/a	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-2.4	-2.2	-1.5	-9.5	-7.2	-5.6	-4.8
General government gross debt/GDP	134.2	134.4	134.1	154.9	150.3	144.8	144.6
Interest/revenue	8.1	7.9	7.2	7.3	7.4	n/a	n/a
Debt/revenue	289.5	290.8	285.6	327.4	312.4	n/a	n/a
Total residual maturity of debt securities (years)	6.9	6.8	6.9	7.0	7.1	n/a	n/a
Foreign exposure							
Current account balance/GDP	2.7	2.6	3.3	3.9	3.1	n/a	n/a
International reserves/imports	0.3	0.3	0.4	0.5	0.4	n/a	n/a
NIIP/GDP	-7.3	-5.0	-1.2	1.4	8.1	n/a	n/a
External debt/GDP	122.1	120.5	124.2	139.6	137.9	n/a	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Istat, MEF, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	28.10.2016	BBB- /stable
Monitoring	29.09.2017	BBB- /stable
Monitoring	31.08.2018	BBB- /stable
Monitoring	30.08.2019	BBB- /stable
Monitoring	21.08.2020	BBB- /negative
Monitoring	05.03.2021	BBB- /negative
Monitoring	11.02.2022	BBB- /stable
Monitoring	20.01.2023	BBB- /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Ministero dell'Economia e delle Finanze (MEF) participated in the credit rating process as it provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of MEF during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's ["Sovereign Ratings" methodology](#) (v1.2, July 2016) in conjunction with its basic document ["Rating Criteria and Definitions"](#) (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG's rating methodologies and basic document "Rating Criteria and Definitions" is published on our [website](#).

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Dipartimento del Tesoro/ Ministero dell'Economia e delle Finanze, Banca d'Italia, Istituto Nazionale di Statistica, Ufficio Parlamentare di Bilancio (PBO).

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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